

PART III — TAX PLANNING

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14 TAX PLANNING OVERVIEW

¶14-001 Structure of compensation package

A remuneration package should be structured in such a way that the employee will receive the best value for his or her work while complying with the rules. Using fringe benefits can be an important part of tax planning although the taxation of fringe benefits is not entirely clear-cut.

This chapter provides a general description of the most common elements of expatriate compensation currently delivered to non-PRC nationals working in China. It describes these pay elements and provides a review of the general tax treatment of these compensation items. As with any tax technical discussion, all of the details surrounding the transaction are essential to its ultimate proper treatment under the law. The tax planning techniques discussed in the following paragraphs are general and may need to be amended according to an expatriate's particular circumstances. It is therefore advisable that a potential taxpayer or person planning an expatriate's compensation seeks professional advice in constructing the pay package. Please note that different types of terminology are often used to describe or label similar compensation items, especially expatriate compensation items.

¶14-002 Relocation allowances

Companies often provide supplemental pay packages to employees who are relocating at the company's request. Depending on whether the relocation is permanent or temporary, the company will often reimburse the employee for out-of-pocket expenses relating to the actual relocation. This may include travel expenses, packing and shipment of household goods, meals and lodging en route to the new location and temporary living accommodation and expenses at the destination location. If the relocation is temporary, the employer may also reimburse storage of household goods at the home location for a period of time. If the employee has to sell a home or car before leaving the home location, or pay a penalty to break a car lease or home rental contract, sometimes the employer may reimburse the costs associated with these transactions or provide an allowance to cover related losses. Such loss reimbursement policies sometimes come with a cap on the amount allowed.

Once on location, the employee may incur certain costs that would not be incurred if he or she has not moved at the request of the employer. For eg an employee may have to purchase new appliances for an apartment or home or purchase a vehicle

on location. Some companies provide an allowance for these purchases as well (see ¶15-003).

¶14-003 Assignment allowances

For executive level positions or temporary assignments to certain high cost locations, some employers will provide supplemental pay to cover the items described below. It is not possible to list all assignment allowance items in detail in the pages that follow. As always, it is advisable that the taxpayer checks with a professional advisor to confirm proper tax treatment.

Housing and housing related allowance

This allowance is usually based on local market housing data and allowance amounts will often be set according to marital status and family size. The data can be provided by local or regional real estate agents and brokers or by professional third party data providers who specialise in expatriate and executive compensation information.

The amount to be reimbursed is usually based on, but not necessarily equal to, the amount of housing expense that the employee will incur in the host location (ie the rent as stated in an actual lease). It is common to expect the employee to make some sort of contribution towards the total housing amount. Many employers will therefore either provide housing allowance or reimbursement up to a cap, or they will assess the employee a housing “norm” or a housing deduction. A housing norm is the amount that an employee would have paid for housing had they not moved. Housing norm figures may be represented by the employees’ actual rental or housing payment at the time they left the home location, or it could be provided by similar external data sources as described above. The housing norm is usually recorded as negative compensation, ie a reduction in pay.

In the PRC, it is important to note that the housing norm be incorporated as a reduced salary amount, and not stated separately as a negative allowance amount. This is because PRC individual income tax law does not really allow for deductions from pay for tax calculation purpose, so a negative allowance such as a housing norm may not be accepted by the authorities. Alternatively, if an employer assesses a housing norm as part of its company policy, they can simply reduce other allowances provided to the employee (such as hardship allowance). Certain housing amounts can be delivered tax free to the employee provided certain criteria are met (see ¶15-003).

Housing — second homes

It is important to note that while the provision of housing in China is a tax-free benefit, this applies only to one home in China: where an employer provides second or subsequent accommodation, this additional accommodation will be subject to IIT.

