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INDIVIDUAL INCOME TAX REFORM IN CHINA: AN EVALUATION THROUGH A NEW ZEALAND LENS

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Abstract

The People's Republic of China's (China's) recent reform of their individual income tax is amongst the most significant reforms for the country in decades. Not only have tax rates altered, with a number of new deductions introduced, but also the tests for residency determination will potentially 'capture' many foreigners working in the country. The analysis of these changes from various commentators, legal and accounting firms, and other organisations, is extensive and informative. Collectively these highlight overall that this recent reform brings China closer to international norms. Indeed, it is arguable that this move towards 'law-based' governance is a step towards recognition of the rule of law in China.

Rather than traverse well-trodden ground, the intention of this paper is to examine these changes through the lens of the New Zealand (NZ) (individual) tax system. New Zealand's taxation of individuals is simple, efficient, and effective in raising revenue. New Zealand's tax system integrates closely with social policy and income support for taxpayers, an important factor in the Business Transformation Programme (BTP). New Zealand and China have a close economic relationship, reflected in part in the Free Trade Agreement (FTA).[1] The author, who is reasonably acquainted with main principles of the Chinese tax system, is able to offer an outsider's perspective through a comparative evaluation of China's recent reforms with NZ's current approach to individual income taxation.

Key words: China, individual income tax, New Zealand, residency

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1 Free Trade Agreement between the Government of New Zealand and the Government of the People's Republic of China (2008).

1. Introduction

The People's Republic of China's (China's) recent reform of individual income tax is amongst the most significant reforms for the country in decades.[2] Not only have tax rates altered, with a number of new deductions introduced, but also the tests for residency determination will potentially 'capture' many foreigners working in the country. The analysis of these changes from various commentators, legal and accounting firms, and other organisations, is extensive and informative. Collectively these highlight overall that this reform brings China closer to international norms. Indeed, it is arguable that this move towards 'law-based' governance is a step in the direction of recognition of the rule of law in China.

Rather than traverse well-trodden ground, the intention of this paper is to examine these changes through the lens of the New Zealand (NZ) (individual) tax system. New Zealand's taxation of individuals is simple, efficient, and effective in raising revenue. New Zealand's approach to tax policy is regarded internationally to be world leading.[3] In addition, NZ's tax system integrates closely with social policy and income support for taxpayers, an important factor in the Business Transformation Programme (BTP). The BTP is the largest IT project in NZ history, with an expected spend of $NZ1.6 billion ($US1.1 billion). Importantly, the BTP is having a significant impact on tax administration and Inland Revenue's (IR's) engagement with taxpayers.[4] The BTP has four key stages:

(1) Enabling secure digital platforms;

(2) Streamlining all tax types;

(3) Streamlining social policy; and

(4) Completing a new tax administration system.

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[2] These reforms are known as the seventh revision of the *Individual Income Tax Law of the People's Republic of China*, as approved at the 5th Session of the Standing Committee of the 13th National People's Congress on 31 August 2018. They were effective from 1 January 2019.

[3] See for example, Adrian Sawyer, "Reviewing Tax Policy Development in New Zealand: Lessons from a delicate balancing of 'Law and Politics'" (2013) 28(2) *Australian Tax Forum*, 401-425.

[4] For further details on the BTP, see https://www.classic.ird.govt.nz/transformation/bt-programme/bt-programme-section-contents.html.

[5] See n 1 above.

Chinese tax system, is able to offer an outsider's perspective through a comparative evaluation of China's recent reforms with NZ's current approach to individual income taxation.

The perspective taken in this paper is normative, with the intention being to offer suggestions for possible further reform of the individual income tax in China. The paper takes a policy perspective, drawing upon documentary analysis of various scholars and international firms that offer insights in English of the recent reforms in China. These are supplemented by the observations of the author who has engaged with academics and members of the State Administration of Taxation (SAT) in China.[6] Importantly, the paper does not attempt to analyse legislation and regulations in detail, and as a consequence does not utilise blackletter law analysis techniques.

The paper adopts an in-depth exploratory case study approach, whereby it compares China's recent individual income tax reform with the approach to taxing the income of individuals in NZ. It is common to see criticism of case studies as a research method, with some viewing the method to be a non-scientific approach to undertaking research. Notwithstanding this view, case study research is utilised extensively in academic enquiry in traditional social science disciplines as well as practice-oriented fields. When adopting a comparative case study approach, the design and analysis considerations are of prime importance, more so often than the description of events or the scenario under review. As Yin states,[7] the need for a case study arises out of the desire to understand complex social phenomena and allows investigators to retain the holistic and meaningful characteristics of real-life events.

The research question this paper seeks to answer is: *What can China learn from NZ's experience with individual income tax reform?* As noted above, this necessitates a comparative case study analysis.

The remainder of this paper is organised as follows. Section 2 provides an overview of, with some commentary on, the 2018 changes to the individual income tax that took effect in 2019 in China. This is followed in section 3 by a brief overview of income taxation of individuals in NZ. Section 4 offers some insights through a NZ lens of the reforms in China, with section 5 setting out the concluding observations.

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6 See further http://www.gov.cn/english/2005-10/09/content_75307.htm.

7 Robert K Yin, *Case Study Research and Applications: Design and Methods,* (Sage Publications, 6th ed. 2017).

2. Background – major reforms to China's individual income tax

Until the recent reform in China, the individual income tax has contributed a very small portion of total tax revenues (around 6-7 percent). In many developed countries, this figure is around 30-50 percent (in NZ it is around 49 percent in the 2018-19 income year[8]). Indeed, in effect there was no individual income tax system in China before 1980. With the first individual income tax, a few areas were included as part of a schedular system. China's early experience with individual income tax effectively exempted domestic, working class and sole traders from liability.[9] Only high income noncitizens and those from China's special administrative regions or territories (Hong Kong, Macao and Taiwan) were subject to the tax. Indeed, following reforms made in 1986, an extremely high marginal tax rate of 84 percent applied.

