



Global Reward Update

People's Republic of China — Guidance issued on taxation of income from stock incentive plans

Overview

The recent overhaul of China's individual income tax (IIT) system has been accompanied by clarifying guidance, in particular, guidance related to income from stock incentive plans. The new rules, which are effective from 1 January 2019, address how residents and nonresidents are taxed on stock incentive plan income, and while the preferential taxing regime continues to apply to resident and nonresident employees, the tax calculations have changed. The reporting requirements for non-domiciled employees relating to stock incentive plans still requires further guidance.

Stock incentive plan income

Where a stock incentive plan (for example, stock options, restricted stock awards, or restricted stock units) is offered

by a publicly traded company (publicly traded in China or elsewhere) to employees of its member entities in China, the income derived by employees from such plan (for example, in the case of a stock option, the excess of the fair market value of the underlying shares over the exercise price paid by the plan participant, or the "spread at exercise") is generally categorized as employment income for IIT purposes. If an incentive plan is registered with the Chinese tax authorities and certain criteria are met, a preferential Chinese taxing regime applies to the income earned under that plan. Broadly speaking, the preferential treatment allows such share plan income to be taxed separately from other employment income to potentially arrive at a lower marginal Chinese income tax rate. The new IIT rules retain the preferential tax regime, though the tax calculations for residents and nonresidents have changed. These new rules apply based on tax residency status. With respect to individuals who do not habitually reside in China because of family or economic ties (i.e. non-domiciled individuals), those individuals will become Chinese tax residents if they stay in China for 183 days or more within a calendar year. These new methods to calculate Chinese income tax are applicable from 1 January 2019; the new method for residents is applicable through 31 December 2021, with further guidance from 1 January 2022 to be announced.

Under the new IIT law, stock incentive plan income derived by residents is still taxed separately from other employment income (now referred to as "comprehensive" income) at progressive rates. Since the comprehensive income of Chinese tax residents is now subject to a set of tax brackets and rates on an annual basis, there is no need to divide the amount of stock incentive plan income by the number of relevant months. Nonresidents are also taxed separately applying progressive Chinese income tax rates on such income, but the amount received (e.g. the spread at exercise of a stock option) is divided by six to determine the applicable Chinese income tax rate, since the employment income of nonresidents is subject to a set of tax brackets and rates on a monthly basis.

Reporting obligations for non-domiciled employees

Under the new IIT law, when a foreign related party of a domestic employer (e.g. the U.S. parent company offering employee share plan awards to employees of a Chinese

employer) pays a non-domiciled employee China-source employment income, the employee may file a tax return in China and pay tax on his or her own, or request that the domestic employer file and pay tax on his or her behalf. If the employer does not file or pay tax, the employer still must report the income information to the Chinese tax authorities.

Since stock incentive plan income is treated as employment income, the new IIT rules also should apply to stock incentive income derived by non-domiciled employees (notably many expatriates working in China). However, given the ambiguity surrounding these rules, the tax authorities' interpretation and practice may vary until further guidance is issued.

Stock incentive plan registration requirements

As discussed above, a stock incentive plan offered by a publicly traded company must be registered with the tax authorities for the preferential tax treatment regime to be applied. This registration requirement was not revoked under the new IIT law, so it still applies. Furthermore, most local tax offices have established a more comprehensive internal management system to track the registration of plans and the relevant tax reporting records.

In addition to registering with the tax authorities, a stock incentive plan offered by a foreign publicly traded company also may need to be registered with the State Administration of Foreign Exchange (SAFE) and its local offices, requiring continuing information reporting requirements. If such a plan is not registered with the SAFE, relevant foreign exchange amounts may be unable to be remitted or received as required by the plan. The SAFE has been increasing its enforcement of rules and regulations applicable to stock incentive plans as evidenced by the following:

- The SAFE and its local offices have enhanced their review of companies' prior years to identify noncompliance with the foreign exchange rules with respect to stock incentive plans. Penalties have been imposed by local SAFE offices due to historical noncompliance.
- Companies' ongoing reporting obligations have been under strict scrutiny. For example, the Shanghai SAFE requires the relevant companies to annually disclose the

information of foreign exchange fund flows of stock incentive plans (e.g. the amount of inbound remittance), and then will cross check the information with information obtained from local banks. Any discrepancy may trigger further inquiries.

- Timely repatriation of sales proceeds also is under review. Some local SAFE offices recently have required Chinese groups listed overseas through special purpose vehicles to repatriate sales proceeds of stock incentive awards to China within six months from the time the stocks were sold.

Deloitte's view

Under the new IIT law, stock incentive plan income will continue to be taxed pursuant to a preferential taxing method; thus, stock incentive plans remain a tax efficient vehicle in China to attract and retain talent. However, since the taxing methods for residents and nonresidents differ, it is important to correctly assess the resident status of each employee, especially foreign employees working in China.

It is worth noting that both tax and foreign exchange authorities have enhanced their review of compliance issues relating to stock incentive plans. Therefore, companies with such plans should review their compliance procedures and take proactive steps to mitigate any noncompliance exposure.

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