Housing — employee-owned accommodation

It is becoming increasingly common for assignees to purchase property in China, and for these assignees to continue to receive a housing allowance. In such circumstances,

the housing allowance paid to the assignee will not qualify for tax exemption and such allowances should be subjected to monthly withholding taxes by the employer. Some employees have the ownership of their accommodation in the name of their spouse, and then arrange for a rental agreement to be signed between their spouse/landlord and employer in the belief that the housing allowance will then qualify for tax exemption status. This could be regarded as “aggressive” and great care should be taken regarding the effectiveness of such an agreement. It is recommended that the employer obtain Local Tax Bureau agreement before treating such rental payments as tax free for the employee.

Education reimbursement for school age children

This is another common employer-paid reimbursement to a relocated employee where schooling in the new location is taught in a language other than the employee’s native language. The amount of reimbursement depends on the employee’s company policy and the local education available to the expatriate’s child or children. Some companies may decide to supplement pay only, and expect the employee to contribute to the education cost of the child or children. Certain education expenses paid by employers may be paid free of tax provided certain documentation requirements are met (see ¶15-003).

It is important to recognise that schooling costs paid for an employee’s children may only be treated as tax free if the school is located in Mainland China (although some areas may allow for schools in Hong Kong to be included). Employers should consider stipulating in employment offers that schooling costs will only be reimbursed where the school is located in Mainland China where the employer is paying a net of tax salary. Overseas boarding school fees will not usually qualify as eligible for tax exemption.

Car and driver

This perquisite is mostly reserved for senior personnel. However, in many cases, even local middle managers may be allowed a car and driver if the job requires extensive in-city travel. If the car and driver is used for business purposes, it will not usually be considered a taxable benefit.

Home leave allowance

A common expatriate benefit, home leave allowance is intended to ease the burden on employees who wish to be able to go home to visit family and friends. This is a benefit that is usually provided only to employees who are temporarily relocated to a host location. As is the case of housing allowance and education reimbursement, the home leave allowance for an employee may be provided free of tax if certain documentation requirements are met (see ¶15-003). However, the PRC individual income tax law may not allow for tax-free treatment if the home leave allowance or reimbursement is paid to or named in benefit of an employee’s family.

Tax reimbursement

This is usually the most confusing and complex of all assignment allowance items. At its simplest level, a tax reimbursement policy is one that reimburses the employee for

some or all income taxes incurred on assignment. As with other assignment allowance items, the amount to reimburse usually takes into consideration the actual amount paid for the allowance item (in this case taxes). Also like other allowances, the provision of a tax allowance may result in the increase of taxable compensation and lead to a further increase in tax. This phenomenon, of the tax on tax, is frequently referred to as a tax gross-up effect.

In order to further explain tax reimbursement policies, we will outline three different types of common expatriate packages that seem to be in use in China at this time:

- Traditional expatriate package (¶14-004)
- Local plus allowances package (no tax equalisation) (¶14-005)
- Local plus allowances with some tax protection (¶14-006).

¶14-004 Traditional expatriate package

In this package, the sponsoring employer attempts to keep the individual employee and his or her family financially “whole” during the assignment duration. By providing some of the core allowances described above, the employer is able to protect the employee from duplicate household living expenses, or from the extra costs associated with relocating to a new home and living in an unfamiliar location. However, one of the costs that can be considered a burden to employees is the additional tax cost in the new location. This additional tax cost may come from a higher tax rate in the host country (e.g. the highest PRC tax rate is 45%, whereas the highest effective rate in Hong Kong is only 15% for year 2015-2016). Also, since many allowances are taxable, the provision of such allowances not only drives up the employee’s tax burden in the PRC, but for employees who may still be obligated to pay home country taxes (such as those from the United States working in the PRC), the provision of allowances may drive up the employee’s tax cost in the home country as well.

An employer may choose to reimburse the employee for these taxes in order to provide protection from the higher tax burden associated with being on assignment. In these cases, the employee is often expected to pay an amount of the taxes at least equal to that which they would have paid had they stayed at home. Such charges are often referred to as hypothetical tax or a tax norm (similar use of terminology to the “housing norm” discussed in “Housing and housing related allowance” at ¶14-003). When an employer charges an employee a tax norm, it is usually taken out of current pay as negative compensation (just like the housing norm).

