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China's New Personal Income Tax Return Filing Regime

by Wei Cui

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In December 2005, as newly authorized under the amended Personal Income Tax Law (PITL),¹ China's State Council announced that taxpayers with annual income in excess of RMB 120,000 (US \$15,000) would be required to file annual tax returns.² The task of designing the procedures for the new return filing requirement was delegated to the State Administration of Taxation (SAT). On November 6, 2006, 11 months after the new return filing requirement was announced,³ and less than two months before the first filing season was to begin, the SAT finally issued a set of rules⁴ on filing procedures, including a new sample annual tax return. That means that local tax bureaus, which are responsible for administering the personal income tax (PIT), and Chinese taxpayers have had less than two months to learn about and prepare for what is potentially a historic change in China's PIT administrative and compliance regime. The disproportion between the tasks faced by tax agencies and taxpayers on the one hand, and the minimal time and published guidance provided on the other, makes the likely impact of the new procedures difficult to assess.

Nonetheless, this article will attempt to assess the new return filing regime from three different perspectives. First, it reviews the main changes in applicable law brought by the new return filing procedures. Second, it ventures some predictions regarding the impact that the new compliance regime, along with other recent and imminent changes in Chinese tax law, could have on the incidence of the PIT. Third, it discusses what the new return filing requirement implies for the overall PIT compliance and the administrative structure for the PIT.

I. Legal Changes

A. Comparison With 1995 Rules

The first thing to note about the trial measures is that they replace an old set of rules issued in 1995.⁵ In other words, legal rules on self-assessment returns are not entirely new. The new trial measures do more than just add a new category of taxpayers (that is, those with an annual income in excess of RMB 120,000) to the list of return filers, even though in the overall scheme of things, that is indeed perhaps the most consequential development. They introduce other significant changes as well. For example, three categories of taxpayers required to file self-assessment returns under the 1995 rules are eliminated:

- taxpayers receiving remuneration for labor services, author royalties, other royalties, or rental payments in installments;
- taxpayers who receive income on which PIT was not properly withheld; and
- other taxpayers whom the relevant tax agencies may require to file self-assessment returns.⁶

The three eliminated categories deserve comment because their creation by the SAT under the 1995 rules were not explicitly authorized under either the

¹The Personal Income Tax Law of the People's Republic of China, promulgated under Presidential Decree 44, Oct. 27, 2005; art. 8.

²Implementation Rules for the Personal Income Tax Law, (PIT implementation rules) State Council Order 452, Dec. 19, 2005, art. 36.

³Notice Regarding Matters Relating to the Filing of Personal Income Tax Returns, *Guoshuifa* (2005) 207 (Dec. 28, 2005), clarified that the annual return filing requirement for taxpayers with annual income in excess of RMB 120,000 would begin to apply only to income received in 2006.

⁴(Trial) Measures Regarding the Filing of Personal Income Tax Self-Assessment Returns (the trial measures), *Guoshuifa* (2006) 162 (Nov. 6, 2006).

⁵Provisional Rules Regarding the Filing of Personal Income Tax Self-Assessment Returns (the 1995 rules), *Guoshuifa* (1995) 77 (Apr. 28, 1995).

⁶*Id.*, at art. 2.

PITL in effect in 1995 or the administrative regulation adopted by the State Council to implement the PIT statute.⁷ Moreover, in creating the third category, the SAT further delegated the authority to impose self-assessment return filing obligations to lower-level tax agencies. Thus, for example, in 1995 the Fujian provincial local tax bureau imposed self-assessment return filing obligations on “middle- and upper-management” and “middle- and upper-technical personnel” in nine different industries, regardless of whether the taxpayers in question had return filing obligations under the PIT statute in effect then.⁸ And as late as 2002, some local tax bureaus authorized local tax agencies to impose return filing obligations on a discretionary basis to high-income taxpayers in some industries.⁹ It could have been questioned whether that was a sustainable practice — to impose return filing requirements that the statute and even the State Council administrative regulation did not contemplate. In any case, now that the 1995 rules are repealed by the trial measures, presumably local tax agencies will refrain from imposing their own return filing requirements.