Further reforms in 1994 simplified the progressive structure, introduced a monthly taxable income threshold of 800RMB, along with a schedular system to tax ordinary salary income separately to other forms of income earned by individuals. Few countries continue to employ a schedular system to separate salaries from other types of income. The monthly tax threshold was subsequently increased to 1,600RMB in 2005, 2,000RMB in 2008 and 3,500RMB in 2011. The individual income tax and property taxes combined by 2015 had risen to 11.7 percent of China's total tax revenue.[10] While a significant increase, this was well below international benchmarks.

Furthermore, the tax structure violated vertical and horizontal equity principles, with the monthly tax threshold only applying to salary income. Higher income earners had a disproportionately high benefit of exemptions and received favourable tax treatment. Pressure from both outside and within China to create something closer to a consolidated tax base that includes all forms of individual income would come to bear upon China, and is reflected in part in the 2018 reform.

In comparison to Western norms, issues such as indexing of thresholds at which rates apply (either by some measure of inflation, or regular adjustments), would assist in improving equity in China. To further improve equity, itemization of deductions would simplify the process of

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8 See IR, *Multinational Enterprises Compliance Focus 2019* (November 2019) at 2.

9 This discussion draws upon Yue "Daisy" Dai, "China's 2018 Individual Income Tax Reform: A Global Perspective" (2019) *Tax Notes International* (May 27) 849. It also incorporates the excellent \work of Jingyi Wang and Wilson Chow, "Individual Income Taxation Reform in China: What is the Real Change?" (2019) 14(2) *Journal of Comparative Law*, forthcoming.

10 See Dai, above n 9.

determining tax liability and make them available against a wider range of income sources. However, a major issue is the extent to which these deductions or allowances should vary based upon provincial differences in wealth and income throughout China. A reduced burden for those on lower incomes would be a vital area of improvement.

To further protect the tax base, China needed to enact a form of general anti-avoidance rule (GAAR) to ensure the rich pay their fair share and to capture types of income that are not listed in the schedules.[11] In this regard China is moving closer to international norms in seeking to protect and expand its income tax base.

So what happened in 2018 that led to major reform occurring from the commencement of 2019? The 2018 reform[12] sought to reduce the tax burden on working people and increase redistribution through raising the threshold at which individual income tax is payable, aggregating income of a similar nature on a consolidated basis, and introducing new itemised deductions. Supporting documentation needs to be maintained, increasing the compliance costs of taxpayers. In addition, rules that are inconsistent with international practices were revised, loopholes closed and measures to enhance the integrity of the tax base introduced. Specifically, the reforms:[13]

1. reduce the tax burden of working class and to deepen reform of the income distribution system;

2. change the basis upon which individual income taxpayers and their employers, account for, or withhold, the individual income tax;

3. shift more burden of responsibilities to the taxpayers through individual income tax self-declaration and clarify the accountability of withholding agents; and

4. align the related rules with international practices so as to protect the integrity of the tax base.

The timeline of events were as follows:[14]

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11 See Dai, above n 9.
12 See n 2 above.
13 The following discussion draws upon Rosanna Choi, *Key issues concerning China's individual income tax reform* (29 January 2019) CW CPA (China).
14 See n 13 above.

- **August 31, 2018**: China's National People's Congress published the Amendment to the China Individual Income Tax Law, which went into effect on January 1, 2019;
- **December 22, 2018**: The Ministry of Finance State Administration of Taxation (MOF SAT) published the Final Implementation Rules of the China Individual Income Tax Law Reform and the Practice Guidance of Additional Special Deduction;
- **March 14, 2019**: MOF SAT published its Announcement on the Criteria for Determining the Residence Time of Individuals without Residence in China; and
- **March 16, 2019**: The MOF SAT issued its Response to Reporters' Questions Over the 183-day Criteria over the Tax Resident Determination for Individual Income Tax.

Rules for determining residency/non-residency of taxpayers were aligned more closely with China's double tax agreements (DTAs) and international practice. The hurdle to becoming a resident of China for tax purposes was lowered, with concessions retained for expatriates working in China. Specifically the new law and implementing rules impose tax filing obligations on the worldwide income of foreigners (which includes Hong Kong, Macau, and Taiwan residents, for tax purposes) if their physical presence in Mainland China reaches or exceeds 183 days in a calendar year for six consecutive years. This is a much lower threshold for tax residency than was in place before the reforms. More discussion on this reform follows shortly.

Tables 1 to 3 sets out a comparison of the income categories and rates between the pre- and post-2018 reforms. Table 4 sets out the new itemised deductions, while Figures 1 and 2 set out how to determine residency under the new rules:

Table 1: Major changes in taxation of categories of income.[15]

Current IIT Law		IIT Reform Proposals	
Category	**Tax Rates**	**Category**	**Tax Rates**
Wages and salaries	3% - 45% (7 progressive bands)	Comprehensive income	3% - 45% (7 progressive bands)
Service incomes	20% - 40% (3 progressive bands)		
Authors remuneration	20%		
Royalties	20%		
Income from production and business operations	5% - 35% (5 progressive bands)	Business operations income	5% - 35% (5 progressive bands)
Income from contractual or leasing operation by enterprises	5% - 35% (5 progressive bands)		
Interests and dividends	20%	Interest and dividends	20%
Income from lease / transfer of property	20%	Income from lease / transfer of property	20%
Contigent incomes	20%	Contigent incomes	20%

15 Source: https://www.hrone.com/chinas-new-individual-income-iit-tax-reform-2018/. The column "IIT Reform Proposals" reflects the recent amendments with effect from 1 January 2019.

