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China alert

Issue 13 – June 2012

SAT clarifies corporate income tax treatment of equity incentive compensation plans

Regulations discussed in this issue:

Announcement on the corporate income tax treatment of equity incentive compensation plans by Chinese resident enterprises, Announcement [2012] No. 18 issued by the State Administration of Taxation on 23 May, 2012, effective on 1 July , 2012.

On 23 May, 2012, the State Administration of Taxation (SAT) released Announcement [2012] No. 18 (Announcement 18) to clarify corporate income tax (CIT) treatment related to equity incentive compensation plans (EICP) instituted by Chinese resident enterprises. Announcement 18 will take effect on 1 July, 2012.

Background

As the Chinese securities market progresses, more and more companies in China have adopted various forms of EICPs as part of the remuneration packages for their management teams. The purpose of these plans is to align the management objectives with these of the shareholders and incentivise the management to increase company value. For listed companies, the PRC GAAP has prescribed accounting treatment for EICPs. For employees that participate in such plans, the Ministry of Finance (MoF) and the SAT have also issued several circulars to discuss the individual income tax implications. However, prior to Announcement 18, the SAT did not provide details on the income tax treatment of equity compensation expenses at the corporate level, i.e., whether, when and to what extent these expenses are deductible for corporate income tax purposes. Officials from the local tax authorities often hold different views on this issue. This absence of a consistent and uniform tax treatment creates significant uncertainties for Chinese companies with EICPs.

In view of this lack of official guidance, KPMG held multiple seminars and roundtable sessions in several major cities across China and discussed with the business community on the reasonable CIT treatment related to EICPs. In these events, KPMG gathered real cases and feedback from the participating businesses and presented the issue to the SAT. After conducting further research on the technical background and the common practices in the market, the SAT developed and released Announcement 18.

The key points of Announcement 18 and our discussions are summarised below:

The scope

Announcement 18 adopted certain concepts in the Trial Administrative Measures for Equity Incentive Compensation by Listed Companies (Administrative Measures), which was issued by the China Securities Regulatory Commission in 2005. Specifically, the following concepts are brought up in Announcement 18:

- Equity Incentive Compensation refers to the scenario where a listed company covered by the Administrative Measures grants its own stock to its directors, supervisors, senior executives, and other employees (target employees) as long-term compensation. The specific forms may include the issuance of restrictive stocks, stock options, and other instruments as prescribed by PRC laws and regulations.

- Restrictive stock refers to the scenario where a listed company as specified in the Administrative Measures issues its own stock to its target employees pursuant to an EICP, after the target employees meet certain requirements under the EICP.

- Stock option refers to the scenario where a listed company as specified in the Administrative Measures issues rights to its target employees which entitle the latter to purchase a certain number of the listed company's own stock at prescribed price (strike price) within a future period pursuant to an EICP, after the target employees meet certain requirements under the EICP.

To reflect the principle of equality in tax policy, Announcement 18 states that Chinese resident enterprises listed overseas as well as non-listed Chinese resident enterprises could also enjoy the same corporate income tax treatment with respect to their EICP under Announcement 18, provided that these companies satisfy the following conditions: (1) the EICP is established using the standards in the Administrative Measures; and (2) the accounting treatment adopted by the company complies with the PRC GAAP.

Tax deduction of costs/expenses in equity compensation

The following summarises the CIT treatment of cost and expenses incurred by Chinese companies in EICPs as described in Announcement 18:

- Equity compensation expenses are generally deductible for PRC corporate income tax purposes.

- Tax deduction should take place at the time of exercising the stock option rights. No tax deduction should be taken during the vesting period.

- The amount of tax deduction equals the product between (1) the excess of the company stock's market price per share over the strike price (intrinsic value) on the exercise date and (2) the number of rights actually exercised by the target employees.

- The characterisation of the tax deduction is salary compensation.

Numerical illustration

Company A is a Chinese listed company. On 1 January, 2013, based on an EICP established under the Administrative Measures, Company A issues 50 stock option rights to each of its 100 management personnel. If a management person remains employed in Company A during the two years period between 1 January, 2013 and 31 December, 2014, he or she is entitled to purchase one share of Company A's stock at RMB 5 per share with each stock option right after 31 December, 2014. On 1 January, 2013, it is estimated that each option right's fair market value is RMB 10. On 1 January, 2015, all 100 personnel remain employed by Company A and exercise all the stock option rights issued to them. The closing price of Company A's stock on the exercise date is RMB 12 per share.

i. Accounting treatment

According to PRC GAAP No. 11 – Equity Compensation that was issued by the MoF in 2006, if Company A provides equity compensation in exchange for employment services from its management team, Company A should record costs or expenses using the fair market value of the equity instrument involved.

If the stock option rights are exercisable only after the target employees finish rendering specified services within a vesting period, Company A should make a best-effort estimate on the number of rights that will likely be exercised after the vesting period. The amount of costs or expenses to be booked by Company A for accounting purposes equal the anticipated number of rights to be exercised multiplied by the estimated market price of Company A's equity on the grant date. The corresponding credit entry may be an account in the equity section of the balance sheet, such as the 'other capital reserve' account.

On the exercise date, Company A would compute the amount to be transferred from the 'other capital reserve' account to the share capital and capital premium accounts, for instance, according to the actual number of rights exercised. Company A normally does not retroactively adjust the amounts in the accounting entries previously booked.