Persons who are not tax residents of China are not subject to the new annual filing requirement.

For those categories of taxpayers for whom return filing requirements are retained, the trial measures also introduced changes in administrative details (where, when, and what to file). Those details are summarized in tables 1 and 2.

For other aspects of the return filing process such as extensions, penalties for late filing, and fraudulent returns, the drafters of the trial measures appear to deem further development of the law

unnecessary and refer to existing provisions in the law on tax collection and administration and related administrative regulation instead.¹⁰ To obtain an extension, one must apply for the tax agency’s permission;¹¹ the conditions for granting extensions, their lengths, and whether interest accrues on unpaid taxes are not stated. Failure to timely file a return, even if no tax is owed, is subject to penalties of up to RMB 2,000 or, in “egregious circumstances,” of up to RMB 10,000.¹² Filing a fraudulent return constitutes tax evasion and is subject to a penalty between 50 percent and 500 percent of the amount of unpaid tax,¹³ and may result in criminal prosecution.¹⁴ What constitutes egregious circumstances and fraudulent reporting are not specified. Nor is there any discussion of the amendment of returns.

What gives all those issues new significance, and what will likely expose the thinness of existing law, is the new return filing requirement for persons with an annual income in excess of RMB 120,000.

B. The RMB 120,000 Threshold

According to the trial measures, persons who are not tax residents of China — those who are not domiciled in China and who have not lived within Chinese territory for a complete year — are not subject to the new annual filing requirement.¹⁵

⁷See The Personal Income Tax Law of the People’s Republic of China, promulgated under Presidential Decree 32 (Oct. 31, 1993); Implementation Rules for the Personal Income Tax Law, State Council Order 142 (Jan. 28, 1994).

⁸Fujian provincial local tax bureau, Notice Regarding the Application of Personal Income Tax “Dual Reporting” Requirements to Select Industries and Individuals, *Mind-izhenger* (1995) 9.

⁹Hunan provincial local tax bureau, Provisional Rules Regarding Personal Income Tax “Dual Reporting” Administration, *Xiangdishuifa* (2002) 58; Hunan Province, Hanshou County local tax bureau, Administrative Measures on Personal Income Tax “Dual Reporting” in Hanshou County, *Handishuifa* (2002) 21; see also Beijing local tax bureau, Provisional Rules on the Administration of Personal Income Tax Self-Assessment Returns, *Jingdishuige* (2003) 590 (repeating the 1995 rules’ authorization of local tax agencies to impose return filing requirements).

¹⁰The Law on Tax Collection and Administration of the People’s Republic of China, promulgated under Presidential Decree 49 (Apr. 28, 2001); Implementation Rules for the Law on Tax Collection and Administration of the People’s Republic of China, State Council Order 362 (Sept. 7, 2002).

¹¹The Law on Tax Collection and Administration, *supra* note 10, art. 27. Under *force majeure*-type circumstances, extension is automatic until relevant circumstances cease to hold. Implementation Rules for the Law on Tax Collection and Administration, *supra* note 10, at art. 37.

¹²The Law on Tax Collection and Administration, *supra* note 10, art. 62. If one fails to file a return and tax is owed, in addition to the unpaid tax liability and interest thereon, a penalty between 50 percent and 500 percent of the amount of unpaid tax may be assessed. *Id.*, at art. 64.

¹³*Id.*, at art. 63.

¹⁴Chinese criminal law provides that the offense of tax evasion, if the amount evaded is between 10 percent and 30 percent of the amount of tax owed and is between RMB 10,000 and RMB 100,000, may result in a sentence of detention or imprisonment of up to three years. If the amount evaded is 30 percent or more of the amount of tax owed and exceeds RMB 100,000, the offense may result in a prison sentence of between three and seven years. Additional criminal fines may also accrue. The Criminal Law of the People’s Republic of China, promulgated under Presidential Decree 83 (Mar. 12, 1997), and subsequently amended (the criminal law), art. 201.

¹⁵The trial measures, *supra* note 4, at art. 4. See PIT implementation rules, *supra* note 2, at arts. 2 and 3.

