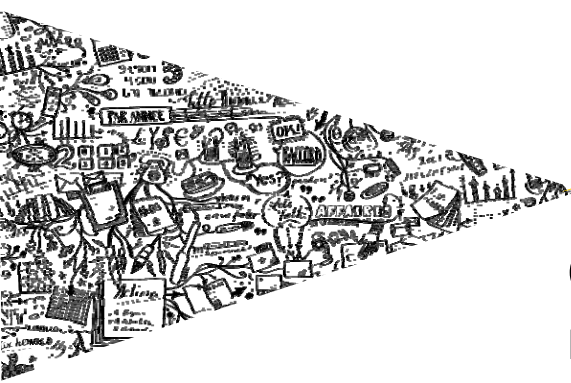


# Human resource & Tax alert



## China tax authority issues new regulation regarding the Individual Income Tax treatment on stock incentive income

### Executive summary

Further to Guoshuihan [2009] No. 461 (namely, the Notice regarding the Individual Income Tax (IIT) Treatments on Stock Incentive Income, hereinafter referred as "Circular 461"), the PRC (The term "China" is interchangeably used) State Administration of Taxation ("SAT") issued Circular [2011] No. 27 (hereinafter referred as "Circular 27") on 18 April 2011, which relaxes the criteria for the favorable IIT computation method related to stock incentive schemes prescribed in Circular 461 for publicly listed companies' subsidiaries.

### Highlights

- ▶ In case where employees of a publicly listed company' subsidiaries participate in stock incentive plans, the related IIT liabilities can be calculated based on the favorable IIT computation method mentioned in Circular 461, provided that the subsidiary's shares held by the listed company should not be less than 30% of the total equity of subsidiaries. The previous hierarchy holding limitation on tiers of subsidiaries that can enjoy this favorable IIT computation method as stipulated in Circular 461 is now relaxed.
- ▶ The words "subsidiaries are limited to two tiers in hierarchy below a listed company" bracketed in Section 1 Article 7 of Circular 461 are revoked.
- ▶ Circular 27 took effect on 1 May 2011.



## Current relevant circulars on stock incentive schemes

With intensifying market competition, more and more companies adopt equity incentives including stock options as a way to motivate their senior executives and key employees. Prior to Circular 27, China tax authorities issued a series of tax regulations regarding the IIT treatment on stock incentive income. The major five relevant tax circulars are tabulated as follows:

Circular Code	Title	Key points	Effective date
Circular Caishui[2005]No.35	The Notice regarding IIT treatments on Stock Option Income	<ul style="list-style-type: none"> <li>▶ Provides specific guidelines on the determination of stock option income and the relevant taxation</li> <li>▶ Specifies the calculation method for relevant IIT payable</li> <li>▶ Stipulates relevant collection and administration requirements (i.e., withholding obligation, self-reporting and documentation requirements)</li> </ul>	1 July 2005
Circular Guoshuihan[2006]No.902	The Supplementary Notice for IIT treatments on Stock Option Income	<ul style="list-style-type: none"> <li>▶ Extends the calculation method provided in Circular 35 to stock appreciation rights (SAR)</li> <li>▶ Further clarifies the calculation method provided in Circular 35</li> <li>▶ Clarifies the IIT treatment on stock options granted to employees of publicly listed companies</li> <li>▶ Provides the consolidated calculation method applies where an employee received multiple accounts of stock option income within one calendar year</li> </ul>	1 July 2005
Circular Caishui[2009]No.5	The Notice regarding IIT treatment on SAR and Restricted Shares (RS)	<ul style="list-style-type: none"> <li>▶ SAR and RS gains would be able to enjoy the preferential tax calculation method set out in Circular 35 and Circular 902</li> <li>▶ Definition of SAR and RS</li> <li>▶ Documentation /reporting requirements</li> </ul>	7 January 2009
Caishui[2009]No.40	The Notice regarding IIT treatment on Stock Option Gains Derived by Senior Executives of Listed Companies	<ul style="list-style-type: none"> <li>▶ Applies to stock option gains derived by directors, supervisors or senior managers of listed companies</li> <li>▶ The calculation of relevant IIT payable refers to related rules set out in Circular 35 and Circular 902</li> <li>▶ Provides a possibility for tax payment in installments</li> </ul>	4 May 2009
Guoshuihan[2009]No.461	The Notice regarding the IIT treatment on Stock Incentive Income	<ul style="list-style-type: none"> <li>▶ Determination of the category and tax calculation method for income derived from equity incentive schemes</li> <li>▶ Determination of the taxable income of SAR and RS</li> <li>▶ Timing of taxation</li> <li>▶ Documentation requirements for tax registration</li> </ul>	24 August 2009

## Types of stock incentive schemes and the relevant IIT administrative requirements

So far, the circulars issued by China tax authorities generally recognize three different types of stock incentive schemes, i.e., stock options, RSs and SARs. The respective tax administration requirements are summarized below for your reference:

Key Types of stock incentive schemes			Relevant IIT administrative requirement	
			Timing of taxation	Documentation requirements
Equity-based schemes	Stock options	Listed companies grant employees (including subsidiaries' employees) a right to purchase a specific quantity of the listed companies' stocks at a prescribed price in the future	Upon exercise (categorized as "wages and salary")	Companies that offer stock option plans shall submit relevant documents to in-charge tax authorities prior to the implementation of the plan, including: stock option plans, agreements and grant notice. While prior to exercising date, the following documents should be submitted to in-charge tax authorities: stock option exercise notices, relevant plan amendments, etc.
	Restricted stocks (RSs)	Listed companies grant employees a specific number of shares of the listed companies conditioned by criteria set in stock incentive plans	The date when the restrictions are lifted and the employees are entitled to the economic benefits of the shares granted (categorized as "wages and salary")	Companies with RS schemes shall register with in-charge tax authorities within 15 days after the RSs are registered with the China Security Registration and Settlement Company (or overseas securities registration/ depository institutions) and announced to the public, with the following documents: RS plan, implementation protocol, registration date, closing price of that day, agreement letter, grant notice, vesting period and participants list, etc.
Cash-based scheme	Stock appreciation rights (SARs)	Listed companies grant employees an entitlement to cash payments based on pre-determined conditions in accordance with the future appreciation of a listed company's stock	At the time when a listed company's SAR to an authorized person is cashed	Same as rules set out for stock options



## Preferential tax calculation method

For stock option plans related income, it should be treated as “wages and salary” subject to IIT upon the exercise and relevant tax liabilities shall be calculated based on the difference between the fair market value of shares on the exercise date and the purchase price (grant price). For SAR and RS related income, the relevant IIT liabilities shall be taxed as wage/salary according to the calculation method set out for stock options. Qualifying stock incentive income would not be aggregated with other monthly taxable compensation but would be treated as stand-alone employment related income instead. The relevant IIT liabilities shall be calculated based on the following formula:

*Individual Income Tax (“IIT”) = [(Taxable income from stock incentive income / Spread-over number of months) x Applicable IIT rates - Quick reckoning amount] x Spread-over number of months*

Spread-over number of months refers to the number of months that the stock incentive income is sourced from China services, capped at a maximum of 12 months. The applicable IIT rate and quick reckoning amount are determined by the quotient of total stock incentive income divided by spread-over number of months.

Thus, for qualifying stock incentive income the overall tax burden is effectively reduced\*. On the other hand, non-qualifying stock incentive income shall be aggregated with other monthly taxable compensation, while the applicable IIT rate and quick reckoning amount will be determined based on the total income of the month, which very likely will increase the IIT burden.

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*\*: If an employee has stock incentive income from multiple exercises or vesting, as well as simultaneously receives different kinds of stock incentive income within one tax year, the said stock incentive income should be aggregated together for tax calculation purpose.*

## Criteria for qualifying stock incentive income

According to Circular 461, previously issued in 2009, to enjoy the aforesaid favorable IIT calculation method, the following criteria shall be met:

- ▶ Participants are employees of publicly listed companies (including branches) and their subsidiaries
- ▶ The subsidiary’s shares held by the listed company should not be less than 30% of the total equity of subsidiaries. The qualifying subsidiaries are limited to two tiers below a listed company.

For companies indirectly held by a listed company, the ownership percentage is determined by multiplying the respective shareholder percentage at each level of ownership. If a publicly listed company owns more than 50% of its first tier subsidiary company, the listed company’s holding percentage is deemed to be 100%

- ▶ Relevant stock incentive plans have been established after the listing of a company. In other words, stock incentive income derived from those plans established prior to the listing of a company shall not qualify; and
- ▶ Relevant documents have been submitted/registered with in-charge tax authorities according to Circular 461

Pursuant to Circular 27, as long as 30% or more of a subsidiary’s shares is held by a listed company, the aforesaid favorable income tax computation method could apply, and is no longer restricted by the holding tiers limitation. In view of the relaxation in the application of the tax favorable calculation method for stock incentive income, more employees would be able to enjoy such tax concession thus the overall tax burden on stock incentive income will be reduced.

## Effective date

Circular 27 came into effect on 1 May 2011. The Circular did not point out whether the circular is effective retroactively, which could be interpreted in different ways by local tax authorities:

- ▶ Applies to stock incentive income on which relevant IIT liabilities arise on or after 1 May 2011
- ▶ Applies to stock incentive plans granted on or after 1 May 2011; or
- ▶ Applies to stock incentive plans established on or after 1 May 2011

Technically speaking, as the income derived from the stock options and RSs are generally taxed at the date of exercise or the date when the employees are entitled to the economic benefits of the shares granted, the relevant tax circulars shall apply to the stock incentive schemes which trigger the IIT liabilities. In this case, it is reasonable to expect that the interpretation of the effective date for Circular 27 would mean scenario 1 listed above applies. Based on our verbal discussions with some tax officials in certain major cities, this interpretation would be likely be implemented locally. Nevertheless, as the local practice may vary, it is recommended that companies should communicate with relevant in-charge tax authorities for the application of Circular 27.

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