

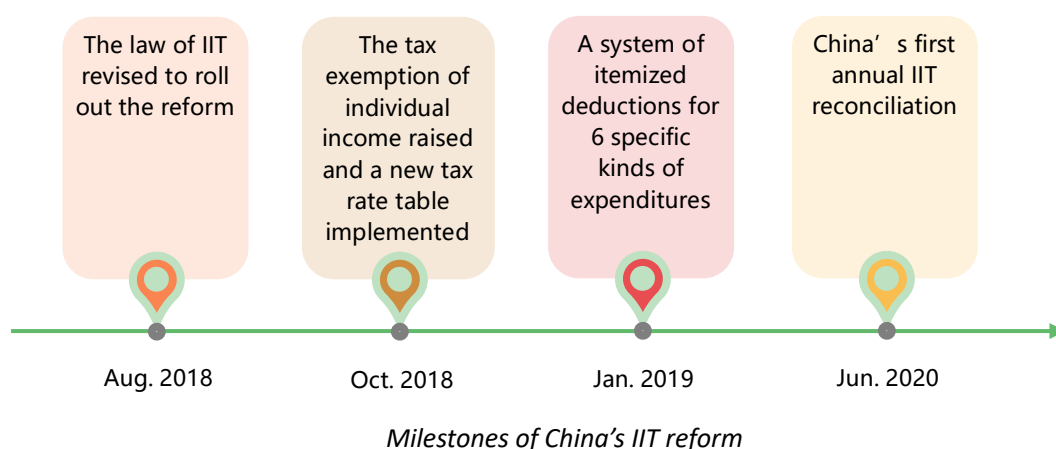
## Case Study No.1 from China

### **Individual Income Tax Reconciliation, Practice from China**

#### **Background**

Before 2018, China's Individual Income Tax (IIT) adopted a schedular tax regime, where different categories of individual income applied different expense deductions and tax rates. Back then, it was mainly the withholding agents instead of taxpayers themselves who filed IIT tax returns. However, with the development of China's economy and the increase of people's income, the drawbacks of the schedular tax system have become increasingly obvious: the tax burden among different categories of income is unbalanced. Therefore, an IIT reform to better guarantee fairness was urgently needed.

Taking into account the strengths and restrictions of its administration capacity, China's State Taxation Administration (STA) formulated an IIT reform plan borrowing experience from international best practices. A hybrid tax system that combines comprehensive and schedular regimes was implemented<sup>1</sup>, with an aim to tax different types of income proportionately. This system not only takes the taxpayer's capacity to bear the tax burden into account, but also makes it easier for the tax authority to put the IIT regular administration into place. The itemized deductions for specific expenditures are newly adopted to consider different backgrounds of taxpayers from the perspective of common and necessary family expenditures, thus can help reduce tax burdens and enhance fairness.



<sup>1</sup> In China, the comprehensive income refers to wages and salaries, labor remuneration, author's remuneration, and royalties, which are subject to China's IIT annual reconciliation.

## Main challenges

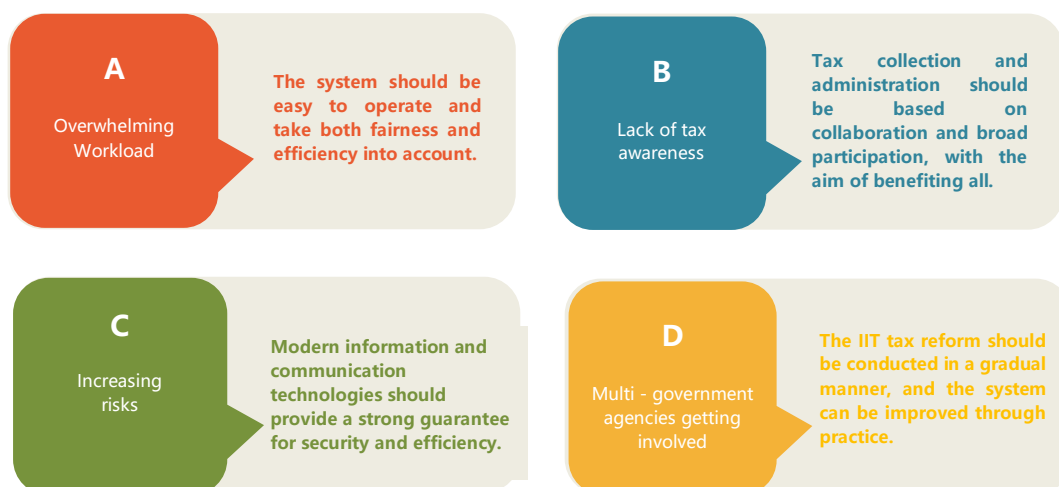
**Overwhelming Workload.** The annual IIT reconciliation requires a high degree of cooperation in terms of tax collection, tax service and tax information system. Considering China's huge population base, those systems are under enormous pressure.