Table 1. The 1995 Rules

Taxpayer Type	When to File	Where to File	Content and Documentation Requirements
General rule	Unless otherwise provided, returns must be filed and tax paid within the first seven days of the month after the date when income is received.	Location where income originates. Change of filing location requires approval of tax agency.	Return should separately state different categories of income. Documentation requirements to be determined by relevant tax agency.
Taxpayers receiving wage income from more than one source	General rule applies.	Taxpayer may choose one location for filing but must keep to that choice.	General rule applies.
Taxpayers with income from outside China	(1) If income from outside China is subject to foreign personal income tax on an annual basis, the income should be reported within 30 days after the end of the tax year in the country where the income originates and where tax is payable or the date by which the annual tax liability is satisfied. (2) If the income from outside China is exempt from foreign personal income tax, or if it is subject to such tax but the tax liability is satisfied when income is paid, a Chinese return must be filed and tax paid before January 30 of the subsequent year.	Location where residence is permanently registered or where taxpayer habitually resides.	General rule applies.
Taxpayers receiving income for which there is no withholding (individual industrial and commercial households (IICH), partners, owners of single-owner enterprises, and operators of businesses by contract or lease)	(1) For taxpayers keeping adequate accounting records, tax is determined on an annual basis but estimated taxes are prepaid monthly. Returns must be filed and tax prepayment made within seven days after the end of the month. Annual return is filed within three months after the end of the year, whereby tax paid and tax due are reconciled. For taxpayers without adequate accounting records, local tax agencies are to determine collection methods. ^a (2) Operators by lease or contract must file a return and pay tax within 30 days of receiving income if the relevant income is received once a year. If they receive relevant income more than once a year, they must file returns and prepay tax within seven days after each payment is received. Annual return is filed within three months after the end of the year, whereby tax paid and tax due are reconciled.	General rule applies.	General rule applies.

^aThere have been some specific SAT regulations regarding tax collection from IICHs, partnerships, and owners of single-owner enterprises, according to which prepayments of tax are sometimes allowed to be made on a quarterly, and not monthly, basis. *See, for example*, Rules on the Application of the Personal Income Tax to Single-Owner Companies and Investors in Partnerships, *Caishui* (2000) 91 (Sept. 19, 2000), art. 6(2).

Table 2. The Trial Measures (2006)

Taxpayer Type	When to File	Where to File	Content and Documentation Requirements
Category A: taxpayers with annual income in excess of RMB 120,000 ^a	Within three months after the end of the tax year (between January and March of each year).	<p>(1) Taxpayers employed by a business within Chinese territory should file returns where the business is located.</p> <p>(2) Taxpayers employed at two or more businesses within Chinese territory may choose to file at the location of any one of the businesses, but should keep to that choice.</p> <p>(3) Taxpayers who are not employees at any business within Chinese territory, but who have income from IICHs or from operating businesses by contract or lease (income from production and trade), should file at one of the locations where the businesses are carried out.</p> <p>(4) A taxpayer who is not an employee at any business within Chinese territory and who does not receive any income from production or trade may file at the location where his residence is permanently registered. If that location differs from the location of the taxpayer's habitual residence,^b he may choose among the two locations but must keep to that choice. If the taxpayer does not have a permanently registered residence, he should file where he habitually resides.</p>	A return specifically applicable to Category A is to be used. A copy of the effective personal identification document should be provided, plus other documents that may be required by the relevant tax agency.
Category B: taxpayers receiving wage income from more than one source	Same as under previous rule.	Same as under previous rule.	A return specifically applicable to Category B is to be used. Other documents may be required by the relevant tax agency.
Category C: taxpayers with overseas income	Within 30 days after the end of the tax year.	<p>(1) At the location where the taxpayer's residence is permanently registered.</p> <p>(2) If such location differs from the location of the taxpayer's habitual residence, he may choose among the two locations but must keep to that choice.</p> <p>(3) If the taxpayer does not have a permanently registered residence, he should file where he habitually resides.</p>	A return specifically applicable to Category C is to be used. Other documents may be required by the relevant tax agency.
Category D: taxpayers receiving income for which there is no withholding	<p>Owners of IICHs, single-owner companies, and partners' interests in partnerships:</p> <p>(1) if they pay monthly estimated taxes, during the first seven days of each month;</p> <p>(2) if they pay quarterly estimated taxes, during the first seven days of each quarter; and</p> <p>(3) everyone files an annual return within three months after the end of the year, whereby tax paid and tax due are reconciled.</p> <p>Operators of business by lease or contract are subject to the same rules as before.</p>	<p>An IICH owner files where the business of the IICH is actually carried out.</p> <p>Investors in more than one single-owner company or partnership:</p> <p>(1) if all businesses invested in are single-owner companies, returns are separately filed at the locations where businesses are actually carried out;</p> <p>(2) if businesses invested in include a partnership, return should be filed at the place of habitual residence;</p> <p>(3) if businesses invested in include a partnership, and if the location of habitual residence differs from the location where one of the businesses is managed, the taxpayer may choose to file at a location where at least one of the partnerships he has invested in is managed (except under special circumstances, the choice cannot be altered within five years).</p>	Returns specifically applicable to the various subcategories of Category D are to be used. Other documents may be required by the relevant tax agency.

