



## **Gains from sales of restricted stocks held by enterprises for individuals will be taxed on enterprises only**

### **Regulation discussed in this issue:**

- [Announcement on Income Tax Issues Concerning Transfer of Listed Companies' Restricted Stocks by Enterprises, SAT Announcement \[2011\] No. 39 \(Announcement 39\), issued by the State Administration of Taxation on 7 July 2011, effective from 1 July 2011](#)

### **Background**

The State Administration of Taxation (SAT) issued the announcement [2011] No. 39 (Announcement 39) on 7 July 2011 to deal with the income tax treatment of the transfer by enterprises of restricted stocks in listed companies. Announcement 39 serves to reduce the risk of double taxation of gains where enterprises transfer restricted stocks that they hold on behalf of other individuals or enterprises.

Announcement 39 takes effect from 1 July 2011. Announcement 39 shall be applied where the relevant issues have still not been resolved after this announcement takes effect, whereas no adjustments need to be made where such issues have already been settled.

The salient points of Announcement 39 and our comments on them are set out below:

#### **1. What are restricted stocks?**

Restricted stocks are not defined in Announcement 39. We are not aware of any tax regulations or rules that provide definition of restricted stocks. However, certain Individual Income Tax (IIT) regulations such as Cai Shui [2009] No.167 (Circular 167) provide the scope of restricted stocks. According to Circular 167, restricted stocks include the following:

- The original non-tradable stocks held by shareholders after the completion of the share split reform and before the date of the stock trading resumes, and the stocks derived from the above-mentioned stocks by way of distribution or conversion during the period from the resumption of trading to the lifting of restrictions over sales

- Restricted stocks created out of companies in initial public offerings after the 2006 share split reform to sever the new and old shareholdings, and the stocks derived from the above-mentioned stocks by way of distribution or conversion during the period from the listing date to the lifting of restrictions over sales
- Other restricted stocks stipulated by the Ministry of Finance (MoF), SAT, Legislative Affairs Office and China Securities Regulatory Commission.

Based on Circular 167, Cai Shui [2010] No. 70 further clarifies the sources from which individuals may acquire restricted stocks. The restricted stocks in Announcement 39 may also be taken to fall within a similar scope and be acquired from similar sources.

## **2. How will gains derived by enterprises from the transfer of restricted stocks be treated for Corporate Income Tax (CIT) purposes?**

According to Article 1 of the CIT Law and Article 3 of its Implementation Rules of CIT Law (CIT Rules), enterprises (including public institutions, social bodies and private non-corporate entities), which derive revenue from the transfer of restricted stocks, shall pay CIT.

Based on the general principles in the CIT regulations, revenues derived by enterprises from the transfer of equity interests shall be taken into account and the costs incurred in acquiring the equity interests shall be deductible in calculating the taxable income for CIT purposes.

## **3. What if the restricted stocks are held by enterprises on behalf of individuals as a result of the split share reform?**

The issues will be addressed at the enterprise level and the individual level respectively, as follows.

### At an enterprise level

- Proceeds derived by enterprises from the transfer of such restricted stocks shall be included as revenue for CIT purposes. Gains derived from the transfer of such restricted stocks are calculated as follows:

|   |          |
|---|----------|
| Proceeds from the transfer of restricted stocks | X        |
| Deduct original costs                           | (X)      |
| Deduct reasonable taxes and levies              | (X)      |
| Gains   | <u>X</u> |

- Where enterprises are not able to provide the complete and genuine certification of the original cost of restricted stocks, and not able to accurately calculate the original cost, the tax authorities in charge will deem the original cost and the reasonable taxes and fees of the restricted stocks as 15 percent of the revenue derived from the transfer of the restricted stocks. In summary, the gain will be as follows:

|  |          |
|--|----------|
| Proceeds from the transfer of restricted stocks                      | X        |
| Deduct deemed costs and reasonable taxes and levies (15% x proceeds) | (X)      |
| Gains (85% x proceeds)   | <u>X</u> |

The standard CIT rate is 25 percent. However, where an enterprise disposing of the restricted stock is an hi-tech enterprise or small enterprise with low profitability, whether the preferential CIT rate can be applied to the gains derived by the enterprise from the transfer of restricted stocks is not clearly

addressed in Announcement 39. In such circumstances, it is advisable that enterprises confirm the tax treatment with the tax authorities in charge beforehand.

#### At an individual level

The remaining part of the proceeds from the transfer of such restricted stocks, after tax has been paid in accordance with above provisions, will not be subject to tax when it is passed to the actual owner.

Where the restricted stocks held by enterprises on behalf of individuals are passed to the actual owner directly through the securities registration and clearing organisation according to the decision or ruling of the court, such a change will not be deemed as a transfer of restricted stocks.

#### **4. What if the restricted stocks are transferred to other enterprises or individuals (transferees) before the restrictions over sales are lifted?**

- Enterprises shall include the entire proceeds derived from the reduction of the restricted stocks, which are registered in the securities registration and clearing organisation in calculating the taxable income for CIT purposes in current year.
- Where enterprises have entered into agreements with transferees for transferring the restricted stocks before the restrictions over sales are lifted but the ownership registration remains unchanged, and the stocks are still held by enterprises, the enterprises shall pay tax according to the abovementioned provisions regarding the revenue derived from the actual disposal of the restricted stocks. The transferees need not pay tax when the net proceeds are paid over to them.

According to abovementioned provisions, enterprises are not required to pay tax when they enter into transfer agreement with transferees, but they shall include the entire proceeds derived from the disposal of restricted stocks in calculating the taxable income for CIT purposes in the period the disposal actually occurs.

#### **KPMG observations**

Before Announcement 39 was issued, when enterprises transferred restricted stocks held on behalf of individuals and passed the net proceeds to the actual owner, there were high risks of double taxation. Firstly, the enterprises holding the restricted stock on behalf of the individuals may not have full details and supporting documents for the costs of the stocks. Secondly, under the general principles of the CIT Law and IIT Law, the Chinese tax authorities would have the power to impose CIT and IIT on the enterprises and individuals respectively on the same gains. The introduction of the taxing-the-enterprise-only principle and the deemed 15 percent costs mechanism will reduce such exposures considerably.

However, it is important to note that Announcement 39 should only deal with CIT treatment of the transfer of restricted stocks held by enterprises on behalf of individuals as a result of the share split reform. Where enterprises hold stocks on behalf of individuals due to other reasons, regardless of whether the stocks are restricted or not, Announcement 39 will likely not be applied. In those cases, double taxation of the gains from the transfer of shares so held can occur.

Overall, Announcement 39 has provided relief and clarity to a specific group of taxpayers that have entered into special shareholding arrangements under the share split reform. This builds on Circular 167 issued by SAT in 2010, which clarifies certain IIT issues in relation to the transfer of restricted stocks by individuals (please refer to [China alert Issue 5, 2010](#)).

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