

Global Rewards Update: PEOPLE'S REPUBLIC OF CHINA (PRC)

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INDIVIDUAL INCOME TAX (IIT) TREATMENT OF SHARE-BASED COMPENSATION CLARIFIED

BACKGROUND

Over the past several years, the Chinese government has issued several tax circulars addressing the IIT treatment of stock-based compensation. Specifically, Circular 35 (2005), Circular 902 (2006) and Circular 5 (2009) provide guidance on the IIT treatment of stock options, share appreciation rights (SARs) and restricted stocks. To assist taxpayers in determining their IIT liability with respect to these awards and, to help clarify some of the outstanding issues arising under these Circulars, on August 24, 2009, the PRC State Administration of Taxation released Circular 461.

Circular 461 covers a number of topics, including the scope of the preferential tax treatment available for stock-based compensation plans and the registration requirements that these plans must satisfy. These topics, as well as a few of the other key features found within Circular 461, are presented below.

TAX REGISTRATION OF STOCK INCENTIVE PLANS

Circular 461 emphasizes that listed companies (including local entities of overseas listed companies) operating stock incentive plans are required to submit the relevant plans and implementation details to the competent tax authorities for registration in accordance with Circular 35. In addition, domestic-listed companies operating restricted stock plans are required to register the plan with the tax authorities within 15 days after the plan is announced and relevant shares are registered with the China Securities Depository and Clearing Corporation (the designated securities depository and settlement center in China) or its counterpart outside China for companies whose shares are listed overseas.

Listed companies or their affiliates, as withholding agents, are required to withhold the relevant IIT and submit related information to the appropriate local tax authorities.

DETERMINATION OF TAXABLE INCOME UNDER SAR AND RESTRICTED STOCK PLANS AND POINT OF TAXATION

Circular 461 provides distinct methodologies for determining the taxable income arising from stock-settled SAR awards and restricted stock awards.

Stock-Settled SAR Awards

Circular 461 explains that the taxable income generated from a stock-settled SAR is equal to the difference between the fair market value (FMV) of the underlying shares on the grant date and the FMV of those shares on the exercise date, when the employee receives the cash value of those shares. The calculation can be stated as such:

SAR Taxable Income =

$$\text{FMV at exercise - FMV at grant} \times \text{Number of SARs exercised}$$

Circular 461 also clarifies that IIT is payable at the time the employee receives the payment from the employer.

The tax treatment applicable to cash-settled SAR awards is not specifically addressed in current PRC regulations. Employers offering these awards in China, or considering offering these awards, should discuss the details of their programs with a tax professional.

Restricted Stock Awards

Circular 461 provides a separate formula to calculate the taxable income arising under a restricted stock plan. Taxable income will be determined on the date the award vests, and will reference the average FMV of the underlying shares between grant and vest. The calculation can be stated as such:

Restricted Stock Taxable Income =

$$\left(\frac{\text{FMV of the underlying shares on the date of grant} + \text{FMV of the underlying shares on the date the award vests}}{2} \right) \times \text{Number of shares vesting} - \left(\text{Total price paid by the employee for the award at grant} \times \left(\frac{\text{Number of shares vesting}}{\text{Total number of shares originally granted}} \right) \right)$$

FMV for purposes of calculating restricted stock taxable income refers to the closing price of the underlying shares on the grant date and vesting date, respectively. Circular 461 also states that IIT is payable at the time the employee becomes fully vested in the shares.

SCOPE OF PREFERENTIAL TAX TREATMENT

Circular 461 further clarifies that the preferential treatment in Circulars 35, 902 and 5 applies only to employees of a listed company (including branches) and employees of companies in which the listed company holds directly or indirectly at least 30% of the shares. The indirect shareholding is limited to second-tier affiliated companies.

An employee is not entitled to preferential treatment in the following circumstances, and so the relevant income must be included in the normal monthly employment income for Chinese IIT reporting purposes:

- The income is derived from a stock incentive plan offered to an employee working for companies other than the above-mentioned eligible listed companies and their qualifying subsidiaries;
- The income is derived from a stock incentive plan that was set up before the company was listed, even though the employee derives the income after the company has become listed; and
- Where the company offering the stock incentive plan has failed to register the plan with relevant local Chinese tax authorities.

IIT PAYABLE ON STOCK-BASED COMPENSATION

After the taxpayer determines their taxable income pursuant to one of the formulas presented above, the taxpayer must then calculate their actual IIT liability.

Preferential Tax Treatment – First Exercise (Vesting) in a Tax Year

Circular 461 reiterates that the income derived from the first exercise (vesting) of a stock incentive plan (including stock options, stock-settled SARs and restricted stocks) during a given tax year will receive preferential IIT treatment. To calculate the preferential IIT payable on this first exercise (vesting), Circular 461 confirms that the formula presented in Circular 35 should be used. This formula spreads the income received from the exercise (vesting) over a number of months, thereby achieving a lower marginal tax rate when the income is first received, and can be stated as such:

IIT Payable on First Exercise (Vesting) =

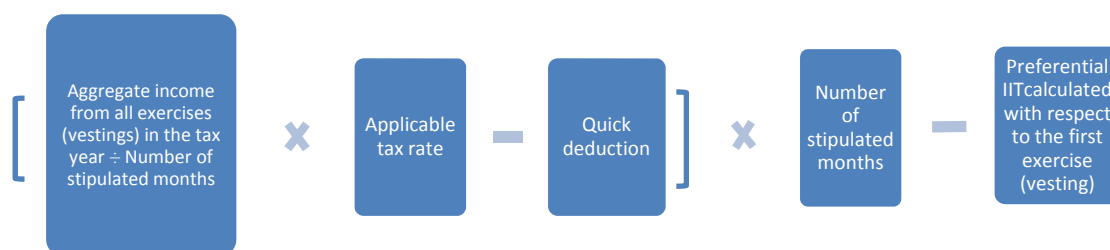
$$\left[\frac{\text{Income derived from the first exercise (vesting) of a stock incentive plan}}{\text{Number of stipulated months}} \times \text{Applicable tax rate} - \text{Quick deduction} \right] \times \text{Number of stipulated months}$$

The “number of stipulated months” is the number of months the employee worked in China over the grant to vest period of the award, not to exceed 12 months. The 2009 “applicable tax rate” in China ranges from 5% to 45%. The “quick deduction” is meant to simplify the calculation of

tax on wages and salaries and varies depending on the amount of income received by the employee.

Multiple Exercises (Vestings) Within One Tax Year

Circular 461 also clarifies the IIT treatment where an employee derives income from multiple exercises (vestings) under the same or different plans within the same tax year. Circular 461 confirms that, with respect to these subsequent exercises, the IIT payable will be calculated pursuant to the formula stipulated in articles 7 and 8 of Circular 902. As such, upon all subsequent exercises (vestings), IIT will be calculated as follows:



Where the "number of stipulated months" for multiple gains is a weighted average of the stipulated months for each exercise (vesting).

ACTION

- Companies operating stock-based incentive plans, as well as those planning for an Initial Public Offering in China, should review their existing award plans to determine if additional tax planning opportunities are available.
- Employers should ensure that their employees are aware of the IIT considerations applicable to award exercises.

People to Contact

For assistance in this matter or any other issue related to the operation of your global rewards plans, please contact your local Deloitte global rewards consulting services advisor or email us at: globalequity@deloitte.com and a global rewards consultant will contact you.

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