Table 2: Changes in individual income tax rates and thresholds[16]

INDIVIDUAL INCOME TAX (IIT) COMPREHENSIVE INCOME

	Current IIT Law		IIT Reform Proposals	
Bracket	Monthly Taxable Income (RMB)	Tax Rate	Monthly Taxable Income (RMB)	Tax Rate
1	0 - 1,500	3%	0 - 3,000	3%
2	1,501 – 4,500	10%	3,001 – 12,000	10%
3	4,501 – 9,000	20%	12,001 – 25,000	20%
4	9,001 – 35,000	25%	25,001 – 35,000	25%
5	35,001 – 55,000	30%	35,001 – 55,000	30%
6	55,001 – 80,000	35%	55,001 – 80,000	35%
7	Over 80,000	45%	Over 80,000	45%

16 Source: https://www.hrone.com/chinas-new-individual-income-iit-tax-reform-2018/. The column "IIT Reform Proposals" reflects the recent amendments with effect from 1 January 2019.

Table 3: Taxation of business operation income[17]

INDIVIDUAL INCOME TAX (IIT) BUSINESS INCOME

	Current IIT Law		IIT Reform Proposals	
Bracket	Annual Taxable Income (RMB)	Tax Rate	Annual Taxable Income (RMB)	Tax Rate
1	0 - 15,000	5%	0 – 30,000	5%
2	15,001 – 30,000	10%	30001 – 90,000	10%
3	30,001 – 60,000	20%	90001 – 300,000	20%
4	60,001 – 100,000	30%	300001 – 500,000	30%
5	Over 100,000	35%	Over 500,000	35%

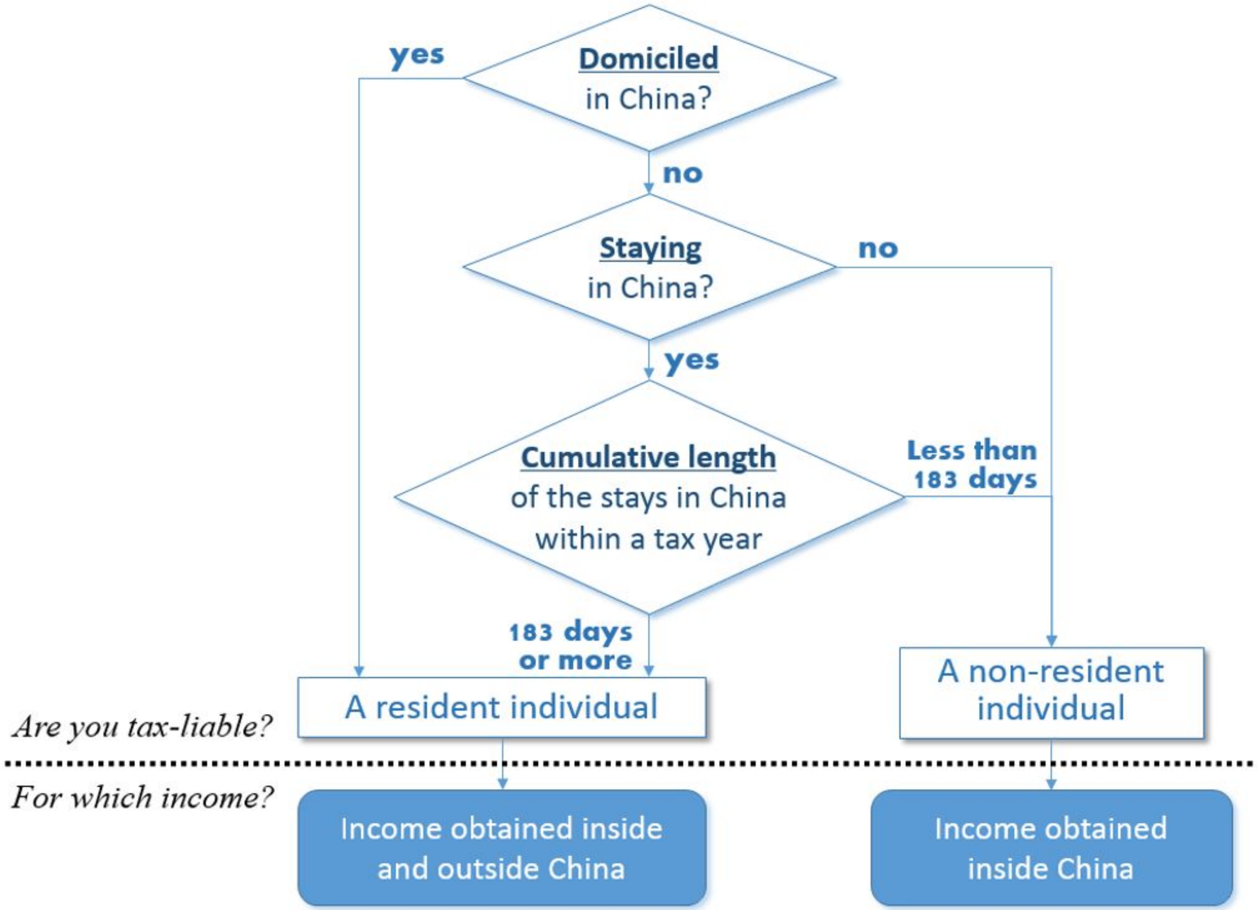
[17] Source: https://www.hrone.com/chinas-new-individual-income-iit-tax-reform-2018/. The column "IIT Reform Proposals" reflects the recent amendments with effect from 1 January 2019.

