



In this issue:

**Summary**

**Background**

**Deloitte's view**

**People to contact**

## GES NewsFlash

# Preferential Tax Treatment on Equity-Based Compensation Extended to Lower-Tier China Subsidiaries

May 31, 2011

### Summary

The PRC State Administration of Taxation (SAT) recently issued a tax circular, Bulletin [2011] No. 27 ("Bulletin 27"), providing further clarification on the Individual Income Tax (IIT) treatment of equity-based compensation. The Bulletin 27 is effective from 1 May 2011 and substantially expands the beneficiaries of the preferential tax treatment.

### Background

The preferential tax treatment on stock incentives was firstly introduced under Cai Shui [2005] No. 35 ("Circular 35") effective from 1 July 2005. Under Circular 35, when an employee exercises options, the "spread," i.e., the difference between the grant price and the market value of the shares on the date of exercise, will be considered as employment income and subject to IIT. The Circular defined a specific tax calculation methodology on stock option income, with the tax calculated separately from regular monthly salary according to the following formula:

$$\text{IIT payable} = [(\text{Taxable income from stock option} \div \text{stipulated number of months}) \times \text{applicable tax rate} - \text{quick deduction}] \times \text{stipulated number of months}$$

The "stipulated number of months" is the number of months an employee works in the PRC that relate to China-sourced stock option income, which is capped at

a maximum of 12 months.

The preferential IIT calculation method was subsequently extended to Stock Appreciation Rights ("SARs") and Restricted Stocks ("RSs") by Cai Shui (2009) No.5 issued at the beginning of 2009.

Guo Shui Han (2009) No. 461 ("Circular 461"), again issued in 2009, however set strict conditions for when the preferential treatment could be applied, restricting the preferential treatment to employees of listed companies (including its branches), and the employees of companies in which the listed company directly or indirectly holds a minimum of 30% of shares. The indirect share holding was limited to the second-tier affiliated companies only.

As a result, a number of multinational companies (i.e., with below second-tier affiliates in China) were unable to benefit from the preferential taxing methodology.

Bulletin 27, however, abolishes the subsidiary tier limitation, but still keeps the 30% shareholding requirement. As a result, the preferential calculation method can now be applied when a listed company grants equity awards to employees of its subsidiaries if the listed company holds no less than 30% in the subsidiaries, regardless of how many tiers the subsidiaries are below the listed company.

#### **Deloitte's view**

- Bulletin 27 has not changed other conditions set out under Circular 461 for applying the preferential tax treatment. Essentially, tax registration is still required if the company would like to apply for the preferential tax treatment.
- As Bulletin 27 is effective from 1 May 2011, it is unclear whether the expanded preferential tax treatment can apply to equity compensation derived by employees of lower-tier companies retroactively.
- Bulletin 27 still keeps the 30% shareholding requirement. However, there is no clear indication at what point the 30% shareholding requirement would be looked at. In practice, if there is a change on the holding structure (i.e., less than 30% before or after the change), in-charge tax bureau's interpretation should be sought on whether the preferential tax treatment can apply.
- It is recommended that companies implementing equity plans in the PRC, especially those cannot enjoy the preferential taxing method given tier requirement, should review the existing structure and IIT treatment adopted on equity income and perform the IIT registration timely, if applicable, to

ensure PRC IIT on equity income is correctly reported and IIT efficiency can be achieved. In some cases, it may also be necessary to conduct proactive discussions with local tax bureaus to understand their practice in implementing Circulars 461 and Bulletin 27.related tax costs or net salary packages when the methods of financing the recovery become clearer.

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**[Back to top](#)**

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