



China Tax Alert

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Tax incentive policy on equity based compensation

Regulations discussed in this issue:

- *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.
- *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.

Background

On 22 September 2016, the Ministry of Finance (MOF) and the State Administration of Taxation (SAT) jointly issued Caishui [2016] No. 101 (Circular 101), which discusses preferential PRC individual income tax (IIT) treatment on certain employee equity incentive awards granted by private companies, and capital contributions to PRC resident enterprises through technology investment. This circular sets out the qualifying criteria for enjoyment of the favourable tax treatment, and is supplemented by SAT Announcement 62 which provides for the administrative guidelines and detailed implementation rules. The new rules came into effect on 1 September 2016.

These circulars underpin governmental support for national mass entrepreneurship and innovation to promote economic structural transformation. The preferential tax treatments apply solely to unlisted domestic resident enterprises, which should stimulate interest of those private companies and pre-Shanghai and Shenzhen Stock Exchange IPO companies in the market for wider deployment of equity awards.

Salient points

Since enactment, the new rules have proven to be a stimulus for private companies to consider the use of equity awards as tax effective tool to 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% (top marginal tax rate applicable to employment related income) to 20%.

Circular 101 covers broadly, restricted shares and share options granted by unlisted PRC resident companies to their employees, and laid down the criteria 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's minutes
- 3) The underlying share must be the shares in the PRC resident company, or shares of another PRC resident company received by the employing company as a result of capital contribution in the form of technology
- 4) The number of participants cannot exceed 30% of 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) Expiration period of share options must not exceed ten years
- 7) Shares which immediately vest upon grant must be granted PRC resident companies in the qualified industry

Recent development

Following the release of Circular 101 and Announcement 62, KPMG proactively 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 as follows:

- According to some tax officers, equity incentive awards granted under limited partnership do not qualify for preferential tax treatment under Circular 101. In addition, Employees of the PRC resident company's branch office participating in the equity incentive plan are deemed eligible employees for the purpose of Circular 101, whilst employees of subsidiaries of the PRC resident company are not.
- With respect to condition 5 of Circular 101, most tax authorities we consulted reputed that the count of for the vesting (i.e. minimum of three years) period and sales restriction period (i.e. minimum of one year) cannot overlap. Where the equity incentive awards were granted/acquired before 1 September 2016, the count on the holding periods could begin from the date of actual grant/acquisition.
- Concerning the 7th condition, most tax authorities consider 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 we consulted were of the opinion that share incentive awards granted by private companies that 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), and the qualifying condition on ownership structure imposed on listed companies do not apply to private companies.

With the rollout of the new rules, PRC IIT preferential treatment is now available to equity awards granted by both listed and unlisted companies and the extent of potential tax savings largely depend on the design of the plan. Our team of KPMG professionals will be pleased to analyse the relevant implications of these new rules to your business and assist you with completing the relevant formalities to secure the preferential treatment.

For any enquiries, please send to our public mailbox: taxenquiry@kpmg.com or contact our partners/directors in each China/HK offices.

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