In the example above, Company A will recognise a total compensation expense of 10×100×50 = RMB 50,000 during the two year vesting period. No accounting entries are needed on the grant date. During the vesting period, Company A will recognise 50,000/2 = RMB 25,000 of compensation expenses for accounting purposes on 31 December, 2013 and 31 December, 2014 respectively.

ii. CIT treatment

Tax Deduction Amount = (Market Price per Share on Exercise Date – Strike Price) x Number of Rights Exercised, i.e., (12-5) × 100×50 = RMB 35,000. Company can deduct RMB 35,000 of compensation expense for corporate income tax purposes for the year that the exercise date falls in.

iii. Book-to-tax difference

As described above, the PRC accounting and tax treatments differ with respect to the compensation expenses incurred by Company A from its EICP. This different treatments lead to a difference between Company A's 'profits before income tax' under PRC GAAP and its 'taxable income' under PRC corporate income tax law. Before Announcement 18 takes effect, local tax authorities in China often disallow tax deduction of equity compensation expenses, even though such expenses are recognised for accounting purposes. Such a book-to-tax difference is practically permanent in nature. After Announcement 18 is enforced, this book-to-tax difference arguably becomes temporary in nature. However, a permanent difference may still exist for the following reason. The compensation expense for accounting purposes is the product between the number of option rights granted and the fair market value of the option rights estimated on the grant date. In contrast, the compensation expense for tax purposes equals the product between the number of option rights actually exercised and the intrinsic value of the option rights on the exercise date. It is highly unlikely that these two expense amounts will be identical.

If a business uses 'profits before income tax' under PRC GAAP as the starting point to derive its 'taxable income', it should make appropriate reconciliation adjustments to take into account the book-to-tax difference related to equity compensation expenses. In the above example, although equity compensation expenses are recognised annually during the vesting period for accounting purpose, because the actual payment has not occurred, Company A needs to add back the equity compensation expenses to increase taxable income for corporate income tax purpose. For the year when an exercise takes place, the accounting profits of Company A are not affected, but Company A is allowed to take tax deduction to arrive at a lower taxable income figure. It is recommended that Company A should consider the impact of such potential timing differences on deferred tax computations when relevant.

KPMG observations

Implications

The release of Announcement 18 is welcome news for Chinese companies with EICPs. It clarifies the CIT deduction issue that was not previously addressed, and serves to boost the development of Chinese securities market and the growth prospect of Chinese businesses.

PRC GAAP No. 11 – Equity Compensation mentioned two types of EICPs. A Type 1 plan is equity compensation using equity settlement (e.g., stock option plan). A Type 2 plan is equity compensation using cash settlement (e.g., stock appreciation right).

The Chinese tax authorities generally agree that compensation expenses that arise from a Type 2 plan are tax deductible. However, the issue of deducting compensation expenses in a Type 1 plan for CIT purposes has always been controversial among tax officials. The focus of the debate is: since EICP using equity settlement does not lead to a reduction of overall shareholder value in the company and only results in a shift in value from the original shareholders to the target employees, does the compensation expense booked for accounting purposes represent an expense item for CIT purposes? Announcement 18 adopts the mainstream view in the international tax practice and unifies the tax positions within the PRC tax authorities by recognising that EICP is, in essence, a compensation mechanism and creates real business expenses. Therefore, tax deduction of expenses from EICP should, in principle, be allowed, although the timing of tax deduction lags behind expense recognition for accounting purposes.

As mentioned before, another bright spot in Announcement 18 is that for Chinese companies listed overseas and non-listed Chinese companies, their EICPs can also follow Announcement 18 as Chinese listed companies do, if certain conditions are met. Announcement 18 does not discriminate against Chinese companies not listed in China, but only require that these companies observe the Administrative Measures in setting up their EICPs and comply with PRC GAAP on the accounting side.

In recent years, many non-listed Chinese companies are considering launching, or have already launched, various EICPs. Broadening the coverage of Announcement 18 would encourage such business initiatives to further spread among Chinese companies. We hope the relevant government authorities will announce additional guidance to help non-listed Chinese companies address practical issues in executing EICPs, such as how to value non-listed shares and how to deal with restrictions placed by the PRC Company Law on a company's purchase of treasury shares.

Open issues

Due to the complexity in legal form, accounting rules, and tax treatment, Announcement 18 did not cover some key issues, such as:

- Whether resident enterprises listed in China refer to the listing vehicles themselves only or whether they include unlisted Chinese subsidiaries?
- Whether non-resident enterprises listed overseas and their unlisted Chinese subsidiaries are allowed to follow Announcement 18?
- Whether the target employees include employees of Chinese subsidiaries owned or effectively controlled by the listed vehicle?
- For equity compensation expenses that are tax deductible under Announcement 18, but were not deducted in prior tax years, whether a company is allowed to make retroactive adjustment on previous tax returns that have been filed. If so, how far can the adjustment go back in time?

In addition, Announcement 18 did not mention whether advance approval from local tax authorities is necessary or whether recordal filings should be submitted in order for a company to deduct the equity compensation expenses on the corporate income tax return. Businesses should seek clarification from the tax authorities at the appropriate level to reduce tax uncertainties.

Next steps

When Chinese companies that plan to be listed or are already listed consider EICPs, they should fully assess the tax impact of Announcement 18. If one of the following circumstances applies to your company or you wish to discuss any other related matters, the KPMG tax team is available to assist:

- A Chinese resident enterprise plans to implement an EICP and wishes to understand the associated commercial, financial and tax planning aspects in greater detail.
- A Chinese resident enterprise already has an EICP in place and needs to control the various risk factors associated with the plan implementation.
- A Chinese resident enterprise has encountered uncertain financial and accounting issues while implementing an EICP.
- A Chinese resident enterprise desires to conduct further communications with the tax authorities in charge to understand how certain aspects of Announcement 18 should be applied.
- A Chinese resident enterprise faces uncertain tax issues related to EICP and wants to clarify these issues with the SAT.

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