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Tax and regulatory developments

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TAX

Taxation of stock appreciation rights and restricted stock units

In brief

Notice 461 aims to strengthen tax collection of stock appreciation rights (SAR) and restricted stock units (RSU) plans through rules on registration, taxation timing and qualifying conditions for preferential tax treatment.

Relevant regulations discussed in this issue:

Notice on taxation of individual income taxation of employee incentive plans, Guoshuihan [2009] No. 461, issued by the State Administration of Taxation (SAT) on 24 August 2009 (Notice 461)

Supplementary Notice on Relevant Issues of Individual Income Tax (IIT) on Stock Option Income, Guoshuihan [2006] No. 902, issued by the SAT on 30 September 2006 (Notice 902)

Notice on IIT Issues regarding Stock Option Income, Caishui [2006] No. 35, jointly issued by the MOF and the SAT on 28 March 2006, effective from 1 July 2005 (Notice 35)

Guoshuihan [2009] No. 461 (Notice 461) came into effect on 24 August 2009, and clarifies the following areas.

Determination of taxable income and timing of taxable events

SAR

A taxable event arises on the date on which an individual exercises the rights awarded under an SAR plan.

Taxable income = (stock price on the date of exercise – stock price on grant date) x number of stocks exercised

RSU

A taxable event arises on the date on which any of the stock awards become fully vested, i.e. when the restrictions are lifted.

Taxable income = (closing price of the stock on the date the stocks are registered + closing price of the stock on date of vesting) /2 x number of stocks vested - total acquisition cost paid by the individual x (number of stocks vested / total number of stocks awarded)

Qualifying plans

The preferential tax treatments prescribed under Notice 35 and Notice 902 can only be applied where the conditions listed below are met; otherwise, the income derived must be added to normal salary and taxed together.

- The plan must be implemented by a publicly listed company. Plans implemented before listing and income crystallising after listing are specifically excluded.
- The publicly listed company must hold at least 30 percent direct or indirect interest in shares of the individual’s employer.

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- The plan must meet all necessary reporting and documentation requirements.

Documentation requirements

Domestically listed company

Under Notice 461, domestically listed companies implementing stock option and SAR plans should register the relevant plan documents and implementation rules with the in-charge tax authorities.

Domestically listed companies that implement RSU plans should register:

- the stocks awarded under the plan with the China Securities Depository and Clearing Corporation
- the relevant plan documents and implementation rules with the in-charge tax authorities within 15 days of publicly disclosing the implementation of the plan.

Foreign-listed companies

Foreign-listed companies should also observe the registration requirements stipulated in Notice 35 to submit the plan rules, agreements, grant notices and other supporting documentation to the local tax authority prior to implementing the plan. Exercise notices and any amendments to the plan rules must be submitted to the tax authorities prior to exercising the options or SAR.

Withholding obligations

The payer or the individual taxpayer should fulfil the withholding and/or reporting obligations in respect of the income arising from participation in qualifying plans within the timeframe stipulated by the respective tax authority. In addition, details such as the type, quantity, exercise price, market price and transfer price of the underlying stock must be provided to the local tax authority.

Recommended action

In view of the efforts made by the SAT to strengthen the administration and tax collection of equity-based incentive plans, companies should:

- review their existing equity-based incentive plans, to ensure application of the appropriate tax treatment
- register the relevant plan documentation with the local tax authority.

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