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### **Management to be Mindful of Annual Bonus Pitfalls**

Looking at the year-end around the corner, management teams may already be preparing to review the yearly performance of their staff, for the purpose of recognizing their contribution and awarding year-end bonuses to them. Whilst this is always a rewarding exercise to both the employers and the employees, it is sometimes a challenging exercise to ensure that the bonus system provides proper incentives to the employees as intended.

It should be noted that some pitfalls in the current Chinese Individual Income Tax ('IIT') system may create imbalances among the staff and potentially turning the incentives into dis-incentives for some. Whilst these potential disparities may not be a general phenomenon across the board, somehow management and human resources directors should be aware of such pitfalls and try to take them into consideration during the year end evaluations.

### **Relevant Rules**

IIT is levied on employment income to individuals at progressive tax rates, which is calculated and collected on a monthly basis on employment income received in individual months. Annual bonus received would be taxed at relatively high marginal tax rates if they were calculated on this basis.

The Tax Circular Guoshuifa [2005] No 9 <<Notice Regarding the Issue of Modifying the Method for Levying of Individual Income Tax on One-Time Annual Bonuses to Individuals>> (the "Notice") issued in 2005 provided a more lenient treatment for calculating the tax on one-time annual bonuses obtained at the end of the year by employees.

Under the Notice, annual bonus is treated as stand-alone income of a month and tax is calculated separately from the monthly basic salary income. The Notice basically allowed the whole of the annual bonus, even though it is received in a particular month, to be effectively spread over the whole year (by dividing the annual bonus by 12 months,

assuming the employee has been employed for the full year), and be taxed at the applicable progressive marginal tax rate applicable to the pro-rata monthly amount of the bonus. It provides a relief to taxpayers because otherwise the annual bonus will be taxed at higher marginal rates had it been taxed as income of a particular month.

It should be noted that this special treatment under the Notice is only available to be used once a year. Any other incentives and bonuses received, even though they relate to periods longer than a month, eg quarterly or semi-annually, are calculated and taxed together with other employment income in the month of receipt.

### Implications

Nevertheless, since the tax rates are on a progressive scale but that the applicable tax rate to a particular bonus amount is applied on the whole amount of the annual bonus, there may be cases that disparities will be created in that higher before-tax bonuses may result in lower after-tax income. It should be noted that since the Notice was introduced in 2005, these disparities have existed for a few years. However, the issue has developed into a bigger issue in this year.

One reason is that the revised IIT tax rates introduced this year have somehow amplified the impacts of such pitfalls. This is because the progressive tax rate table has been simplified and that the 15% and 40% tax rate brackets have been abolished, which means that the difference in some tax rate brackets have been enlarged, which in turn result in higher impacts. The following table provides some case studies of the disparities by demonstrating that if the bonuses are higher (say by 5% in each case), the after-tax income may be considerably less.

### *RMB*

| Case  | Annual Bonus | Applicable Tax Rate | Tax Payable | After-Tax Income | Effective Tax Rate |
|-------|--------------|---------------------|-------------|------------------|--------------------|
| (I)   | 18000        | 3%                  | 540         | 17460            | 3.00%              |
|       | 18900        | 10%                 | 1845        | 17055            | 9.76%              |
| (II)  | 54000        | 10%                 | 5355        | 48645            | 9.92%              |
|       | 56700        | 20%                 | 10995       | 45705            | 19.39%             |
| (III) | 108000       | 20%                 | 21255       | 86745            | 19.68%             |
|       | 113400       | 25%                 | 27105       | 86295            | 23.90%             |
| (IV)  | 420000       | 25%                 | 103755      | 316245           | 24.70%             |
|       | 441000       | 30%                 | 124555      | 316445           | 28.24%             |
| (V)   | 660000       | 30%                 | 190255      | 469745           | 28.83%             |
|       | 693000       | 35%                 | 228805      | 464195           | 33.02%             |
| (VI)  | 960000       | 35%                 | 322255      | 637745           | 33.57%             |
|       | 1008000      | 45%                 | 431105      | 576895           | 42.77%             |

Taking the example of case (II) in our analyses above, the effective tax rate is almost doubled with just a minimal increase of the annual bonus amount. Again, in case (VI), the higher bonus amount results in much lower after-tax income because the effective tax rate is almost 10% higher.

The other reason why this issue has caught a lot of attention this year is that in July this year a notice from an unknown source aiming at rectifying the pitfalls had been widely circulated, but was quickly recognized as a falsified document because the tax authorities quickly denied its issuance. Somehow the matter attracted a lot of attention and new disgruntlement on the pitfalls, therefore company management should keep a close eye on the development of such an issue.

### Action

Bonus schemes are used to provide incentives to staff, and higher amounts of bonuses usually represent higher recognition. However, due to the effect brought about by the tax system, higher amounts of bonuses sometimes may end up in lower after-tax income. Management and Human Resource departments should be mindful of such potential implications, and avoid undesired adverse effects.

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