Table 2. The Trial Measures (2006) (continued)

Taxpayer Type	When to File	Where to File	Content and Documentation Requirements
Category E: other taxpayers prescribed by the State Council	Rules to be announced.	Rules to be announced.	Rules to be announced.
General rule (for taxpayers not specifically provided for above)	Within the first seven days of the month after the date when income is received.	At the location where income originates. Change of filing location requires approval of tax agency.	Return should separately state different categories of income. Documentation requirements to be determined by relevant tax agency.

^aThe filing requirement imposed on this category of taxpayers is in addition to the requirements that a taxpayer may be subject to by virtue of falling into categories B, C, D, and E.

^bThe place of habitual residence is the last place where the taxpayer has continuously resided for more than one year after leaving the place where his residence is permanently registered; trial measures, at art. 14.

Besides that important exemption, the trial measures offer, along with a subsequent SAT notice,¹⁶ some detailed instructions for determining the amount of income to apply to the RMB 120,000 threshold. First, income exempt from the PIT under some statutory exemptions is not to be counted in determining annual income.¹⁷ That includes, for example, interest on state bonds and income exempt from the PIT under tax treaties. Second, income from sources outside China received by taxpayers who are not domiciled in China and who have resided in China for more than one year but less than five years is excluded from the calculation, provided that the income is not currently taxable in China.¹⁸ Third, contributions to and distributions from some social insurance funds that are currently exempt from the PIT may also be left out of the annual income computation.¹⁹ But all other income that does not fall within those exemptions must be used when determining whether the RMB 120,000 threshold is met, including many types of income currently exempt from the PIT. For example, capital gain from the transfer of a sole residence in which the owner has resided for five years is exempt from

the PIT,²⁰ but must be counted in determining annual income. Similarly, capital gain from the transfer of shares listed on stock exchanges is currently PIT-exempt,²¹ but must be included (subject to a special rule further discussed below) in determining whether a taxpayer exceeds the RMB 120,000 threshold.

The trial measures and the subsequent SAT clarifying notice also state that the determination of annual income for the new reporting obligation is to be made on a gross basis; that is, without taking into account allowable deductions.²² The clarifying notice contains at least two further interesting provisions.

The first resolves a legal issue relating to the application, to some types of income, of presumptive tax rates: that is, tax applied without actual determination of income. An important example is the taxation of partnerships such as law firms. Many local tax bureaus do not currently require partners to report their shares of actual profits, but collect tax as a percentage of partnership revenue instead. In Beijing, for example, in lieu of partners paying PIT

¹⁶Notice Clarifying the Application of the RMB 120,000 Threshold for Self-Assessment Return-Filing (the clarifying notice), *Guoshuifa* (2006) 1200 (Dec. 15, 2006).

¹⁷The trial measures, *supra* note 4, at art. 6(1), referring to exemptions under PITL art. 4, items (1)-(9).

¹⁸The trial measures, *supra* note 4, at art. 6(2), referring to PIT implementation rules, art. 6.