Example

Please note that the tax rates used in the example below are for illustration purposes to explain tax equalisation only. They do not reflect correct tax rates in either the US or the PRC.

Mr B is a US citizen working in the US and he earns US\$120,000 per annum which is paid to him at the rate of US\$10,000 per month. Assuming that Mr B's effective tax rate in the US is 25% and his US taxes are withheld by his employer, he receives a paycheck of US\$7,500 per month after the tax withholding. Then Mr B is assigned to work in the PRC. Assuming that Mr B receives no other allowances except for tax equalisation and that his PRC tax rate is 40%.

In a tax equalisation policy, Mr B's employer will reduce Mr B's monthly pay by his home country tax rate of 25%. This will allow Mr B to receive US\$7,500 per month (this amount is consistent with what he was receiving when he was working in the US).

The employer will use the PRC tax gross-up formula to calculate the tax due with Mr B's monthly individual income tax filing. If the effective PRC individual income tax rate in this case is 40%, the amount of monthly tax due and payable by the employer in the PRC will be US\$5,000 ($(7500/(1 - 40\%)) - 7,500$). However, since the employer saves US\$2,500 when it reduced Mr B's monthly pay by charging him a hypothetical tax, the company's additional out-of-pocket cost is only US\$2,500 (US\$5,000 of PRC tax cost less US\$2,500 of hypo tax charged to employee).

In such cases illustrated by the above example, it is likely that the employee will have no residual US income tax obligation because of the availability of foreign tax credits to offset US tax. However, the employer would pay the residual US tax as well because in a tax equalisation policy, the employer ultimately pays directly, or reimburses the employee, for all of the employee's actual taxes. Therefore, if an employee is obligated to pay taxes in multiple jurisdictions, paying taxes on behalf of an employee (or reimbursing them) can turn into a complicated process.

Hypothetical tax

Hypothetical tax or "hypo tax" is actually negative compensation. That is to say, it is a reduction in pay. Hypo tax is "withheld" from regular pay and, as illustrated in the example above, is usually intended to represent the amount of income tax that a person would have paid had they received certain income (commonly base salary or bonus) if they stayed at home. Hypo-tax is, more accurately, pay that is never actually delivered. At the end of the year, hypo-tax withheld is sometimes trued up in a process called tax reconciliation. In this process a mock or hypothetical home country tax return is created for the employee to determine the final and most accurate approximation of the tax that the employee would have paid had he or she remained working in the home country. This final hypo tax calculation will then be compared to the hypothetical "withholdings" deducted from employee pay throughout the year and a settlement is made between employer and employee.

Tax equalisation amount deemed income

It should be noted that because the parties involved have an employment relationship, any monies that pass between them, including the tax equalisation settlement, is likely to be deemed as income (or reduction in income if the employee has to pay the employer). The result is, once again, a change in the amount of reportable taxable income and therefore actual income tax is affected by such a payment.

It can be seen that fully tax-equalised expatriate packages can be complicated to administrate and very costly because of the tax on tax impact of these programmes. It is because of the compounding effect of the gross-up tax that companies are eager to put into place effective tax planning programmes so that companies and their employees pay their fair share of income tax and no more than that. However, even after the careful construction of a compensation package in order to take advantage of all allowable tax concessions, a tax-equalised package may still be a high cost option and will be inappropriate in some assignment cases.

¶14-005 Local plus allowances package (no tax equalisation)

At the other end of the spectrum is an expatriate package with no tax equalisation at all. In such cases, employees may receive relocation allowances and assignment allowances, but they are “on their own” for all income taxes, even if the effective tax rate in the host jurisdiction is greater than the home country tax rate that the employees pay before their assignments.

Such packages are becoming more common for many reasons. First, they provide the company with a more predictable cost of employment. In tax-equalised packages, unpredictable results can occur which create variability in the tax cost and therefore in the total assignment cost. In non-tax-equalised packages, the most unpredictable assignment cost (taxes) is removed from the equation. This allows companies to budget for employment costs more effectively.

