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# Tax Analysis

## Favorable Tax Treatment Extended to More Equity Compensation Plans / Contributions of Technology

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China's Ministry of Finance (MOF) and the State Administration of Taxation (SAT) jointly issued a circular on 20 September 2016 (Caishui [2016] No. 101 (Circular 101)) that provides detailed guidance on the preferential individual income tax (IIT) policies relating to equity compensation plans (i.e. stock options, restricted and unrestricted stock awards) and capital contributions made to a Chinese company in the form of technology. On 28 September 2016, the SAT issued Bulletin 62 to provide further guidance on the implementation of Circular 101. Both Circular 101 and Bulletin 62 apply as from 1 September 2016.

The key IIT incentives provided in the new rules on equity compensation plans are as follows:

- Favorable IIT treatment is extended to equity compensation plans offered by unlisted companies;[1] specifically, taxation of equity awards granted to employees may be deferred until the time the employee disposes of the equity;
- Equity compensation plans offered by companies listed on the Shanghai and Shenzhen stock exchanges continue to benefit from the tax treatment provided in earlier guidance, but Circular 101 extends the period for the individual to settle the tax due; and
- Favorable IIT treatment is offered to investors that make equity investments in Chinese companies using achievements in technology.

[1] According to Circular 101, companies whose shares are quoted on the National Equities Exchange and Quotations (NEEQ) will be considered "unlisted domestic companies" for purposes of the circular.

## IIT treatment for equity compensation plans

### A. Equity compensation plans offered by unlisted domestic companies

Prior to Circular 101 and Bulletin 62, preferential IIT treatment was available only for equity compensation plans offered by listed companies and qualifying high-tech companies (discussed below). For employees of most unlisted companies, the relevant income derived from these plans was subject to Chinese IIT as "employment income" at the time of exercise/vesting at a progressive tax rate ranging from 3% to 45%. Capital gains realized at the time of disposal of the relevant equity were subject to tax as a "transfer of property" at a flat rate of 20%.

The new guidance, however, provides for deferred taxation on income derived from qualified equity compensation plans (including stock options and restricted and unrestricted stock awards) granted by unlisted domestic companies.

#### QUALIFIED PLANS

***Tax deferral point:*** Unlike the previous treatment, under which income derived from equity compensation plans was taxed separately as employment income and capital gains at two different points of taxation, Circular 101 provides that the taxation of income can be deferred to the time the relevant equity is sold; thus, the income will be taxed only as a "transfer of property" at a flat rate of 20% at the time of sale. Taxable income for these purposes is defined as the gross proceeds from the sale of the equity reduced by the original cost (e.g. the exercise price paid by an employee) and reasonable taxes and expenses incurred.

The impact of deferred taxation could be significant: it will benefit employees that may not have sufficient cash flow to pay tax at the time the option is exercised or the restricted stock is vested, and will reduce the tax burden by applying a flat rate of 20%.

***Qualifying industries:*** Circular 101 introduces a "negative list" of industries in which companies operating in a listed industry will not be able to apply for the deferred treatment for its employees. Industries on the negative list include real estate development, wholesale and retail sales, accommodations and catering, etc.

***Conditions:*** Circular 101 sets out a number of requirements that must be met for an equity compensation plan to qualify for the deferred treatment:

- The unlisted company offering the plan must be a Chinese resident company;
- The plan must be approved by the company's board of directors and shareholder meetings (or by the relevant government authorities where no shareholder meeting has been set up for certain state-owned companies);
- The underlying shares of the plan must be those of the granting company, i.e. if the plan grants shares of the company's affiliates, the plan will not qualify for deferral treatment (however, for stock award plans, the underlying shares may be shares of other domestic resident companies that were obtained by the granting company in exchange for contributions relating to achievements in technology);


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- **The eligible participants in the plan must be core technical personnel and senior management employees determined by the board of directors or shareholder meetings, and the total number of participants cannot exceed 30% of the average active employee population in the previous six months;**
- **The shares must be held for a minimum period, as follows:**
  - **For stock options, the period between the grant date and the sale date must be three years or more, and the shares must be held for one year or more after the employee exercises the option;**
  - **For restricted stock awards, the shares must be held for three years or more from the grant date, and one year or more after the restriction lapses or is removed; and**
  - **For unrestricted stock awards, the shares must be held for three years or more.**
- **For stock option plans, the period between the grant date and the exercise date cannot be longer than 10 years; and**
- **The business of the relevant company cannot be in one of the industries on the negative list, determined by reference to the main business revenue of the company in the previous year.**

**If a plan fails to meet all of the above requirements, deferred taxation will not apply and the equity income will be taxed as income from a nonqualified plan.**

