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Top frequently asked questions about PRC individual income tax on foreign income of Chinese HNWI's



Recent media coverage of the “rich tax” on the foreign income of Chinese HNWI's has sparked widespread public interest, leading to overwhelming inquiries from overseas asset management institutions and clients. I have summarised the following FAQs to help clients navigate our complex tax landscape and to avoid pitfalls arising from misunderstanding of the PRC tax law.

FAQ 1: Are you required to report all of your foreign income?

When determining whether a Chinese individual is liable to pay PRC Individual Income Tax (the “IIT”) on foreign income, two primary factors under the PRC IIT policies must be considered. Those factors are (1) the individual's tax residency status, and (2) the scope of Foreign Income.

(1) Resident or non-resident?

When evaluating tax residency status, people often instinctively start counting the days. That is the 183-day test. Is it applicable in China? The Individual Income Tax Law of the People's Republic of China (effective January 1, 2019) has classified Chinese tax residents to two categories, domiciled individuals and non-domiciled individuals. Typically, Chinese nationals fall into the former category, while foreigners in China are considered the latter.

When evaluating PRC tax residency, the criteria should be generally considered in the following priority order: domicile and length of stay.

“Domicile” refers to more than just a physical residence. The Regulations for the Implementation of the Individual Income Tax Law of the People’s Republic of China (effective January 1, 2019) define “domicile” as habitually residing in China due to household registration (i.e., Hukou), family, and economic ties. “Habitual residence” does not imply physical residence for a specific period. For example, Mr. Li has relocated to Singapore for business purposes, while his family members continue to reside in China. Since Mr. Li intends to return to China in two years, it remains his habitual residence. Consequently, Mr. Li is considered a Chinese tax resident and is subject to PRC IIT on his worldwide income.

If the individual does not have a domicile in China, then next criterion is 183-day test. That said, we must then count the number of days this individual has stayed in the Chinese mainland. If the stay exceeds 183 days within a calendar year, the individual is considered a PRC tax resident.

A more complex scenario arises when a Chinese entrepreneur no longer qualifies as a PRC tax resident due to business and family arrangements. Does that mean this non-PRC resident is exempt from all Chinese taxes? Not necessarily. For instance, if a non-PRC resident individual transfers properties which are located in China, such transferor would be subject to PRC IIT even if sales proceeds are received outside China.

(2) Foreign Income: taxable or not?

In principle, Chinese tax residents must declare and pay PRC IIT on their worldwide income. However, the challenging issue is how the tax authority can identify an individual’s foreign income if the individual fails to report it. The situation has evolved with the implementation of the Common Reporting Standard (CRS) in China since 2018. Interestingly, the CRS has led to a misconception among some people who believe that the exchange of financial information under the CRS creates new tax liabilities for PRC residents.

As mentioned at the beginning of the paragraph, in addition to determining tax residency, we need to identify whether the foreign income falls within the scope of taxable foreign income. The Announcement of the Ministry of Finance and the State Administration of Taxation on Individual Income Tax Policies on Overseas Income (Announcement No. 3 [2020]) lists nine types of ‘foreign income,’ including income from labour services rendered outside China, dividends from overseas enterprises, and income from the transfer of overseas real estate or equity interests. Additionally, it is worth noting that determining whether an income is classified as foreign income requires thorough analysis. Under certain circumstances, some income which is received outside China may be considered China-source income instead of foreign income.

FAQ 2: Foreign Income is not under the individual’s account: taxable or not?

HNWIs often hold overseas assets through offshore vehicles such as BVI companies. Some may retain income in the BVI instead of distributing it to individual shareholders to avoid Individual Income Tax (IIT). Does this approach work? Before 2019, it might have been effective. However, the new PRC IIT Law introduced in 2019 includes anti-avoidance provisions.

