

# Tax in China newsletter

Autumn 2011

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## Tax news

# China's Individual Income Tax Reforms

Reforms to the Individual Income Tax ("IIT") system were initially announced in March 2011. The draft reforms were released for public consultation which closed on 31 May 2011. The National People's Congress ("NPC") approved the amended IIT Law on 30 June 2011, and it came into force on 1 September 2011.

It is important that Swiss investors into China with Chinese tax resident employees are aware of the changes, not only from a compliance perspective, but also because it represents an important policy shift in the individual tax base.

## Key Changes

There is currently a standard deduction of RMB 2,000 (approx. CHF 245) for employment income which will increase to RMB 3,500 (CHF 430). This means that there is a deduction of this amount in computing the monthly taxable employment income.

A further deduction is allowed for foreigners and for residents of Hong Kong, Macau, Taiwan and overseas Chinese working in China which is currently at RMB 2,800 (CHF 345). Previously when the standard taxable income threshold was increased in 2008, this additional allowance was reduced by the same amount so that the allowance for foreigners did not change. It is unclear whether there will be any reduction to this to make the overall allowance remain at RMB 4,800 (CHF 590) or whether the additional allowance will remain the same, resulting in an overall increase for foreigners to RMB 6,300 (CHF 775).

The existing 9-bracket progressive rate scale for employment income will be reduced to 7-brackets. As well as the removal of the 2 brackets at rates of 15% and 40%, the bracket of income taxed at 25% will apply to a wider range of salaries. This should provide IIT relief to low and middle income earners but will increase the IIT burden for high income earners.



Existing tax rates and brackets			Amended tax rates and brackets		
Grade	Monthly taxable income*	Tax rate (%)	Grade	Monthly taxable income*	Tax rate (%)
1	500 or less	5	1	1,500 or less	3
2	The part > 500 and ≤ 2,000	10	2	The part > 1,500 and ≤ 4,500	10
3	The part > 2,000 and ≤ 5,000	15	3	The part > 4,500 and ≤ 9,000	20
4	The part > 5,000 and ≤ 20,000	20	4	The part > 9,000 and ≤ 35,000	25
5	The part > 20,000 and ≤ 40,000	25	5	The part > 35,000 and ≤ 55,000	30
6	The part > 40,000 and ≤ 60,000	30	6	The part > 55,000 and ≤ 80,000	35
7	The part > 60,000 and ≤ 80,000	35	7	The part > 80,000	45
8	The part > 80,000 and ≤ 100,000	40			
9	The part > 100,000	45			

\* The monthly taxable income from wages and salaries shall be the balance after the standard deduction (local Chinese [RMB2,000]/ expatriate [RMB4,000]) from the monthly income

\* The monthly taxable income from wages and salaries shall be the balance after the standard deduction (local Chinese [RMB3,500]/ expatriate [it is uncertain if the amount will be increased from RMB4,800 to RMB6,300]) from the monthly income

*The tax rates and brackets for private and individually owned businesses are also amended.*

### **PwC Observations**

The change of tax rates and brackets may also impact tax benefits derived from IIT planning previously adopted, such as compensation structure leveraging on preferential treatment for annual bonuses. Companies should review their existing IIT planning and remuneration structures to ensure that they continuously meet their compensation strategy.

It is forecasted that this round of the proposed IIT reform will likely reduce the annual collection by 23%. Therefore it is highly likely that the SAT will tighten up IIT enforcement to compensate. This may well be by raising the IIT collection from the high income earners.

The main focus includes:

- Tightening up of IIT collection on gains derived from individuals' share and asset transactions
- Enhancing the IIT collection mechanism on individually-owned business operations
- Tightening up IIT administration and collection on high income earners
- Developing a database and mechanism for IIT administration and collection on high income earners

The above measures reflect the SAT's intention to strengthen the IIT administration and collection on high-income earners. Employers and individuals are highly recommended to periodically examine their compliance on IIT withholding and reporting as well as making sure they are up to date with the changing tax rules to mitigate non-compliance risks.

## ***Conclusion***

The IIT reform forms part of a 5-year plan of reform. The direction of the IIT reform includes setting up a consolidated self-reporting system, linking tax deductions to the standard of essential living expenses, and balancing tax rates among employment, service income, investment income and other income. Chinese IIT policies may also be further adjusted to make high income earners and capital-owners make up a larger share of IIT contributions.

This round of IIT reform, whilst only potentially a small step, symbolises a starting point for successive rounds of reforms to be rolled out in the next 5 years. It also symbolises the increased compliance requirements that will be imposed on individuals and employers.

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## ***Hot topic***

# ***Switzerland (EFTA member) and Hong Kong sign Free Trade Agreement – Switzerland to become trading platform for Hong Kong products in Europe?***

## ***Free Trade Agreement***

On 21 June 2011, the EFTA countries (Switzerland, Iceland, Liechtenstein, and Norway) and Hong Kong signed a comprehensive Free Trade Agreement (FTA), which is expected to enter into force on 1 June 2012. The Agreement mainly covers trade in goods (industrial and processed agricultural goods, fish and other marine products), trade in services, investments, the protection of intellectual property rights as well as environmental issues related to trade.