Table 4: Itemised Deductions[18]

Item	Key qualifying conditions		Capping limit		Who can claim?
			Yearly (RMB)	Monthly (RMB)	
Children's education	Pre-school	Three years onwards	12,000	1,000	Each parent – 50% Or 100% to either parent
	Compulsory education	Primary & middle school			
	Intermediate education	High school, Vocational school			
	Higher education	Degree, Masters, Doctorate			
Further education	Formal education	As per above levels of education	4,800	400	Individual taxpayers
	Professional education	Technical/professional certificates	3,600	/	
Serious illness medical fees	Medical expenses > RMB 15,000		60,000	/	Individual taxpayers
Mortgage interest	Limited to first property only		12,000	1,000	If jointly owned, either husband or wife to claim
Housing rental	Not owning property in place of work	Big cities	14,000	1,200	If joint rental, either husband or wife to claim
		Mid-size (population) > 1 million	12,000	1,000	
		Smaller (population) > 1 million	9,600	800	
Supporting elderly	60 years or older parents or other obligations by law	Single child	24,000	2,000	Split between siblings; maximum claim is 1,000 per month for any person
		Not single child	12,000	1,000	

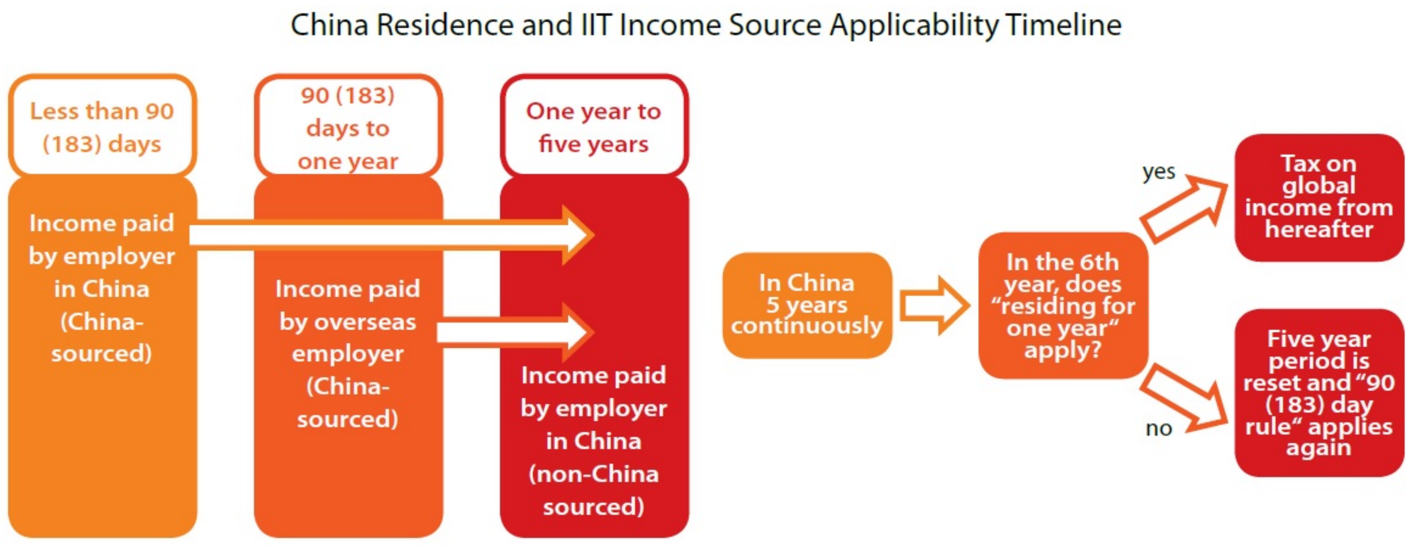
18 Michelle Zhou, Jason Jiang, Murray Sarelius and Sheila Zhang, "One giant step forward in Chinese IIT reform" (2018) International Tax Review (10 December), available at: https://www.internationaltaxreview.com/article/b1f7n2cpdjz436/one-giant-step-forward-in-chinese-iit-reform.

Figure 1: Determining residency in China[19]



[19] Source: https://www.kneppelhout.com/news/are-you-tax-liable-pursuant-to-the-new-china-individual-income-tax-law.

Figure 2: Residency and the 5 year rule[20]



[20] Source: https://www.dezshira.com/library/infographic/china-residence-individual-income-tax-iit-income-source-applicability-timeline-710.html.

As can be seen in the tables and figures above, there has been a reduction in the tax burden on the low and middle income taxpayers through an increase in the level of the lower thresholds. A degree of consolidation of several types of individual income has simplified the process to a limited degree. Nevertheless, there remains inequities with the absence of a complete comprehensive basis of income for individuals (the source of the income still remains a factor), along with individuals earning business income. The range of itemised deductions has increased, reflecting that the tax system is used directly as a form of welfare distribution, adding to the complexity of determining tax liability via self-assessment. The obligations on employers have also increased, increasing overall compliance costs for taxpayers and administration costs for the tax authority. Residency requirements have also been strengthened in part, especially for expatriates needing to ensure they are away for at least 90 days in aggregate a six year period.

Of particular importance going forward is how the rules are rolled out, administered and enforced. More guidance from the officials will be needed. For example, affected individuals will no doubt evaluate their options and perhaps restructure their employment arrangements in China. To avoid becoming subject to Chinese income tax, foreigners residing in China could plan to travel outside of China for a period of more than 30 consecutive days in a calendar year at least once every successive sixth year period. They would need to ensure that this period of absence does not straddle their 30-plus-day absence over two calendar years. If there is any doubt, then the relevant DTA will need to be consulted, as this may vary the standard rules that come with the new reforms. Many jurisdictions will be seeking to renegotiate their DTAs with China where the provisions of the current DTA differ to those in the new reforms.[21]

A significant consequence of the changes is the new accumulative individual income tax. Employers will be required to withhold each resident taxpayer employee's taxes based on the cumulative income the employee has received from the employer during the current tax year.[22] Thus, an employee's after-tax monthly salary and wages might decrease over the course of the year as the employee's cumulative annual income increases over time, triggering higher applicable tax rates from one month to the next. This differs to most jurisdictions that apply an accumulative withholding (such as PAYE), which assumes income is earned evenly for the

21 New Zealand recently renegotiated its 1986 DTA with China – the new DTA, which was signed on 1 April 2019, is expected to come into effect in 2020.

