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SAT Issues Guidance on Tax Treatment of Share Transfers by Individuals

Summary

China's State Administration of Taxation (SAT) issued guidance (Circular 67) on 7 December 2014 that addresses the individual income tax (IIT) treatment and reporting requirements that apply where individual shareholders transfer their shares in Chinese companies. Individuals will be required to pay a 20% IIT (under the tax category of "income from the transfer of property") on such transfers and submit relevant documentation to the local tax authorities. Circular 67 will apply as from 1 January 2015 and will supersede two existing pieces of guidance (i.e. Guoshuihan [2009] No. 285 and SAT Bulletin [2010] No. 27).

Circular 67 also clarifies various concepts relevant to share transfers by individuals, including the assessment of taxable income derived from a transfer, the determination of the original value of the shares, and the tax reporting and withholding obligations relating to share transfers.

Key implications

Definition of share transfer

According to Circular 67, the following are considered to be share transfers:

- A sale of shares;
- A share buyback by a company;
- A sale of shares by the shareholders of an enterprise in the event of an initial public offering;
- A court- or government-ordered transfer of shares;
- A transfer of shares effected in order to make a capital contribution or carry out a nonmonetary transaction;
- A transfer of shares to repay a debt;
- Any other activities that result in a transfer of shares.

Circular 67 does not apply to the IIT treatment of transfers of shares listed on the Shanghai and Shenzhen stock exchanges (provided that such shares are obtained through public offering or trading), transfers of restricted stock or certain other situations involving the transfer of shares where special regulations apply.

Assessment of taxable income derived from a share transfer

The taxable amount of the gain derived from the transfer of shares by an individual will be calculated by deducting from gross income the original cost of the shares and reasonable expenses incurred on the transfer. The gain will be taxed as "income from the transfer of property," at a rate of 20%. If the transaction is not settled in renminbi, the relevant foreign currency must be converted into renminbi at the median price on the settlement date for IIT purposes.

Gross income derived from a share transfer

Circular 67 indicates that gross income from a transfer of shares comprise the various forms of economic benefits (i.e. cash, tangible assets, securities, etc.) received by the transferor as consideration for the transfer. Circular 67 also confirms that "various payments related to a share transfer" (such as penalties, compensation, etc.) must be included in income. Article 9 of the circular further provides that any income obtained after the transfer on the fulfilment of agreed conditions also will be treated as income for IIT purposes; this provision seems to target earn-out payments that commonly are used in acquisitions to allow a seller to obtain additional income after a deal is closed.

Circular 67 confirms that gross income from a share transfer must be recognized at fair market value. The tax authorities are empowered to reassess the gross income if the taxpayer fails to provide relevant documents, or if the gross income is "significantly low" without a "justifiable reason."

- Definition of "significantly low"

  Gross income may be considered significantly low in the following cases:

  1. The reported gross income is lower than the value of the net assets represented by the shares transferred; in particular, fair market value must be used if the enterprise whose shares are being transferred owns land use rights, real estate, intellectual property, exploration or mining rights and shares;
  2. The reported gross income is lower than the original investment cost or lower than the aggregate of the purchase amount and the taxes/expenses paid on the acquisition of the shares;
  3. The reported gross income is lower than the price that would have been obtained had the shares been transferred by another or the same shareholder in the same enterprise under the same or similar conditions;
  4. The reported gross income is lower than the price that would have been obtained had the shares of another enterprise in the same industry been transferred under the same or similar conditions;
  5. The shares are transferred for no consideration for no justifiable reason; and
  6. In other circumstances specified by the competent tax authorities.

- Definition of "justifiable reasons"

  According to Circular 67, the following circumstances could constitute justifiable reasons where the gross income is considered significantly low:

  1. Valid documents are in place to substantiate the fact that the low proceeds on the transfer were attributable to national policy adjustments having a significant impact on business operations;
  2. The transferee is the spouse, parent, child, grandparent, grandchild or sibling of the transferor, or any person of whom the transferor is a legal dependent and legal documents are available to substantiate such relationship;
  3. The transfer involves an internal share transfer by employees where a transfer to external parties is not allowed by law or the company's bylaws and documents are in place to support the reasonableness and authenticity of the transfer price; and
  4. Other reasonable circumstances that can be supported by documentation.

- Reassessment methods

  If the gross income is considered significantly low without a justifiable reason, Circular 67 specifies that the tax authorities may reassess the income using the following methods (and in the following order):

  1. Net asset method

     The income is assessed by reference to the net asset value per share or the net asset value in proportion to the shares held by the transferor. Where the aggregate of land use rights, real estate, intellectual property, exploration or mining rights and shares exceeds 20% (previously 50%) of the total assets of the investee enterprise, the tax authorities may assess the income by reference to a valuation report issued by a qualified appraiser. The report may be used as a reference for any subsequent transfers within six months from the first share transfer provided that there was no significant change in the enterprise’s net assets between the two transfers.