Another reason that non-tax-equalised packages are somewhat popular in the PRC is because the PRC is, for the foreseeable future, a location that promises long-term career opportunity. When companies assign employees to countries with a stable economy, high growth and relatively good and rapidly improving infrastructure, they feel less inclined to offer add-on benefits such as tax equalisation.

Finally, employees are becoming more global themselves. In many ways, employees are willing to go where the opportunities are, and they are more willing than ever before to assume responsibility for whatever complexities and costs of daily living those decisions involve.

Flexible compensation packages

For expatriates on a “gross package” (ie one where they will be meeting the tax costs themselves), a popular option is to offer a flexible compensation package whereby the assignee can pre-select the portion of salary that can be paid as tax-free benefits such as housing, home leave flights, schooling etc. This allows the assignee to help minimise his IIT liability without increasing the overall cost to the employer. Care needs to be taken in the drafting of such agreements and in the accounting treatment made by the employer to ensure that the provision of the tax-free benefits is provided correctly.

¶14-006 Local plus allowances package with some tax protection

Between the traditional tax-equalised and the non-tax-equalised expatriate packages are almost endless variations of partially tax-protected packages. It would

be very challenging to list all of the possible alternatives that companies use to protect employees from some of the tax impact living in the PRC. In a way, employers who carefully administrate their housing reimbursement programme to allow employees to take advantage of tax-free housing are protecting these employees from tax on the housing allowance portion of the package. Similarly, employers with strict guidelines on the relocation expenses they will reimburse (only the tax-free ones) are also ensuring their expatriate employees are tax-protected from incremental costs.

Actual income tax paid for employee

When concessionary or special tax treatments are not available, the employer may need to step in and actively protect an employee from tax by paying some of the actual income tax for the employee. One common example of this is a programme that tax protects the employee from the tax impact of allowances, but will not tax protect the employee from any rate differential between home and host countries on “regular” compensation (ie salary and bonus).

So, in the case of Mr B’s example in ¶14-004, Mr B’s employer will not be reducing Mr B’s pay by the hypothetical tax amount, and Mr B will be paying his own PRC individual income tax. Assuming again the effective PRC individual income tax rate is 40%, Mr B’s gross monthly income of US\$10,000 will be subject to a US\$4,000 PRC individual income tax charge that his company will withhold from him and pay over to the authorities. In fact, Mr B will be paying US\$1,500 more per month on his income than he would pay if he stays at home. But that is a decision that Mr B has to make when he considers the assignment.

Example

To continue with the example of Mr B. Mr B is entitled to a one-time relocation payment of US\$15,000 to assist Mr B with his relocation to the PRC. He may use the funds in any manner he wishes and he does not need to provide the company with any receipts for his expenditures. It is the employer’s intention that Mr B receives the US\$15,000 net of any and all income tax. In such a case, Mr B’s employer will gross-up the US\$15,000 payment. Again, assuming that the PRC individual income tax rate is 40%, the grossed-up tax on US\$15,000 at 40% will be US\$10,000 $((15,000 / (1 - 40\%)) - 15,000)$. The employer will report gross compensation of US\$25,000, pay the authorities US\$10,000 of tax, and Mr B will receive US\$15,000 as the policy intended.

Protection from double taxation

One other common partial tax protection policy is to tax protect the employee from any double income tax on a taxable income item. For eg an employee might receive a bonus related to his PRC assignment, the cost of which is charged to the PRC. This bonus may be paid after the employee leaves the PRC, but because it is related to the PRC assignment and charged to the PRC entity, it is subject to PRC individual income tax. Also, if the employee has taken up residence in another country, and if that country does

not otherwise allow for double tax relief through domestic law or a tax treaty with the PRC, the employee is subject to double income tax. Many company relocation policies will protect employees from the very negative consequences of this type of scenario.

Of course, the key to designing a cost effective package that also satisfies employees and attracts, motivates and retains them, is one that is designed to take advantage of all legitimate methods for tax efficient compensation. This will require an employer to understand the basic planning ideas for PRC individual income tax and to spend some time to educate their employees to ensure that they understand the tax rules and remain in compliance with local law.