22 For further discussion, see Baker McKenzie FenXun, *China releases new rules for its IIT reform* (February 2019) at 5-6.

whole year, leading to relatively consistent net payments each period. The situation is made even worse if an employee changes their employer during the year, with deductions based on what the employee has earned from when they commence their employment with their new employer.

Notwithstanding these changes, China has arguably the shortest tax code in the world at some four pages (printed in Chinese).[23] To fill the gap, China relies upon administration declarations and regulations. While size is not the crucial issue, it is vital that the law is thorough enough to deliver the intended policy, supported by comprehensive and robust regulations that are consistently applied. This process is particularly challenging in China in that the regulations adopt obscure administrative terminology, developed under an environment of relative secrecy. The most recent development would see considerable change in policy development and dissemination. This view is furthered supported by China adopting many of the international tax norms developed by the OECD. As Dai concludes:[24]

> "By learning from the western norm, China is reinstating the equity principle to preserve the tax base and redistribute wealth, reducing artificial distinctions to clarify uncertainties, and introducing anti-avoidance principles to improve tax morale. Moreover, *China is catching up with global tax reform movements by enhancing tax democracy, making tax digital, and enforcing global information exchange programs*."

Likewise, Wang and Chow conclude their comparative analysis of the individual income in China with that of the Special Administrative Region of Hong Kong (HKSAR), as follows:[25]

> "The 2018 amendments to IIT law in China have resulted in major changes and have been regarded as a most significant reform. …
>
> The analysis above shows that the form of organization to which an individual chooses to provide services will have an impact on which tax treatment applies. Such an arrangement is being manipulated and must be guarded against or else aggressive tax avoidance tools observed in more advanced taxations such as Hong Kong and the UK will likely emerge in China sooner rather than later. …

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23 See Dai, above n 9, at 856.
24 Dai, above n 9, at 852 (emphasis added).
25 Wang and Chow, above n 9, at 17-18 (emphasis added).

> *The compliance burden on employers, as withholding agents, has also become heavier. Similarly, the cost and the complexity of tax administration has risen notably*.
>
> The above analysis shows that the *latest IIT reform in China fails properly to satisfy any of the four canons of taxation: equality, certainty, convenience, and economy*; neither is it fit for its purpose. …
>
> As a result, it appears that experience and some of the practices in Hong Kong, such as personal assessment, self-reporting, AFAL [Assess First, Audit Later], and provisional tax may provide useful references to China. In addition, the UK design of diminishing personal allowances as the individual income increases may enhance the redistribution effect. *These are all useful aspects to consider further in sketching out possible future IIT reform directions in China*."

It is very early in terms of the operation of the new law (less than 12 months) making it too early to assess their full impact. That said some general observations can be made, including an assessment through a jurisdiction that has undertaken major reform of its individual income tax over the last thirty years. The jurisdiction selected is NZ. It is first important to set out an overview of how NZ got to its current approach to taxing individuals. This is the subject of the next section of the paper.

3. An overview of individual income tax in New Zealand

New Zealand is internationally recognised for having a relatively simple tax system with respect to the taxation of individuals. This is relatively unusual for a developed country. The key features of NZ's tax system with respect to individuals include:

- no inheritance tax;
- no general capital gains tax, although it can apply to some specific investments;
- no local or state taxes, apart from property rates levied by local councils and authorities;
- no payroll tax;
- no social security tax; and

- no healthcare tax, apart from a very low levy for NZ's Accident Compensation injury insurance scheme (ACC).

The absence of such taxes on the one hand facilitates a relatively simple and efficient tax system. Conversely it does not support comprehensive equity, in that taxpayers who increase their wealth through untaxed means, such as capital gains, are at an advantage, over those that earn income from sources that are fully taxed (such as wages and salaries). Wealth inequality continues to increase in NZ through the absence of wealth taxation.[26]

The basic approach to taxation in NZ is through the use of a framework developed and implemented in the mid-1980s, namely the Board Base Low Rate (BBLR) framework, intended to operate as a coherent structure for refinement of the tax system.[27] To provide some background, before the mid-1980s in NZ, the tax system had narrow bases and high rates. It was full of exemptions and credits. It was inefficient, was unable to raise sufficient revenue and NZ was close to being bankrupt. The incoming Labour Government of the mid-1980s introduced the BBLR as part of its radical reform of the tax system. The idea was to broaden the tax base to allow for a much lower and consistently applied top tax rate to apply (top personal rate reduced from 60 percent to 33 percent). This was achieved by removing tax exemptions, introducing a broad-based goods and services tax (GST),[28] introduction of dividend imputation, and other major changes.

New Zealand collects the bulk of revenue from three broad bases – personal income, company income and consumption. The base could be broader as it does not include a specific capital gains tax, or any other form of wealth taxes (as noted earlier).

The positives of the BBLR model can be described briefly as:

- The model is a simple, understandable and coherent framework;

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26 Income inequality in NZ rose from the mid-1980s through early 1990s but has been generally flat since then. The Gini score is one of many inequality measures that show roughly the same pattern. As with other countries, NZ's Gini coefficient after taxes and transfers is lower than its pre-tax Gini coefficient, providing evidence that the tax and transfer system reduces inequality. See further: https://nzinitiative.org.nz/reports-and-media/opinion/what-is-the-truth-about-income-inequality/.

27 See further on BBLR: Presentation by David Carrigan to IRD's Tax Administration Conference (2014), Wellington NZ.

28 For an evaluation of the impact of NZ's GST, see Andrew Maples and Adrian Sawyer, "The New Zealand GST and its Global Impact: 30 Years On", (2017) 23(1) *New Zealand Journal of Taxation Law and Policy*, 9-26.