¹⁹The trial measures, *supra* note 4, art. 6(3), referring to PIT implementation rules, art. 25.

²⁰Notice on Certain Issues in the Collection of the Personal Income Tax from Transfers of Personal Residences, *Guoshuifa* (2006) 108 (July 18, 2006). For prior coverage, see *2006 WTD 152-3* or *Doc 2006-14882*.

²¹Notice Regarding the Temporary Suspension of Personal Income Tax Collection From Share Transfers, *Caishui* (1998) 61.

²²The trial measures, *supra* note 4, at arts. 6-8; the clarifying notice, para. 1.

on profit shares, partnerships may pay between 5 percent and 7 percent of gross revenue instead.²³ When the trial measures were first issued, there was concern whether that presumptive tax regime (which could be quite favorable to profitable firms) would change (so that partners would have to report their share of actual partnership profit and self-assess tax at the statutory rates). The clarifying notice says the determination of taxable income for partners (and other small-business owners) would be made according to the current rules.²⁴ The new return filing requirement thus should not change the PIT exposure of partnership profits. A similar situation arises in the transfer of real estate. Many local tax bureaus, out of real or alleged difficulty in ascertaining the original purchase price, opted to collect a 1 percent to 3 percent tax on gross proceeds from the sale of residences instead of applying the statutory rate to capital gains.²⁵ That frequently reduced the tax payable on the sale. The clarifying notice reconciles that practice with the new reporting requirement by imputing capital gain income on the basis of actual tax collected.²⁶

China's individual taxpayers have almost no way of offsetting investment or business losses against investment or business gains.

The second interesting aspect of the clarifying notice is the treatment of gains from the sale of stock. In determining whether one's annual income exceeds the RMB 120,000 threshold, the taxpayer is allowed to net out gains and losses from stock transfers. That is interesting because Chinese PIT law does not currently allow offsetting investment losses against investment gains or taxable income in general. Whether that marks new thinking regarding what should constitute taxable income, or merely represents a temporary expedient, is yet to be seen.

²³See, for example, Beijing local tax bureau, Notice Regarding Changes to the Collection of the Personal Income Tax from Investors in Law Firms, *Jingdishuige* (2005) 69 (Feb. 1, 2005).

²⁴The clarifying notice, *supra* note 16, at para. 1(5).

²⁵See "Beijing, Guangzhou and Hangzhou Adopt 1 Percent Rule," *China Taxation News*, Aug. 4, 2006, p. 1.

²⁶The clarifying notice, *supra* note 16, at para. 1(3). Thus a 1 percent tax on gross proceeds implies a capital gain equal to 5 percent of gross proceeds, given the 20 percent tax rate on capital gain.

C. The New Tax Return

The trial measures introduce a new tax return applicable to taxpayers with annual income in excess of RMB 120,000. The simple return would be completely unremarkable but for the declaration a taxpayer must make at its end. The Chinese version of the declaration is identical with what has appeared in previous tax returns, which has previously been translated as:

I declare that this return has been completed according to the individual income tax law of the People's Republic of China. I believe that all statements contained in this return are true, correct and complete.

However, the declaration in English in the new return reads:

Under penalties of perjury, I declare that this return has been filed according to the provisions of the individual income tax law of the People's Republic of China, and to the best of my knowledge and belief, the information provided is true, correct and complete.

Although filing a fraudulent return may constitute tax evasion and result in criminal prosecution under Chinese law,²⁷ there appears to be no support for the position that the same act could constitute the crime of perjury.²⁸ It is probably more sensible to dismiss the English-language declaration in the new return (which is inconsistent both with the Chinese-language declaration and with Chinese law) as a mere translation error than to speculate on its possible legal effect. Both the haste with which the trial measures were drafted and the lack of legal resources devoted to establishing the new return filing regime are plainly in evidence.

