China alert

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New PRC Individual Income Tax on dividends put more onuses on domestically listed companies and investment brokerage companies

Regulation discussed in this issue:

Notice on PRC Individual Income Tax (IIT) collection policy for dividend income derived from companies listed on Stock Exchanges in China, Cai Shui [2012] No. 85 (Circular No. 85), issued by the Ministry of Finance, the State Administration of Taxation and the China Securities Regulatory Commission on 16 November 2012, effective on 1 January 2013.

Background

Circular No. 85 was issued with the intent of fostering long-term stability in the Chinese stock markets by having a differentiated IIT policy for dividends based on holding period. To achieve this objective, Circular No. 85 has introduced a complicated withholding system on the IIT of the individual investors, which will significantly increase the administrative burden of domestically listed companies and security brokerage companies.

The difference in IIT rates based on the holding period will significantly increase the demand on the withholding system capabilities. Domestically listed companies and security brokerage companies should complete a detailed review of their IT systems before the end of 2012 to ensure the security brokerage companies are equipped to assist domestically listed companies to fully comply with the withholding requirements set out in Circular No. 85. As the effective date of Circular No. 85 is fast approaching, domestically listed companies and security brokerage companies must take immediate action.

Differentiated IIT policy for dividend income based on holding period

From 1 January 2013, individuals who receive dividends from domestically listed companies will be subject to a flat rate of 20 percent, and income tax discounts will be available to those who hold the shares for:

a) More than one month, but less than one year: 50 percent of the dividend income will be treated as exempt

b) More than one year: 75 percent of the dividend income will be treated as exempt.

Dividends derived by individuals from the following types of holdings will be subject to the new rules:

a) Shares of China listed companies which are acquired from IPO or secondary markets

b) Restricted shares of domestically listed companies which have vested

c) Securities investment funds.

The table below shows the effective IIT rate on dividend income under the current and new rules:

Holding period	Effective IIT rate (current rule)	Effective IIT rate (new rule)
≤ 1 month	10%	20%
> 1 month and ≤ one year		10%
> 1 year		5%

IIT withholding procedures

The IIT withholding on dividend will become a two-step process from January next year.

Upon dividend distribution, the domestically listed companies shall withhold and remit IIT on 25 percent of the payout from the individual investors.

For individuals whose holding period does not exceed one year, security brokerage companies shall calculate the IIT due on dividend income based on the actual holding period, and deduct any outstanding IIT due (if any) on the dividends from the individual's investment account and remit the fund to the domestically listed company within five working days following the month-end of share transfer. The domestically listed companies shall then report and settle the IIT with the tax authority in charge within the filing due date in the same month.

Holding period

For the purpose of Circular No. 85, the holding period counts from the day which the shares are acquired to the day preceding the day of share transfer. At the time of share transfer, a first-in-first-out principle is adopted for the counting of the holding period. For restricted shares which have vested, the holding period commences from the vesting date.

A one-year holding period refers to a consecutive year starting from a date in the prior year to the day preceding the same date in the current year. A one-month holding period refers a consecutive month starting from a date in the prior month to the day preceding the same date in the current month.

KPMG observations

Circular No. 85 was issued with the intention of fostering long-term stability in the Chinese stock markets by reducing tax burdens on long-term investors and at the same time discouraging short-term speculation. It is another step closer to a sophisticated personal tax system for China. This is reflected through the aim of taxing individuals based on their investment horizon by imposing tax on dividends at a standard rate of 20 percent and lowering the tax rate to 10 percent for investors who hold the shares for no more than one year, and a further 5 percent reduction in tax rate if investors hold the shares for more than one year.

The new IIT collection rules will encourage individual investors to invest in quality stocks with high dividend payout and senior management of the list companies for long term holding of the companies' shares.

However, this differential IIT system would significantly increase the administrative burden of the domestically listed companies and security brokerage companies to ensure compliance to the rules. The domestically listed companies and security brokerage companies would have to review their IT framework and modify the IIT withholding system by 31 December 2012 to ensure full compliance to Circular No. 85 from 1 January 2013 onwards. Also, individual investors should be aware of the new rules so that the amounts of dividend income and IIT liabilities are properly captured in their annual tax returns.

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