- It means that all areas of economy are taxed reasonably consistently;
- It generally reduces economic distortions;
- The key bits of it are understood by public; and
- Simplicity and coherence makes it durable.

The negatives of the BBLR model can be described briefly as:

- The most efficient revenue tax would apply different tax rates depending on elasticities – BBLR does not do this;
- BBLR does not correct for positive and negative externalities; and
- It may not include sufficient levels of progressivity to reflect desired levels of equity

That said, the BBLR is theoretically not a first-best model, but in practice it is considered to an acceptable way of structuring a tax system, based on the desired policy outcomes. It implicitly recognises that the wider welfare and transfer system can handle most of the inequities in the tax system. This model applies largely unchanged in 2019 since its inception, although recent attempts to broaden the base have in the main failed to progress (including the recent proposal for a capital gains tax which the NZ Government rejected earlier in 2019).[29]

For individuals, taxation depends upon whether their income is taxed at source (such as wages, salaries, interest and dividends) or whether they have income not taxed at source (such as self-employed income, overseas income, and business income). For the former, there is no requirement to file a tax return; such taxpayer can check through their MyIR whether they are due a refund or have tax to pay. MyIR is IR's secure online services facility which can also be used by a taxpayer to check their student loan (if they have one); check their Working for Families Tax Credits (if these apply); check their KiwiSaver payments; check their child support payments (if relevant); file a tax return; or to update their personal details.

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29 The Government Tax Working Group (TWG) was established in 2017 and issued its final report in February 2019. The Government responded in April 2019, rejecting the TWG's principal recommendation of a comprehensive capital gains tax. See further Tax Working Group (NZ), *Future of Tax: Final Report* (Wellington, NZ Government, 21 February 2019); available at: https://taxworkinggroup.govt.nz/resources/future-tax-final-report; and Hon Grant Robertson and Hon Stuart Nash, *Govt responds to Tax Working Group Report* (2019) Media Release (17 April), see http://taxpolicy.ird.govt.nz/news/2019-04-17-government-responds-twg-recommendations.

This process of determining an individual's income tax liability is made simpler through the absence of any deductions (other than income protection insurance premiums). With payday filing required of most employers, plus with accurate rates for taxing interest and dividends, taxpayers should have a no refunds/no tax to pay position at year end. For other individuals, an IR3 return will need to be filed (and in many instance, provisional tax paid in three instalments in advance during the year).[30]

So how did this significant change come about? New Zealand undertook what many perceived at the time to be a radical approach to simplifying the income tax requirements for individuals, primarily wage and salary earners and those whose income is taxed at source, either through imposing a withholding tax and/or Pay As You Earn (PAYE). This reform included removal of the ability for employees to claim certain types of work-related expenditure deductions from 1 April 1988. The major reasons for removal of the ability for employees to claim deductions were to increase certainty, prevent abuse, reduce workload for IR, and simplify return filing while recognising employers could reimburse employees for such expenditure. Concurrent with this change, the marginal tax rates were also reduced. Some months later in October 1989, interest and dividends became subject to a withholding tax. Furthermore, the requirement for most individual taxpayers to file annual income tax returns was abolished from 1999-2000 income year.

Individual taxpayers face progressive marginal tax rates, commencing with the first dollar of earnings (there is no tax free threshold in NZ), although rebates are used within the PAYE system to reduce effective tax rates for lower income earners. Parental tax credits, in-work tax credits and guaranteed minimum family income initiatives, serve to reduce the taxes on individuals and in some cases top up incomes (creating negative income tax).

A separate form for claiming rebates for payments made to approved charitable organisations and school donations (but not school fees) can be made by individuals, including non-filing taxpayers; the credit is worth 33 percent of qualifying expenditure. These rebates are available to all individuals that make such donations provided they have sufficient taxable income.[31] Since the 2018-19 income year, receipts can be uploaded via MyIR such that at the end of the income year, the tax credit can be confirmed and paid.

[30] For a discussion on IR3 tax returns and provisional tax, see https://www.classic.ird.govt.nz/forms-guides/keyword/individualincometax/ir3g-individual-tax-return-guide.html.

[31] See further discussion on IR's website at: https://www.ird.govt.nz/topics/income-tax/tax-credits/tax-credits-for-donations.

A critical distinction for individuals is whether they are employees (and unable to claim work-related expenses) or are self-employed. Inland Revenue provides guidance in its Interpretation Guideline 11/01,[32] which explains how the courts distinguish between contracts of service and contracts for services. Essentially a contract of service means there is an employer-employee relationship, while a contract for services means there is a principal-independent contractor relationship. In making this determination five tests need to be applied to the facts to determine whether a person is an employee or self-employed, namely: intention; control; independence; fundamental and integration.

The most recent (and important) development is IR's BTP, which over a period of 6-7 years should result in new and modern tax administration information system. At the time of writing the BTP is around two thirds complete.[33] This new system will enable earlier and more accurate determination of taxpayers that are over withheld, with IR able to make adjustments in real time and process refunds efficiently. Overall, as a result of the reforms over the last fifteen to twenty years, most individual taxpayers in NZ whose income is taxed at source, will have little to no direct interaction with IR. The process for those that will need to contact IR is being made simpler through the expansion of MyIR services, albeit with a number of significant teething issues (especially affecting those that use a tax agent).

With is overview of the NZ tax system, the paper now turns to examining the recent individual income tax reforms in China through the lens of the NZ individual tax system.

4. Reviewing China's individual income tax reform through a New Zealand lens

In a sense it is debatable whether one can make a valid comparison and offer suggestions for change when comparing the tax system of a small developed nation with an open economy (NZ), compared to the world's second largest economy represented by a centrally planned developing country (China). Nevertheless, the two countries have a close relationship when it comes to trade (China is NZ's largest trading partner), with NZ being the first developed nation

[32] Inland Revenue, *Income tax; goods and services tax - determining employment status for tax purposes (employee or independent contractor)*, (Inland Revenue, December 2011). The leading cases are: *Bryson v Three Foot Six Ltd* [2005] NZSC 34, [2005] 3 NZLR 721 (SCNZ) and *TNT Worldwide Express Ltd v Cunningham* [1993] 3 NZLR 681 (CA).