2. Comparable method

   The income is assessed by reference to:

   - § The price that would have been obtained had the shares been transferred by another or the same shareholder in the same enterprise under the same or similar conditions; and
   - § The price that would have been obtained had the shares of another enterprise in the same industry been transferred under the same or similar conditions.

3. Other reasonable methods

Assessment of original share value

The original share value should be determined using the following methods:

1. For shares acquired through a cash investment, the share value should be determined according to the actual cost paid plus reasonable taxes/expenses incurred directly related to the acquisition of the shares.

2. For shares acquired through nonmonetary means, where specific nonmonetary assets were contributed to capital, the share value should be determined based on the price assessed by the tax authorities plus reasonable taxes/expenses incurred directly related to the acquisition of the shares.

3. For shares acquired from the above-mentioned family members or legal dependents for no cost, the share value should be determined based on the original value of the shares in the hands of the last transferor plus reasonable taxes/expenses incurred on the acquisition of the shares.

4. For shares converted from capital surplus, surplus reserves or retained earnings, where the individual shareholder has paid IIT on the relevant portion of the surplus, etc. converted, that portion should be taken into account in determining the share value;

5. In other situations, the competent tax authorities should use a reasonable method to determine the share value with a view to avoiding double taxation of the same income under the IIT regime.

Where the gross income is assessed by the tax authorities, the gross income so assessed plus relevant reasonable taxes/expenses incurred on the share transfer will be considered the deductible value for IIT purposes on a subsequent transfer of the shares.

Where an individual transferor acquired the shares transferred in multiple transactions, a weighted average method should be adopted in determining the share value for IIT purposes.

Tax reporting and withholding obligation

Circular 67 confirms that the competent tax authorities are the authorities in the place where the investee enterprise is located. The circular also introduces various reporting requirements applicable to the transferor (i.e. the taxpayer), the transferee (i.e. the IIT withholding agent) and the investee enterprise.

Pre-transfer reporting

Transferee – The transferee must report the transaction to the competent tax authorities within five business days after the transfer agreement is signed.

Investee enterprise – The investee enterprise must report board resolutions and minutes of shareholder meetings to the competent tax authorities within five business days after the relevant meeting is held.

Tax reporting

Transferor/transferee – The transferor/transferee must report income and file a tax return with the competent tax authorities within 15 days of the month subsequent to that in which any of the following events takes place, where it appears the reporting/filing obligation is triggered on the occurrence of the earliest event if more than one of the events relates to the same transfer:

- The transferee paid, in whole or in part, the consideration for the shares;
- The transfer agreement was signed and became effective;
- The transferee actually fulfilled the shareholder's obligations or executed the shareholder's rights;
- The registration or announcement procedure with the relevant government department was completed so that the transfer became effective;
- The relevant transfer action was completed (e.g. a court or government-mandated transfer, the use of shares to make a capital contribution, etc.); or
- Other events as determined by tax authorities indicating that there was a share transfer.

Post-transfer reporting

Investee enterprise – The investee enterprise must report the change in individual shareholders' ownership of the shares to the competent tax authorities within 15 days of the month following the month in which the change occurred.

Deloitte's view

- Circular 67 clarifies various key concepts relevant to share transfers by individual shareholders, including the assessment of taxable income derived from such a transfer, the determination of the original value of the shares, and the tax reporting and withholding obligations relating to such transfers.

- Circular 67 clearly sets out the withholding obligation of the transferee in a share transfer transaction, as well as the pre- and post-transfer reporting obligations of the investee company where the transfer is made by an individual shareholder. The circular highlights the enhanced tax monitoring of share transfers made by individual shareholders. Specifically, the tax authorities are required to establish internal controls for implementing the IIT treatment of share transfers, and to set up electronic registration to record all individuals holding shares in enterprises within their jurisdiction and key information relating to those individual shareholders.

- In line with the IIT reform that has been in progress since 2011, Circular 67 is regarded as a key measure in improving the tax monitoring of the personal investment income aspect of high-income individuals. The individual shareholders and companies involved will need to take a close look at the policy update and ensure that they are in compliance with the reporting and withholding obligations involved. All supporting documentation relating to share transfers must be retained as it will need to be produced should the tax authorities subsequently decide to conduct a tax audit. In addition, prior to undertaking any share transfer, it is highly recommended that professional assistance be sought with a view to the proper fulfillment of tax compliance obligations.

Note: Contents discussed in this Tax Analysis pertain to Deloitte Global Employment Services

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