The main objective of the Agreement is to enhance economic ties and promote trade and investment between the two sides. One of the FTA's most important effects is the abolishment of import duties on products originating in Hong Kong exported to EFTA countries. The Agreement thus benefits Hong Kong resident companies engaged in manufacturing products that are sold to EFTA countries as it will allow easier access to the Swiss, EFTA and ultimately to the European markets.

## ***Industrial Products***

Hong Kong will continue to maintain its existing exemptions from duty for imports from the EFTA states, whereas the EFTA states commit themselves to abolishing import tariffs and quantitative restrictions for industrial products originating in Hong Kong.

The EFTA states hence eliminate import duties aimed at industrial protection, but in return receive the right to levy charges on imports and to grant refunds on exports in order to compensate for differences in commodity price levels between the EFTA markets and the world market.

The rules of origin are largely in accordance with the European model. However, given that the countries in question are of very small size and cannot furnish an entire supply chain themselves, the rules with regard to industrial products are less restrictive as products may contain an increased proportion of contributions from countries outside the free-trade area.

### ***Processed Agricultural Products***

The Agreement also facilitates trade in processed agricultural products in both directions. Nevertheless, certain tariff classifications which are considered sensitive from a Swiss agricultural policy perspective are exempt.

### ***Trade in Services***

With regard to trade in services, the Agreement contains provisions guaranteeing market access and national treatment which are more favourable than the WTO General Agreement on Trade in Services (GATS). National treatment ensures that Swiss firms will be treated as if they were local companies. The most important improvements from a Swiss perspective pertain to services such as leasing, insurance, architecture, engineering, civil engineering, distribution and trade, logistics, maritime traffic, and the supply of services by a commercial presence, such as may be generated by secondments or business trips.

### ***Investment***

The provisions on investments regulate market access and ensure the continuation of the present open-market access policy among the parties. The Agreement makes investing in or acquiring a company in the other contracting party easier, manifestly granting national treatment.

### ***Intellectual Property Rights***

The provisions on the protection of intellectual property rights are based on the principles of national treatment and most-favoured-nation treatment. The Agreement reaffirms the parties' commitment to applicable international agreements, in particular the WTO Agreement on Trade-Related Aspects of Intellectual Property Rights (TRIPS), which is reinforced in certain areas.

Furthermore, with regard to trade and environment, the parties commit themselves to promoting international trade so that it contributes to the goal of sustainable development.

### ***Implications for Switzerland***

Hong Kong is currently Switzerland's third largest business partner in Asia, after China and Japan. In 2010, Swiss exports to Hong Kong amounted to CHF 6.5 billion (accounting for 3.2% of Switzerland's total exports), whereas imports reached CHF 1.6 billion (accounting for 0.9% of Switzerland's total imports). Trade in goods in both directions has been dominated by clocks and watches, precious metals, jewellery and machinery. Swiss direct investments in Hong Kong amounted to some CHF 4.5 billion as of December 2009. More than 150 Swiss companies have operations in Hong Kong, whereby the watch industry, the banking and insurance sectors as well as trading companies account for the majority.

The FTA will further promote economic relations with Hong Kong, an important and dynamic business partner in Asia, who is the world's third biggest financial centre and the main trading hub in the region. The Agreement provides a favourable and stable framework for trade and ensures equal treatment of Swiss enterprises with all current and future free trade partners of Hong Kong.

Having a FTA with one of the special administrative regions of the People's Republic of China in place, the trade between EFTA countries and Hong Kong may also open the doors for further planning space. Especially, the different countries involved in the FTA can in future be used as gateways for components produced elsewhere while still being able to benefit from the newly established FTA. Thus, manufacturing of products under a properly set-up supply chain might lead to lower customs duties.

Here an example that illustrates the potential benefit under the new regime: a manufacturer in Hong Kong purchases components from a contract manufacturer in the People's Republic of China. As they are further processed in Hong Kong, the goods can basically acquire Hong Kong origin. Having this origin, the finished goods shipped to the EFTA countries will usually be exempt of duty. As the EU currently does not have a FTA with Hong Kong, any subsequent processing in one of the EFTA countries (including change of origin and further export to the EU) may keep the customs burden at a low level. Thus the EFTA countries and Hong Kong are ideal gateways to their respective wider region. The benefit of those gateways may be considered when setting-up or amending an international supply chain.

### **Outlook**

China and Switzerland formally launched bilateral negotiations on a comprehensive free trade agreement in January of this year. Switzerland is hence expected to be the first European country to sign a FTA with China, which will further enhance Switzerland's role as investment location for Chinese groups doing business in Europe.

If you would like more information, simply call or e-mail one of the contacts below.

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## *About the Swiss-Chinese Chamber of Commerce*

The Swiss-Chinese Chamber of Commerce (SCCC) is a Swiss-based non-profit association registered in Zurich. Close to 700 corporate and individual members, among them the leading banks, trading companies, insurances and industrial firms have joined the association; making it one of the largest bilateral Chambers in Switzerland. Since its inception in 1980, the Chamber has always contributed to the development of the bilateral economic relations and with its diversified range of services it has consistently assisted the many Swiss companies doing business with and investing in China.

For more information visit: [www.sccc.ch](http://www.sccc.ch)

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