GMS Flash Alert

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People's Republic of China - New Policies Offer Incentives for Equity-Based Compensation

Recently-issued guidance in the People's Republic of China (PRC) sets out the qualifying criteria for favourable individual income tax (IIT) treatment of certain employee equity incentive awards granted by private companies, and capital contributions to PRC-resident enterprises through technology investment.[1]

The new rules came into effect on 1 September 2016.

WHY THIS MATTERS

With the roll-out of the new rules, PRC IIT preferential treatment is now available to equity awards granted by both listed and unlisted companies, which should encourage the use of equity awards as a form of compensation in the PRC. For private companies, the use of equity awards can be a tax-efficient way to help align employees' interest and behaviour.

In particular, the new rules allow the taxation of these equity awards to be deferred to the point of disposal and reduce the marginal tax rate from 45 percent (top marginal tax rate applicable to employment related income) to 20 percent. The extent of potential tax savings to an equity-award granting employer will largely depend on the design of the plan.

Salient Points

The new guidance, contained in Circular 101 and Announcement 62, covers restricted shares and share options granted by unlisted PRC-resident companies to their employees. It establishes the criteria (noted below) which these equity awards must satisfy in order for the preferential tax treatment to apply:

1. The share incentive plan must be implemented by a PRC-resident company.
2. The share incentive plan must have been approved by the company's board of directors and documented in the shareholders meeting minutes.
3. The underlying shares must be shares in the PRC-resident company, or shares of another PRC-resident company received by the employing company as a result of a capital contribution in the form of technology.
4. The number of participants cannot exceed 30 percent of the average employee population of the company in the last six months.
5. Share options and restricted shares must be subject to a minimum vesting period of three years, and sale restrictions of at least one year should be placed on shares acquired under the plan.
6. The expiration period of the share options must not exceed 10 years.
7. Shares which immediately vest upon grant must be granted by PRC-resident companies in the qualified industry.

KPMG NOTE

Following the release of Circular 101 and Announcement 62, the KPMG International member firm in the PRC reached out to various local tax authorities to seek clarifications on some of the practical implications of the circulars. A summary on some of the key points is provided below.

Insights on Practical Implications of Circulars

- According to some tax officers, equity incentive awards granted under a limited partnership do not qualify for preferential tax treatment under Circular 101.[2] In addition, employees of a PRC-resident company's branch office participating in the equity incentive plan are deemed eligible employees for the purpose of Circular 101, while employees of subsidiaries of a PRC-resident company are not.

- With respect to condition 5 of Circular 101, most tax authorities that were consulted indicated that the vesting period (i.e., minimum of three years) and the sales restriction period (i.e., minimum of one year) cannot overlap (how to count the vesting period and sales restriction period is not specified in the new regulation).[3] Where the equity incentive awards were granted/acquired before 1 September 2016, the holding periods could begin from the date of actual grant/acquisition.

- Concerning the seventh condition, most tax authorities consider that the "List of Industries Restricted from Entitlement to Tax Incentives for Equity Incentives" shall only apply to share awards granted by private companies which vest immediately at grant.

- Most tax authorities consulted were of the opinion that share incentive awards granted by private companies which do not qualify for preferential tax treatment under Circular 101 could apply the preferential tax treatment prescribed by Caishui [2005] No. 35, Caishui [2009] No. 5, Guoshuihan [2009] No. 461. The preferential tax treatment allows equity award income arising from vest/exercise to be taxed as a separate source of income and may potentially lower the applicable marginal tax rate by averaging the taxable value over the attributable vesting period (capped at 12 months). Furthermore, the qualifying condition on ownership structure imposed on listed companies does not apply to private companies.

KPMG NOTE: Some Parting Observations

- These circulars underpin governmental support for national mass entrepreneurship and innovation with the goal of promoting economic structural transformation.

- The preferential tax treatment applies solely to unlisted domestic resident enterprises, which should stimulate the interest of those private companies and pre-Shanghai and Shenzhen Stock Exchange IPO companies in the market for wider deployment of equity awards.

- Companies that believe they may be affected by the new rules should consult with their qualified tax professionals and seek help with:

  - analysing the relevant implications of the new rules to their and

  - completing the relevant formalities to secure the preferential treatment.

FOOTNOTES:

1 Circular on Income Tax Policy Enhancing Equity Incentives and Capital Contribution through Technology Investment (Caishui [2016] No.101, "Circular No.101"), jointly issued by the Ministry of Finance and the State Administration of Taxation on 22 September 2016 and effective on 1 September 2016.

Circular on Administration of Income Tax on Equity Incentives and Capital Contribution In The Form of Technology (Announcement No. 62 of the State Administration of Taxation in 2016, "Announcement 62") issued by the State Administration of Taxation on 28 September 2016, and effective on 1 September 2016. Announcement 62 provides for the administrative guidelines and detailed implementation rules.

2 As we stated in the "KPMG Note" on page 2, tax professionals with the KPMG International member firm in the People's Republic of China have contacted various local tax authorities (generally with the policy regulatory departments in those authorizes) in the PRC to seek clarifications. The points we raise in the "Insights" section of this newsletter reflect the content of these discussions. It is important to bear in mind that the local practice may still vary among different tax authorities. Please consider consulting with your qualified tax professional before taking any decisions affecting your business or your employees/taxpayers.

3 Ibid.

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