

Do I enjoy the tax credit benefit under China-USA income tax treaty?

Description

Recently, an American expat working in China approached me for advice about his situation where he was ordered by local tax authority to pay individual income tax that is inadvertently evaded in the past five years.

The USA expat was originally dispatched by American parent company to offer engineering support to Chinese plant. He was however paid by the parent company for his service rendered in China. In the past five years, he had obtained the work permit and residence permit in China and lived in the city over 183 days in each of past five calendar years. As his salaries were paid in USA, he had been paying USA income tax in due manners.

Local tax authority came to know his working in that company and conducted a tax audit against him and found that he had evaded China individual income tax in the past five years, which added up to more than half a million yuan.

This expat was however appalled at local tax bureau's findings and felt unfair to be ordered to make up for individual income tax in the past five years as he had paid such income tax on his earnings in the USA.

So the core question is whether his payment of USA income tax can serve as tax credit in China. Unfortunately, the answer is NO.

According to China Individual Income Tax Law and the China-USA income tax treaty, in China, tax credit refers to tax paid by a Chinese resident taxpayer in and to a foreign state in respect of income sourced outside China (in such foreign state). For example, a Chinese resident taxpayer (meaning such a person is obligated to declare worldwide income to Chinese tax authority) derives income by reason of his employment in USA, and the amount of income tax he paid in USA on such income can be used as tax credit when he files a tax return with China tax authority.

However, in the case in question, the income he derived from working in China is China sourced income, and therefore there is no tax credit issue before China tax authority. On the contrary, as he is a US resident taxpayer, he should be able to use the amount of tax he paid in China as tax credit in USA.

IMPORTANT NOTE: there are many expats working in China whose salaries are arranged as in the case discussed here, paid by the foreign company and taxed by their home countries. With China strengthening its individual income tax administration against high income earners, esp foreigners employed in China, this will pose a substantial tax risk for such expats. I expect that there will be more cases of this kind surfacing to people's attention soon.

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