For example, Mr. Wang, a PRC tax resident, sets up a red-chip structure to list his company on NASDAQ. He holds the underlying companies through a holding company in the BVI, with cash sitting in the BVI company’s bank account. According to the IIT Law, the Controlled Foreign Company (CFC) Rule would apply. This means the PRC tax authority has the power to claim IIT from Mr. Wang if the BVI company fails to distribute dividends to him without justifiable reasons.

FAQ 3: Change your passport: no longer need to report?

Self-assessment: am I no longer a PRC tax resident?

Clients often ask if a foreign passport or green card could exempt them from declaring as a PRC tax resident. For instance, if an individual only obtains a passport from an island country like St. Kitts, this individual is likely still a PRC tax resident.

Here is a more complex situation. Chinese HNWIs shows a continued interests in applying for a Hong Kong identity card or an Employment Pass (EP) in Singapore. Here is a frequently asked inquiry. Mr. Wang holds a Hong Kong identity card. Is Mr. Wang a Hong Kong resident for tax purpose? Individuals who (i) ordinarily reside in Hong Kong SAR or (ii) stay in Hong Kong SAR for more than 180 days during a year of assessment or for more than 300 days in two consecutive years of assessment are generally considered as Hong Kong tax residents. According to detailed interpretations which have been published by Inland Revenue Department in Hong Kong, an individual is a Hong Kong tax resident if they ordinarily reside in Hong Kong or stay in Hong Kong for more than 180 days in a tax year or more than 300 days over two consecutive tax years. If Mr. Wang needs to manage his companies in Shanghai, it is essential to consider whether he is qualified as a tax resident in Hong Kong.

How to avoid double taxation if an individual is considered as a tax resident in both tax jurisdiction?

Consider Mr. Li from FAQ 1. If Mr. Li is deemed a tax resident in both China and Singapore, dual tax residency occurs. To eliminate double taxation, we must determine his tax residency status according to the Agreement between China and Singapore for the Avoidance of Double Taxation (the "DTA"). This involves identifying which tax jurisdiction has the primary right to tax the individual, using the tie-breaker rules.

Under the tie-breaker rules, the following factors are considered in priority order: permanent home, centre of vital interests, habitual residence and nationality. If these criteria do not resolve the issue, the competent authorities of both countries will negotiate to determine Mr. Li's tax residency.

FAQ 4: Offshore family trusts: making personal foreign income invisible?

According to CRS guidelines, if a financial account is identified as a Reportable Account, the information will be exchanged with the home tax authority. In offshore family trust structures, whether a bank account is reportable depends on the roles of the individuals involved and the nature of the trust. Typically, a settlor's financial account is reportable. What about accounts of beneficiaries or protectors? It depends.

If an individual's financial account information is exchanged to China, it is essential to examine the nature to determine whether those incomes are taxable in China. How do we conduct such an evaluation? We assist clients by reviewing the trust structure and the detailed clauses of the trust deed, such as whether the trust is revocable and the distribution arrangements. This aspect should be analysed on a case-by-case basis, as it involves specific details unique to each trust.

Observations and Takeaways

Tax compliance is fundamental: with the global initiative of tax transparency, it is crucial for taxpayers should make tax filing promptly and accurately.

Clarify the scope of taxable income: It is essential to identify which types of income are taxable. To avoid misunderstanding and panic.

Avoid Copycat approach: tax residency status would not be changed if you simply obtain a foreign passport or PR. In some cases, this would lead to dual tax residency. The tie-breaker rule should be applied to eliminate double taxation.

Case-by-Case Diagnosis and Proactive Planning: the management of foreign income for Chinese tax residents is not new. Taxpayers should stay informed about domestic and international tax policy developments and plan proactively. Avoid one-size-fits-all solutions to prevent potential pitfalls.

Author: Joanna Jiang

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Contact us



Joanna Jiang

Partner - Wei Tu Law Firm*

T: +86 21 63355503

E: joanna.jiang@shlegalworld.com



Kevin Lee

Partner, head of private wealth

(Great China), Stephenson Harwood

T: +852 2533 2843

E: Kevin.Lee@shlegal.com

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