II. Likely Effects of New Regime

The first three months of 2007 promise to offer a fascinating drama of tax compliance in China. Because of rapidly rising urban income, the population of taxpayers subject to the new annual reporting requirement is likely to be sizable, although the government seems to have no good estimate for it. In early December 2006, Beijing tax officials indicated that on the basis of previous surveys of income earners subject to wage withholding, roughly 250,000 Beijing taxpayers have annual income in excess of RMB 120,000. The estimate was immediately greeted with skepticism, and a tax official conceded that it might be too conservative and that

²⁷See *supra* notes 13-14.

²⁸Under Chinese criminal law, only witnesses during a criminal proceeding can commit perjury. See the criminal law, arts. 305-307.

the actual number should be in the “hundreds of thousands.”²⁹ It is in the interest of tax agencies to provide low estimates of expected returns to avoid being embarrassed if the actual number of returns falls short. However, at this stage of the return filing game — a game that will play out all across China in the next three months — a gap between the number of returns filed and any credible estimates³⁰ of the size of the “high-income” group, with the former being far lower, seems unavoidable.

A reasonable guess is that China would adopt something like the British return filing system.

Even if the rate of noncompliance with the new return filing requirement ends up being high in 2007, for many taxpayers subject to the requirement, noncompliance is not a long-term option. The basic reason is that they do not operate in the underground economy or in small businesses. Instead, they are managers or employees at companies that engage in modern financial operations or they are lawyers, professors, journalists, or doctors. Any enforcement effort against those taxpayers is likely to pay off at least in financial terms (if not necessarily in bureaucratic or political terms), unlike enforcement in “hard to tax sectors.” Thus, however poorly the local tax agencies manage the first filing season, the new filing requirement has irreversibly increased the downside risk of noncompliance with the PIT for high-income earners, a risk that is likely to continue to rise as the requirement becomes further institutionalized.

To the extent that the government can make the filed returns reveal sources of income not previously subject to withholding, the new requirement will likely increase the real incidence of the PIT. It may also generate behavioral responses other than mere noncompliance. What makes this particularly interesting in 2007 is another widely anticipated legal development in 2007, the adoption of a unified enterprise income tax applicable to both foreign and domestic enterprises.³¹ Two types of interactions should be considered.

²⁹“250,000 Beijingers Need to File Tax Returns Next Year,” *Beijing Business Time*, Dec. 7, 2005.

³⁰A January 5, 2007, report in the *Chongqing Shangbao* relates that for the vast city of Chongqing (with a population of 31 million), the government estimate of the number of taxpayers with annual income in excess of RMB 120,000 was 20,000 — an estimate that was simply not credible.

³¹For prior coverage, see *Tax Notes Int'l*, Jan. 8, 2007, p. 24.

First, the unified EIT may increase the incidence of the PIT, particularly on wage income. That is because under the existing EIT law for domestic enterprises, the deduction of wages and salaries is subject to very low ceilings. Before July 1, 2006, deductible wage was capped at RMB 960 per worker per month; for tax periods after that date, it was adjusted to RMB 1,600, just slightly above the average urban salary.³² Those unjustifiably low ceilings created significant distortive incentives for businesses to cast compensation to employees as forms of deductible expense other than wage payments.³³ Such disguised compensation simultaneously undermined PIT administration as well, by removing compensation payments from the system of wage withholding. The result is that China has had a high level of collaborative tax avoidance among employers and employees perhaps rare in other countries. However, the Chinese government has announced that in the unified EIT, the entire amount of wage payments will be treated as deductible expenses (as they are for foreign enterprises under existing law).³⁴ As a result, Chinese employees will likely see their employers offering nonwage forms of compensation less often and see more of their compensation subject to PIT withholding. If many Chinese taxpayers have not previously felt the effect of the PIT, the pincer movement of the new return filing requirement and the revised EIT wage deduction rules could change that soon.

Second, the unified EIT may exert an opposite effect on the incidence of the PIT, countering the effects just mentioned. The Chinese government has proposed a new 25 percent EIT rate on business income.³⁵ Nominally, that is still higher than the general statutory PIT rate on dividends and capital gains, which stands at 20 percent. However, China’s individual taxpayers have almost no way of offsetting investment or business losses against investment or business gains, whereas businesses have somewhat greater latitude in doing so. By choosing

³²Notice Regarding the Adjustment of Deduction for Wages for the Enterprise Income Tax, *Caishui* (2006) 126 (Sept. 1, 2006). Wage deductions for partnerships and single-owner companies have been subject to similar ceilings. Rules on the Application of the Personal Income Tax to Single-Owner Companies and Investors in Partnerships, *Caishui* (2000) 91 (Sept. 19, 2000), art. 6(2).