[33] For further information on the BTP, see above n 4.

to sign a free trade agreement with China.[34] The two countries have just renegotiated a new double tax agreement[35] that will replace the 1986 agreement.[36]

New Zealand is well known for operating a tax system that seeks to support the principles of simplicity and efficiency, while ensuring that equity, certainty and overall coherence are maintained and supported where necessary through the wider tax and transfer system. This is reflected in the BBLR model, in principle at least (with some significant gaps, such as the absence of any form of wealth taxation).

In terms of tests for residency, NZ adopts the OECD standard in its DTAs.[37] China's recent changes bring its residency test closer to international norms through use of the 183 days presence test for residency, along with use of the concept of the location of the permanent home and other ties. Where it differs is to maintain the five year test for expatriates to only be taxed on income with a source in China and not be subject to taxation of their worldwide income in China.

New Zealand does provide for a four year exemption for transitional residents, who can be temporarily exempt from paying tax on most types of overseas income. A transitional resident is:[38]

- a new migrant or New Zealander returning home;
- qualified as a New Zealand tax resident on or after 1 April 2006, and
- was not a tax resident at any time in the 10 years before you qualified

Such a person is automatically entitled to the exemption if they are eligible, but can only get the exemption once. The vast majority of income earned overseas is exempt from NZ income tax for this period. The exemption start date depends on how a person qualifies as a NZ tax resident:

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34 See above n 1.

35 Agreement between The Government of New Zealand and The Government of the People's Republic of China for the Elimination of Double Taxation with Respect to Taxes on Income and the Prevention of Tax Evasion and Avoidance (1 April 2019).

36 Double Taxation Relief (China) Order 1986 (SR 1986/314).

37 See further the OECD, *Model Convention on the Taxation of Income from Capital* (2017).

38 See further IR's website at: https://www.ird.govt.nz/topics/income-tax/tax-residency/temporary-tax-exemption.

- If by living in NZ for more than 183 days in any 12-month period the exemption starts on the first of those 183 days;

- If by establishing a permanent place of abode in NZ the exemption starts on the day the person establishes that place.

The exemption period ends on the earlier date of:

- 4 years after the end of the month in which the person had lived in NZ for 183 days, or

- 4 years after the end of the month the person established a permanent place of abode in NZ.

It is possible under Chinese tax law for an expatriate to remain exempt from taxation on their worldwide income in China if they are physically away for at least 90 days after being present for 5 years in China. Given the likelihood that most expatriates can be expected to have high worldwide income, China may need to look to change its approach to grant a one off exemption only for a period of time, at the potential expense of losing some expatriates. This would facilitate an increase in the portion of the tax base coming from individuals.

In terms of the individual income tax, the approach in China has moved closer to that of NZ in terms of increasing obligations on taxpayers to self-assess their liability and for employers to make the necessary deductions. That said, at this point the two systems differ significantly, with the recent amendments in China adding to the overall complexity for those taxpayers that have a tax liability. The most obvious difference is that NZ does not have a tax free threshold – taxpayers are liable to tax on their first dollar, with rebates offered through adjusting the effective tax rates for low income earners. The tax and transfer system work cooperatively to provide top ups to those families that are not at the pre-determined minimum family income levels based on the number of dependants, etc.

China maintains a system of itemised deductions, which is something NZ abandoned in the late 1980s through the lowering of tax rates and the greater reliance on complete taxation at source. With time China may wish to revisit the extent to which the tax system can be simplified through the removal of many of the deduction with tax rate adjustments to offset these changes. However, unless the tax and transfer system are working efficiently concurrently, it could prove more costly and challenging to move away from the current system that operates in China.

This is buttressed by the expectation that wealth levels between the various provinces will remain significantly different for the foreseeable future.

The rates in China are much steeper than in NZ, with not only more income brackets, but a top rate at 45 percent; well above NZ's 33 percent. Overall NZ operates a relatively flat scale, being much less progressive than the structure in China. The choice of top rate is in many respects dependent upon the extent to which vertical equity is desired, along with the extent to which wealthier taxpayers are also contributing through other taxes, such as value added tax and property taxes. New Zealand did have a rate of 39 percent since the reforms of the 1980s, but this was reduced to 33 percent in 2010. Many other jurisdictions operate with a top rate in the mid-40 percent range, so in this regard China is in good company. New Zealand's top marginal rate for individuals is low by OECD standards. The key issue in NZ is the level (threshold) at which the higher rates come in – these thresholds may need to be revisited.

One of the more significant differences is to consider that not all income earned by individuals is the same. New Zealand treats all income as income, whether it be earned as salaries or wages, or as business income by an individual. This reduces unnecessary complexity, and ensure a higher degree of equity across taxpayers. China most certainly needs to revisit its approach with a goal of condensing the current variations such that all income types earned by individuals form part of a comprehensive tax base. This will require a move away from a schedular system, which NZ undertook several decades ago. However, withholding rates for certain type of income could operate on a schedular basis, such as for specific activities undertaken by contractors (e.g. agricultural contractors, company directors, etc.).

A significant difference is that withholding in China is not based on annualising a salary or wage, for instance, but rather changing the withholding for each period after taking into account what the employer has already paid the employee for the year to date. This makes planning very difficult for taxpayers who need to put aside much of what they earn in earlier periods to offset a much lower take home pay in later periods. Regular and consistent withholding would assist with budgeting for taxpayers and the government. This necessitates good withholding information provided to the government by employers so that both are able to assess what the expected year-end tax liability will be for the employee. New Zealand's MyIR, together with payday filing, will mean most taxpayers should have no balance or refund due at year end, as employers can make necessary adjustments on an ongoing basis. China's massive investment in information technology puts it in a good position to facilitate such real time tax position determination for taxpayers. The fact that many individuals are not liable to taxation, as they earn below the threshold at which the income tax commences, reduces the enormity of this exercise to a reasonable extent.

