

Hainan Local Tax Bureau Released the Individual Income Tax (IIT) Policy on Equity Incentive Income Derived from Unlisted Companies, Filling Local Operational Guideline Gaps

Regulations discussed in this issue:

- Letter of Hainan Local Tax Bureau on Opinions relating to Individual Income Tax Issues for Equity Incentive Income Derived from Unlisted Companies (Qiong Di Shui Han [2015] No.1151, hereinafter referred as "Circular No.1151"), issued by Hainan Local Tax Bureau on and effective from 10 December 2015
- Reply of State Administration of Taxation on Alibaba (China) Network Technology Co., Ltd.'s Employees' Individual Income Tax Issues for Stock Option Income Derived from Unlisted Companies (Guo Shui Han [2007] No. 1030)
- Notice of the State Administration of Taxation on the Issue of Individual Income Tax Treatment of Discounts or Subsidies Derived from Subscription of Marketable Securities from Employer (Guo Shui Fa [1998] No. 9)
- Notice of Ministry of Finance and State Administration of Taxation on Issues relating to Collection of Individual Income Tax on Personal Income from Stock Options (Cai Shui [2005] No. 35)

Background

The Hainan Local Tax Bureau recently released its opinions relating to IIT treatment of equity incentive income derived from unlisted companies. After the Reply of State Administration of Taxation on Alibaba (China) Network Technology Co., Ltd.'s Employees' Individual Income Tax Issues for Stock Option Income Derived from Unlisted Companies, Guo Shui Han [2007] No. 1030 (Circular No. 1030) became invalid in 2011, this is the first time the PRC tax authorities have issued operational guidelines on IIT issues for equity incentive income derived from unlisted companies. It will likely encourage unlisted companies (including companies preparing for public listing) to implement employee equity incentive plans.

Main contents

On 10 December 2015, the Hainan Local Tax Bureau replied to a query raised by the Haikou Local Tax Bureau regarding employees' IIT implications for stock option income derived from unlisted companies - Letter of Hainan Local Tax Bureau on Opinions relating to Individual Income Tax Issues for Equity Incentive Income Derived from Unlisted Companies, Qiong Di Shui Han [2015] No.1151 (Circular No. 1151). Circular No. 1151 clarifies the specific taxation practice, including the taxation point, share valuation method, and tax calculation formula relating to shares and options granted to employees of unlisted companies.

Circular No. 1151 states that employees' equity incentive income derived from unlisted companies shall be regarded as "wages and salaries income", and the taxation point is at purchase date. The

taxable income = (value per exercised share - exercise price paid by employee) × number of shares exercised, in which the value per exercised share can be determined based on the net book value of the unlisted company as stated in preceding year's annual report which has been audited by an audit firm.

The IIT payable on the equity-related income of the month shall be calculated according to the following formula:

$$\text{IIT Payable} = (\text{income derived from equity incentive} \div \text{respective number of months} \times \text{applicable tax rate} - \text{quick deduction}) \times \text{respective number of months}$$

Wherein: the respective number of months shall refer to the number of months during which an employee derived the taxable income from equity incentive in China; where the period is more than 12 months, it shall be taken as 12 months.

KPMG observations

The release of Circular No. 1151 fills the gaps in the operational taxation guidelines on the equity incentive income derived from unlisted companies:

Clarification of the taxable value per share of unlisted companies

Circular No. 1151 draws from Circular No. 1030, and suggests that the taxable value per share can be determined based on the net book value per share of the unlisted company as stated in preceding year's annual report which has been audited by an audit firm.

Circular No. 1030 was abolished and became invalid on 4 January 2011. At present, there is no official guidance issued by the Chinese tax authority in respect of the determination of the taxable value of shares which are not publicly traded. It is complicated to calculate the fair market value of share-based compensation of unlisted companies, given the absence of a public market to ascertain the volatility of the share options amongst other relevant parameters. Circular No. 1151 confirms that determination method of the taxable value of unlisted companies' shares, which fills the gaps in this area.

Clarification of the applicability of the IIT preferential treatment method

Currently, the only official guidance available on the taxation treatment of share based incentive awards granted to employees of unlisted companies is the Notice of the State Administration of Taxation on the Issue of Individual Income Tax Treatment of Discounts or Subsidies Derived from Subscription of Marketable Securities from Employer, Guo Shui Fa [1998] No. 9 (Circular No. 9). This circular points out that in calculating the IIT, the taxable value of share-based incentive award can be amortized over a period of no more than six months, and the amortized amount is then aggregated to the employee's regular wages and salaries income for IIT withholding purposes, subject to the local tax authorities' approval. The expired Circular No. 1030 stated that the preferential tax treatment method applicable to annual bonuses can be applied to employees' wages and salaries income in

the form of share options derived from unlisted companies.

The IIT calculation method stated in Circular 1151 makes reference to the IIT calculation method which is applicable to income derived from share based incentive by employees of listed companies as it is stated in Notice of Ministry of Finance and State Administration of Taxation on Issues relating to Collection of Individual Income Tax on Personal Income from Stock Options, Cai Shui [2005] No. 35, (Circular No. 35). This IIT calculation method is more preferential than that method stipulated in Circular No. 9 and the expired Circular No. 1030. However, the requirement for tax registration of the equity incentive plan of the listed company with the local tax authorities, as one of the prerequisites for applying the preferential tax treatment stated in Circular No. 35, was not mentioned in Circular No. 1151.

Circular No. 1151 plays a guiding role in the taxation treatment of the share based incentive income derived by employees who participate in the unlisted companies' equity incentive plans in Hainan Province. As Circular No. 1151 is a reply to query raised in the province of Hainan, it is technically not binding in other locations. Unlisted companies with share based incentive plan may consider using Circular No. 1151 as a reference for consultation with the respective local tax authority to reach an agreement on the appropriate tax treatment.

KPMG will be pleased to assist you with such consultation.