**NONQUALIFIED PLANS**

**Where employees acquire shares from their employer at a price lower than the fair market value (FMV), but the equity compensation plan does not qualify for deferred taxation, the income derived from the "non-qualified" equity compensation plan (i.e. the difference between the lower acquisition price and the FMV) must be taxed at the time the shares are acquired. However, Circular 101 provides for a special method to calculate tax due (initially introduced by Caishui [2005] No. 35 (Circular 35) for listed companies) in this situation, under which the income may be divided by the "number of stipulated months" in the vesting period (capped at 12), to determine the applicable tax bracket.**

**Although less favorable than the deferred taxation method available for qualified plans, the application of the special tax calculation method may be beneficial to nonqualified plans, if compared to the previous treatment under which all of the equity income would be added to the normal salary, likely resulting in a much higher marginal tax rate for the relevant month.**

## B. Equity compensation plans offered by listed companies

**The tax treatment of equity compensation plans offered by listed companies basically remains unchanged (i.e. the rules under Circular 35 continue to apply). Employees will be taxed at the time an option is exercised (for stock options) or when a restriction lapses or is removed (for restricted stock awards), and the relevant income will be taxed as employment income, but separately from the normal salary, under the preferential tax calculation method provided in Circular 35.**

**However, Circular 101 offers one favorable development for senior executives. Since such individuals may not have sufficient cash to pay the tax when exercising the option, the previous guidance required the tax to be paid in installments over a six-month period where the income derived from qualifying equity plans offered by companies listed on the Shanghai and Shenzhen stock exchanges. Circular 101 extends the installment period from six to 12 months.**

## C. Capital contributions made in the form of technology achievements

**Where a taxpayer makes a capital contribution to a Chinese company in the form of a technology achievement, the taxpayer is considered to be disposing of the technology achievement for income tax purposes and, therefore, will be subject to tax on any gains derived from the disposal. However, an individual taxpayer may pay the tax in installments over a five-year period, and a corporate taxpayer may spread the gains over five years for income tax purposes.**

**Circular 101 introduces a new deferral tax treatment for the situation described above, under which the taxpayer may elect to defer the tax until the disposal of the relevant shares. The taxable gains will be calculated by deducting the original cost of the achievement in technology, as well as any reasonable expenses and taxes, from the gross income derived from the sale of the shares. To qualify for the treatment, the technology achievement used for the capital contribution must be in the form of patented technology, software copyright, etc.**

## D. Filing requirements

**Where a taxpayer elects for a type of tax deferral treatment provided by Circular 101, the relevant company must submit certain information and documents relating to the plan (e.g. the names of the participants, description of the plan, meeting minutes of the board of directors, etc.) to the competent tax authorities; otherwise, the deferral treatment will be denied.**

**Where the tax deferral treatment has been granted to an individual, the relevant company, acting as the IIT withholding agent, must submit an annual report detailing the relevant information until disposal of the underlying shares. The report must be submitted within 30 days of the subsequent year. Once the IIT is triggered when the underlying shares are disposed of, the withholding agent and the taxpayer must provide documents to substantiate the income, original cost, expenses and taxes to the competent tax authorities for assessment purposes.**

## Deloitte's view

**Circular 101 is a new benchmark for the favorable IIT treatment offered to equity compensation plans of Chinese companies. It provides substantial tax benefits to domestic resident companies that implement equity compensation plans, particularly unlisted companies. Before Circular 101, preferential tax treatment was available only to equity compensation plans granted by listed companies or stock awarded by qualifying high-tech companies. Circular 101 expands the scope of beneficial tax treatment and the potential beneficiaries:**

- **For qualifying equity compensation plans granted by unlisted companies (including companies whose shares are quoted on the NEEQ), taxation may be deferred to the time the relevant shares are sold, and a flat rate of 20% will be imposed on the gains.**
- **For nonqualified stock incentives acquired by employees from an unlisted employer, the special tax calculation method provided in Circular 35 may be applied; previously, this method applied only to plans offered by listed companies.**
- **For Chinese listed companies, the relevant tax payment on employment income derived from equity compensation plans by senior executives may be made in installments over a 12-month period, which is longer than that under the previous treatment.**

**To enjoy the preferential tax treatment described above, taxpayers and the relevant companies must comply with the tax filing and reporting requirements set out in Circular 101. It is worth noting that, according to Circular 101, the tax authorities will expand cooperation and information sharing with company registration authorities to ensure that tax can be timely collected when the underlying shares are disposed of.**

**Companies already operating equity compensation plans, or that are considering the rolling out such plans, should consider conducting an internal assessment or seeking professional advice on qualifying for the incentives, and comply with the reporting and withholding requirements.**

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