³³See “Interview on Policy Adjustment Regarding Deductible Wages in Domestic Enterprises,” *China Taxation News*, Sept. 11, 2006, p. 1 (citing such distortions as a major reason for adjusting the deduction ceiling).

³⁴“National People’s Congress Plans to Unify Deduction Criteria for Domestic and Foreign Enterprises,” available at http://news.xinhuanet.com/legal/2006-12/24/content_5526398.htm.

³⁵See *supra* note 31.

to form a business entity subject to the EIT, and by designing proper loss offsets, a taxpayer may be able to reduce the effective tax rate to well below the 20 percent rate on investment income, not to mention the higher rates on wages and small-business income. Thus, a movement of capital ownership and some service activities from individuals to corporate entities — the opposite of what happened in the U.S. in the 1980s³⁶ — could well be observed.

Implication for PIT Administration

Chinese government officials have not been very clear about what they expect to accomplish with the new annual returns, particularly how the latter could improve PIT compliance in the short term.³⁷ The PIT law already requires withholding on all types of income subject to the PIT.³⁸ In cases of income when there is no withholding agent (self-employment income), periodic returns were already required under the 1995 rules. The new returns could improve compliance if they reveal sources of income for which withholding has failed or if they induce the self-employed to report income more truthfully. But what prevents a taxpayer from reporting only income that has already been subject to withholding? And why would a self-employed individual report income on the new return any differently than on the returns he is already required to file? The obvious answer to those questions is more audits. Yet there has been no report of plans to expand the audit function at local tax bureaus.

It is somewhat easier to speculate about the long-term significance of the new return filing requirement, although a lot is left to guessing even here. It has been common for Chinese tax officials to say that return filing is a central component in PIT administration in many countries. But return filing systems come in many different varieties. Most importantly, there is the distinction between countries like Britain, where the majority of taxpayers satisfy their tax liabilities through “exact” or “final” withholding and only a minority of taxpayers file returns, and countries like the United States, where

most taxpayers file annual returns.³⁹ Which type of system does China hope eventually to develop?

A reasonable guess is that China would adopt something more like the British system. The logic of the inference is as follows. A 2003 report by the U.S. Department of Treasury,⁴⁰ which compares the U.K. and the U.S. return-filing systems, characterizes the design of return-filing systems for administering the PIT as a function of two sets of variables. The first set relates to the complexity of the PIT, that is, factors such as the progressivity of the rate structure; the comprehensiveness of the tax base; the number of deductions, exemptions, and credits allowed; and whether joint filing is allowed. The more complex the PIT, the less likely that it can be administered through withholding for most taxpayers. The second set of variables relates to how the cost of compliance is distributed. A sophisticated and comprehensive withholding system can reduce the number of taxpayers required to file returns, but it places a greater burden on both withholding agents and on the government. The U.S. has both a complex PIT and a simple withholding system, resulting in most taxpayers having to file returns. The U.K., by contrast, with its simpler PIT and more sophisticated withholding system, imposes a return filing requirement on only about a third of its taxpayers.⁴¹

China’s new annual tax return is not expected to perform many of the important functions that tax returns play in many other countries.

The current Chinese PIT has a simple structure,⁴² making withholding an appealing administrative mechanism. Although there are nine rate brackets applicable to wage income, they are applied to *monthly* income; the problem of applying progressive rates cumulatively to annual income has not yet been posed. And except for two categories of self-employment income (running one’s business and providing occasional services), other categories of income are subject to flat rates. There are also few

³⁶See Roger Gordon and Joel Slemrod, “Are ‘Real’ Responses to Taxation Simply Shifting Between Corporate and Personal Tax Bases?” in: *Does Atlas Shrug? The Economic Consequences of Taxing the Rich*, edited by Joel Slemrod (Cambridge and New York: Harvard University Press and the Russell Sage Foundation, 2000), p. 240.