**Multiple players involved.** During the reconciliation process, STA needs to collaborate with multiple players including the Ministry of Finance (MOF), banks, withholding agents and taxpayers, none of which has ever handled a large number of tax-filings and tax refunds in a very narrow time window.

**Increasing risks.** Individual income shows a trend of diversification and concealment. Disagreements on policies, administration and other issues may happen, which can lead to dissatisfaction and trigger negative public opinions. Personal information security and financial security also need to be prioritized to avoid information leakage or fraudulent tax refunds.

**Underprepared taxpayers.** Every taxpayer may have a unique situation or demand. Some of them are not familiar with the reconciliation process. These are contributing factors for a bumpy process.

## Design concepts and ideas



## **Main characteristics**

- **Scientific and well-designed tax collection and administration system**

***Accurate tax withholding and prepayment on salary and wages.*** A cumulative withholding and prepayment mechanism is applied for taxing salary and wages. Eligible taxpayers and withholding agents apply a direct deduction of RMB 60,000 per year from salary and wages while withholding or prepaying the IIT. That is to say, in the months when the cumulative income is no more than RMB 60,000, no IIT is withheld and prepaid. Only when the cumulative income exceeds RMB 60,000 and in the subsequent months of the tax year, the IIT will be withheld and prepaid. Such mechanism enables taxpayers with a single fixed-term employment to make accurate IIT prepayments and frees them from having to participate in the annual reconciliation.

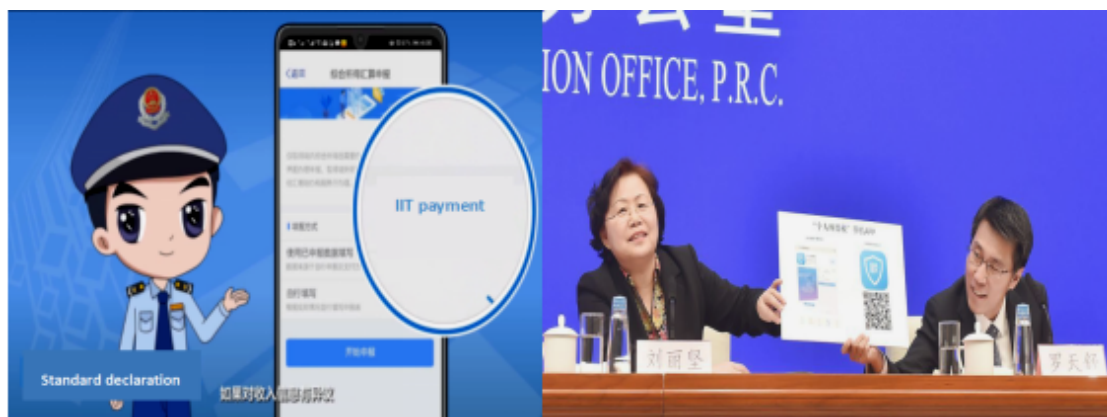
***Exemption of overdue taxes for selective taxpayers.*** Given individual taxpayers' lack of awareness and experience in handling IIT, it is necessary to reduce the risks and scale of overdue tax payment in small amount prior to the IIT annual reconciliation. Specifically, medium and low income taxpayers with an annual comprehensive income of less than RMB 120,000 or less than RMB 400 overdue taxes are exempted from paying their overdue taxes during the IIT annual reconciliation. In the past three years, this preferential policy helped reduce the number of taxpayers subject to overdue tax payment by 70%.

- **Widely used mobile internet and big data technologies**

***Robust use of mobile applications (APP).*** The number of real-name registered individuals on the Individual Income Tax APP has reached over 200 million. The APP is well-received by its users and has become an “influencer” in China’s E-government service for its user-friendly interface and practical functions. Taxpayers can process 94% of the IIT core business on their mobile phones. In 2020, contactless and self-supported tax-filing accounted for 99.22% of the IIT annual reconciliation during the COVID-19 pandemic.

