KPMG

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People's Republic of China - Tax Administration Tightening Compliance on ESOPs

In recent years, the tax authorities in the People's Republic of China ("PRC" or "China") have been increasingly focused on individual income tax (IIT) compliance by tightening administration and enhancing collection enforcement. As part of this initiative, the State Taxation Administration ("STA") recently issued a *Circular on further deepening the reform of tax administration to simplify and streamline tax administration processes, and enhance taxpayer experience, with the aim to cultivate and stimulate market vitality* ("the Circular"). This Circular provides for the introduction of 15 new measures to enforce tax collection and reinforce tax administration.

Article 10 of the Circular, which imposes an additional tax reporting requirement and enforces existing tax reporting requirements on an organization's Employee Share Ownership Plan ("ESOP"), has attracted a lot of attention.

WHY THIS MATTERS

The heightened scrutiny and the authorities' efforts to tighten up administration and reporting requirements mean that companies with ESOPS should exercise greater due diligence and step up their information collection and reporting efforts so as to enhance their compliance. They also should consult with their tax service providers to make sure preferential IIT treatment is appropriate and applicable.

Key Provisions: Reporting

The Circular sets out the following tax reporting requirements for companies with an ESOP:

- Complete and lodge the equity incentive details disclosure form ("the Form"[1]) with the in-charge tax authorities within 15 days following approval of a new ESOP.

- Complete and lodge the Form with relevant supporting documentation for the ESOP that has been implemented, with the in-charge tax authorities by 31 December 2021.

- Continue to submit details on the ESOP to the in-charge tax authorities within the prescribed timeframe in accordance with the prevailing laws and regulations.[2]

The reporting requirements also apply to domestic companies participating in the ESOPs of overseas companies.

KPMG NOTE

Based on the contents of the Circular, the view of the KPMG International member firm in the People's Republic of China is that the STA intends to :

- strengthen administration of ESOP implementation in China;

- enforce collection of IIT due from participation in ESOPs; and

- regulate appropriate use of the preferential tax treatment on qualified equity awards.

In view of the above and based on preliminary discussions the KPMG member firm in China has had with several local tax authorities in major cities, including Shanghai, Beijing, Shenzhen, and Guangzhou recently, two categories of companies are going to be impacted:

Category 1: Companies that have approved implementation of ESOPs in China

- Public companies (domestic or overseas)

- Private companies.

Category 2: Companies that are currently implementing ESOPs in China

- Public companies (domestic or overseas)

- Private companies.

In order for companies to meet the new and ongoing reporting requirements in a timely manner, the following actions where relevant should be considered :

- By December 2021

  – Establish an equity-incentive-based compliance calendar and corresponding standard operating procedures in order to meet compliance requirements in a timely fashion (applicable for all companies).

  – Complete the new ESOP reporting (category 1 and category 2 companies that have not completed the equity-related tax reporting before).

- Starting from 1 January 2022
  - For new plans approved, complete equity incentive reporting by the 15th of the following month.
  - For new grants/vest/exercise, complete Circular 35 reporting by the 15th of the following month.

Furthermore, it is anticipated that the Circular requires companies to lodge the completed Form with the corresponding supporting documents by the end of 2021. In view of the timeline, it is possible that the STA may rely on the data collected from this year-end reporting to assess whether it would be necessary to extend the current preferential tax treatment for equity incentive income beyond 2021.

Where an ESOP is implemented for participants in China under a variable interest entities structure, or "VIE structure," we have observed that application of IIT treatment has been inconsistent across tax bureaux, particularly on the issue of whether the preferential tax treatment can be applied. The Form explicitly includes the VIE structure (direct or indirect) as one of the structures under which reporting is required if an ESOP has been approved for implementation or has been implemented. (This raises questions around whether the preferential tax treatment can be applied to ESOP awards granted to participants under a VIE structure.)

IIT treatment of ESOP awards granted through an indirect shareholding platform, e.g., Limited Liability Partnership, Employee Benefits Trust, etc., may also become the subject of discussion in the coming year.

KPMG in China will continue to pay close attention to the specific operating rules of the local tax authorities regarding the requirements stipulated in the Circular.

FOOTNOTES:

1 The Form mainly covers :

→ Basic information of the participating companies and the target companies, and their connection, e.g., direct or indirect holding relationship, direct or indirect VIE structures, etc.;

→ The type of awards and the approval date to implement ESOP;

→ Basic information of the participants, e.g., personal details, job title, grant details, vesting dates, etc.

2 Notice of Ministry of Finance and State Taxation Administration on Issues relating to the Levy of Individual Income Tax on Personal Income from Stock Options (Cai Shui (2005) 35) ("Circular 35"); Notice of the Ministry of Finance and the State Taxation Administration on Improving Income Tax Policies Relating to Equity Incentives and Provision of Technology in Exchange for Shareholding (Cai Shui [2016] No. 101), etc.

RELATED RESOURCE

This article is excerpted, with permission, from "STA tightening tax compliance on ESOP," *China Tax Alert* (Issue 36, November 2021), a publication of the KPMG International member firm in the People's Republic of China.

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