³⁷For representative examples of government pronouncements on the subject, see Notice on Successfully Handling Returns to Be Filed by Taxpayers with Annual Income of RMB 120,000 or More, *Guoshuifa* (2006) 164, and “Press Interview With SAT Official,” *China Taxation News*, Nov. 10, 2006, p. 1.

³⁸PITL, art. 8.

³⁹See U.S. Department of Treasury, “Return-Free Tax Systems: Tax Simplification Is a Prerequisite,” Dec. 2003 (<http://www.ustreas.gov/offices/tax-policy/library/noreturn.pdf>).

⁴⁰*Id.*

⁴¹See generally William J. Turner, “PAYE as an Alternative to an Alternative Tax System,” 23 *Va. Tax Rev.* 205 (2003).

⁴²See generally Jinyan Li, “China’s Individual Income Tax: A 26-Year-Old Infant,” *Tax Notes Int’l*, July 24, 2006, p. 297.

deduction and credits. Therefore, as long as withholding agents are willing to fulfill their obligations (and receive adequate instructions from tax agencies), there should be, in theory, little concern that the wrong amount of tax would be withheld.⁴³ Indeed, China's new annual tax return is not expected to perform many of the important functions that tax returns play in many other countries, for example, claiming deductions and credits and correcting inaccuracies in withholding due to progressive rates.⁴⁴ However, as the Chinese PIT becomes more complex — as it is likely to do in the future — tax returns may begin to serve those functions. Even then, withholding may remain the method by which most taxpayers satisfy their PIT liabilities, and only the self-employed and higher-bracket taxpayers would file returns.

The implementation of the new return filing requirement, therefore, can be seen as one way in which China has begun to build an administrative framework for a more robust personal income tax. Other components include improving withholding mechanisms and information reporting.⁴⁵ Recent experiments in those areas by local tax agencies

have sometimes produced good results.⁴⁶ A basic fiscal arrangement, however, casts a persistent shadow on the prospect of quick improvements in PIT administration: Although local governments shoulder almost the entire cost of PIT collection, 60 percent of the PIT revenue collected must be surrendered to the central government.⁴⁷ That, along with the fact that the business tax and the EIT dominate the PIT as a source of local government revenue, creates a strong tendency for local tax agencies to underinvest in PIT administration, particularly in human capital (training staff to perform the unfamiliar tasks of processing and auditing returns and accounts and dealing with individual taxpayers). Whether that shadow will eclipse the novel institution of the annual return for high-income taxpayers or, on the contrary, the new institution will shed greater light on the inadequacy of the Chinese tax bureaucracy, is an excellent question to which the year 2007 promises an answer. ♦

⁴³One exception is when a person has wage income from two or more sources. Chinese law requires that he file monthly returns (see Table 1 above). The U.K. PAYE system is able to handle those cases through withholding.

⁴⁴The SAT has made no mention of the annual tax return as a method of obtaining refunds.

⁴⁵Art. 8 of the PITL subjects potentially taxable income not only to withholding but also information reporting. See PIT implementation rules, *supra* note 2, at art. 37. On the basis of information received, tax agencies are now supposed to issue "certificates of tax payment" to individual taxpayers. See

Notice Regarding the Issuance and Delivery by Mail of Certificates of Tax Payment, *Guoshuifa* (2006) 30 (Feb. 20, 2006). In American terms, the certificates are similar to U.S. IRS Forms W-2 and 1099. Moreover, for Chinese taxpayers that do not have to file returns, the certificates can be used like tax returns in the U.S. for providing proof of income.

⁴⁶In Xiamen, for example, the local tax bureau recently identified 16,000 taxpayers through an ID matching program as having multiple sources of wage income and having potentially failed to meet return filing obligations. "Multiple Sources of Income Detected," *China Taxation News*, Dec. 1, 2006, p. 1.

⁴⁷See State Council Notice Regarding the Proportion of Tax Sharing Among Local and Central Governments, *Guofa* (2003) 26.