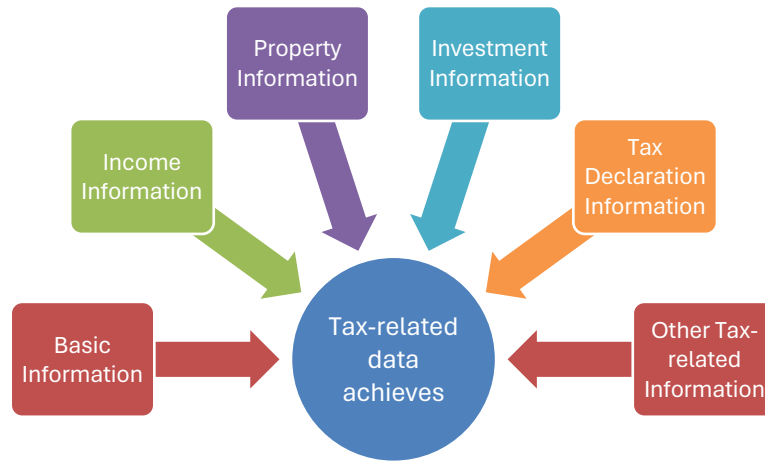
In view of the wide use of mobile phones in China, we have creatively provided taxpayers with remote tax services mainly via the IIT mobile APP together with supplemented websites. The online information channel features efficient one-to-many transmission

and interaction between tax authorities and taxpayers, saving tax service resources and reducing face-to-face interactions. Such exploration and practice has proved to be successful in the modernization of tax governance as well as China's governance system and capacity. Taxpayers can complete the filing processes for itemized deductions and the IIT annual reconciliation, pay taxes via online banking or third-party mobile payment systems, apply for tax refunds and request income tax payment details using the APP. For the majority of individuals doing their taxes on the IIT APP, the whole process takes only a cellphone and a few clicks for about 3-5 minutes.



*The new version of individual income tax APP, created by the STA of China, was launched on Dec 31, 2018.*

**“One-person tax-related data archives”**. Based on instant real-name identity authentication, the one-person data archives of hundreds of millions of individual taxpayers have been built through data sharing with multiple government agencies. The archives can integrate tax-related information from existing systems including information on taxpayers’ identity, income, property, investment and tax-filing by reference to the taxpayer identification number. This has effectively resolved the problem of repeated data collection from individual taxpayers.



*“One-person tax-related data archives”*

- **Automatic and intelligent services**

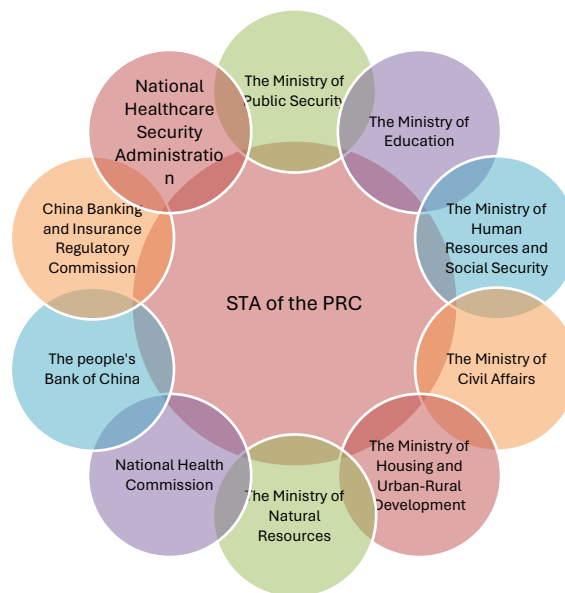
***Pre-filing service.*** Being the choice of over 100 million taxpayers, the pre-filing service is able to produce accurate pre-filing of tax returns and the calculation of taxes for a massive amount of taxpayers using tax-related big data. It has significantly streamlined the tax-filing process, taking just a few minutes for most taxpayers to go through the entire process and apply for tax refunds. Both the scale and efficiency of our pre-filing service rank high on the global table and enable our tax services to not only catch up on but also outperform those of our counterparts. During the IIT annual reconciliation of the tax years 2019, 2020 and 2021, the pre-filing service accurately supported hundreds of millions of individual taxpayers, registering an impressive user coverage of 99%.