In making this assessment of what China could examine further from a NZ perspective, the analysis is made from the perspective of an 'outsider' to the inner workings of the legal and tax system of China. Furthermore, as a Westerner, the perspective offered may differ from that of someone that is based in China and who has personal experience of the Chinese tax system. The paper now moves onto offering some concluding observations.

5. Concluding observations

Before setting out the concluding observations, it is important to acknowledge that the analysis has a number of significant limitations. First, the analysis compares only two countries, and for that matter two very different countries (one large and developing, the other small and developed). A comparison between two more similar size countries (for example, the United States and China), may lead to different observations. Furthermore, comparing two similar size developing countries (for example, comparing China with Indonesia or with India), would also lead to different observations. Nevertheless, the comparison undertaken is based principally on the relative familiarity of the author with the NZ tax system. The NZ tax system for individuals is recognised for being relatively simple and efficient, producing a large portion of the country's revenue (at around 49 percent), and enhanced through greater use of technology. In this regard, as China continues to reform its individual income taxation, NZ can serve as a useful role model for enhancing efficiency and use of technology.

Other limitations include the relative maturity of the two income tax systems, the policies and overall economic strategies of the two countries, along with the different political systems. This is somewhat mitigated through the close trading and business relationship of the two countries, including the current FTA and recently negotiated new DTA.

What can be concluded from this two country case study comparison? It is clear that both countries are working towards simplifying their systems to enhance efficiency, as well as build in greater levels of equity. China's 2018 reform represents a major step towards consolidating the taxation of individuals but with considerable scope for further development in this area. New Zealand has had a consolidated basis for several decades, moving away from a schedular basis. Both operate self-assessment systems, although NZ makes greater use of technology to support this. Compliance costs are increasing for many taxpayers in China due to the need for more record keeping and ensuing they are claiming appropriate deductions. Administrative costs for the tax authority will also be increasing. The usual approach to cumulative withholding places greater budgeting constraints on China's individual taxpayers.

The differences between the two systems are immense. China has very little in the way of actual tax legislation; rather it relies upon administration declarations and regulations. For countries that rely on the rule of law, such as NZ, this situation is troubling in that there is the potential for confusion in the roles of the legislature and executive branches of government. That said, China is demonstrating greater openness in tax policy consultation, notwithstanding that it is a single party state. New Zealand, as a democratic state, operates with a clearer distinction between the branches of government, with the judiciary charged with ensuring the rule of law is applied appropriately.

Outside of those individuals who are in business, China maintains a system of itemised deductions – something that NZ removed with the major reforms of the late 1980s. China has yet to embrace the issue of a complete consolidation of income to remove the inequities created by the schedular approach. The use of an exemptions threshold in the Chinese context makes sense as a developing country will have many taxpayers with low incomes – keeping them out of the tax system reduces compliance and administrative costs, and effectively delivers welfare support through the absence of taxation. With a much less developed welfare state, along with less sophisticated online tax platforms, it makes sense for China to deliver some of the equity adjustments directly through the tax system's itemised deductions. China is not only a large country, but has great diversity in the spread of wealth between provinces; NZ being a small country does not face the issue on such a scale.

China's goals for its tax system include moving toward international norms. This can be seen through changes in the definition of being a tax resident in China, albeit with a much more generous approach for expatriates who are seen as vital to China's continued development. New Zealand offers a one off and more limited exemption for transitional residents. With the passage of time, China will need to revisit the generous treatment of expatriates. More broadly, China's recent DTAs, including the renegotiated DTA with NZ, are much more reflective of international norms, such as in the exchange of information, determination of permanent establishments, and the like, reflecting recent OECD Base Erosion and Profit Shifting (BEPS) developments.[39]

Maintaining a close relationship through trading, education of students, and a focus on enhanced use of technology, suggest that China can continue to draw upon NZ's experiences with the taxation of individuals' incomes, along with the associated administration. The 'success' of IR's BTP will be a key component in providing both an experience and final product for analysis by China's government and tax administration.

Thus in response to the research question posed at the start of this paper, there is a great deal that China can learn from NZ's reforms of its individual income tax. Taken with their timing and context, simplification and efficiency can be enhanced through maximising withholding of tax at source, minimising deductions (for non-business taxpayers), and maximising use of technology. Economic conditions, the level of development, spread of wealth, and policy aims will dictate the extent to which reforms in a small, open and democratic country can be informative for a large, single party centrally planned developing country.

Going forward, future research is needed to assess the impact of the Chinese tax reforms in a few years' time, along with an assessment of any further reforms. Likewise, when BTP is complete in another two years or so in NZ, an assessment also needs to be undertaken of its success or otherwise. What must not be lost, however, is the enormity of the reforms for individual income tax in China in the context of the last thirty years, along with reforms in other areas of the tax system, such as the emergence if the new VAT.[40] These reforms demonstrate a move towards more 'law-based' governance which can be viewed as a step towards recognition of the rule of law in China. Time will reveal the extent and effectiveness of this development.

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39 For an overview of the administrative implications of BEPS, see Kerrie Sadiq, Adrian Sawyer, and Bronwyn McCredie, *Tax Design and Administration in a Post-BEPS World: A Study of Key Reform Measures in 18 Jurisdictions* (Fiscal Publications, Birmingham UK, 2019).

40 For an analysis of China's VAT reform, see Hao Zhong, "The choice of China's business tax to value added tax reform : the traditional VAT model or the modern GST model?", *A thesis submitted in partial fulfilment of the requirements for the degree of Master of Commerce in Accounting in the University of Canterbury* (2016).