***Efficient tax refund mechanism.*** To handle tens of millions of tax refund applications during the IIT annual reconciliation, we have digitalized the entire tax refund process to realize data auto-preview using algorithms. At the same time, we have also achieved early intervention in risk management by facilitating manual review with auto-preview based on risk analysis of tax-related big data. For these reasons, tax refund processing has proved to be more accurate and more efficient. It is estimated that the manual replacement rate of reviewing tax refund applications has reached 90%, with the efficiency and accuracy of the work significantly improved.

- **Improved efficacy via tax co-governance**

***Data sharing.*** Drawing advantages from the “1+10” inter-ministerial information

sharing mechanism, a data verification channel has been established with 10 other government agencies, including the Ministry of Public Security, the Ministry of Education, the Ministry of Human Resources and Social Security, the Ministry of Civil Affairs, the Ministry of Housing and Urban-Rural Development, the Ministry of Natural Resources, the National Health Commission, the People's Bank of China, China Banking and Insurance Regulatory Commission and the Ministry of Medical Insurance. Such mechanism has ensured the authenticity of the information submitted by taxpayers in their application for the itemized deductions, simplified the materials requested from taxpayers for applying preferential treatment, improved the convenience and accuracy of tax-filing as well as reducing risks in tax compliance.



*“1+10” inter-ministerial information sharing mechanism*

***Participation and contribution by relevant parties.*** Multiple parties including withholding agents, trade associations and volunteer groups have actively supported tax authorities in carrying out taxpayer education campaigns and helped taxpayers in their IIT annual reconciliation.

- **Effective and diversified taxpayer education**

The STA strives to communicate the “warmth” of its work through quality tax services, such as quick response to taxpayers’ demands and improved taxpayer experience. The aim is to guide and promote compliance with service. The STA has rolled out a

comprehensive service system integrating the 12366 national tax service hotline, regional (local and municipal) hotline services, interactive online platforms and the direct headquarters hotline. With the Covid-19 pandemic becoming the new normal, local tax authorities have taken the initiative to carry out taxpayer education and Q&As on-site for taxpayers in factories, schools and hospitals. Some local tax authorities also tried to engage with taxpayers using new media forms such as Tiktok and other live broadcasting tools to inform taxpayers about paying the right tax and encourage voluntary compliance.

### **Achievements**

***Enhancing the accuracy of taxation.*** Before the IIT reform, overdue taxes were obliged while tax refunds were not guaranteed, resulting in overpaid taxes. With the roll-out of the IIT annual reconciliation, taxation on individual income has become more accurate, with approximately 52% of taxpayers receiving tax refunds through year-end settlement between tax years 2019 and 2021. Meanwhile, the reform has also rid taxpayers with high one-off (monthly) incomes but low annual total incomes from unreasonable taxation. With approximately 37% of taxpayers achieving a reconciliation result of zero overdue taxes and zero tax refunds, the withholding payment regime has also proved to be more accurate.

***Ensuring fairness of the tax system.*** First, the itemized deductions for specific expenditures help reduce tax burdens for eligible individuals and families. In the first three quarters of 2019 when the reformed system was put in place, 54.63 million taxpayers were entitled to additional deductions for specific expenditures including children's education and elderly care. By taking into account of the practical elements relating to people's livelihood and applying pre-tax deductions for such necessary expenditures, the new system is conducive to reducing the cost of living and increasing horizontal equity in taxation.

Second, the current IIT system can effectively regulate income distribution and benefit the medium and low income groups. For instance, among the 11% of taxpayers obliged to pay overdue taxes in the IIT annual reconciliation (including those enjoying overdue exemption), the group with an annual income above RMB 300,000 contributes to nearly 70% of the total overdue payments. At the same time, the significantly elevated

exemption threshold of individual incomes has reduced the tax basis of tax payable, thus alleviating the tax burden for low-income individuals. To this end, equity in the tax system can be better realized.

***Improving tax service and administration.*** Following the IIT reform in 2018, dedicated bureaus have been timely established by regional tax offices with clarified responsibilities in IIT administration. Meanwhile, the efficiency and quality of IIT collection have significantly increased by strengthening communication and coordination with partner agencies including healthcare, social security, banks, etc.

***Improving voluntary compliance.*** The adoption of voluntary tax-filing with selective post-review for IIT has significantly increased taxpayers' sense of responsibility and helped raise awareness in compliance.