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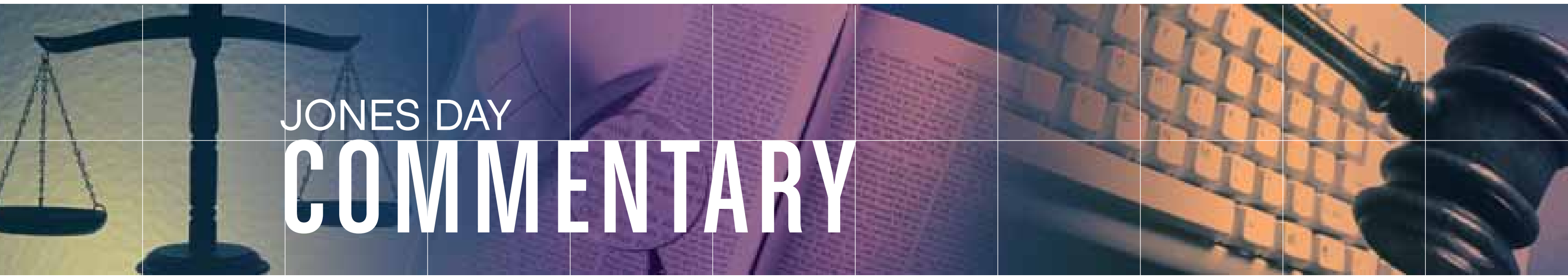

CHINA CLARIFIES TAX TREATMENT OF EQUITY-BASED INCENTIVE COMPENSATION

On August 24, 2009, the State Administration of Taxation (the "SAT") issued the Notice on Individual Income Tax Issues Concerning Stock Incentives, Guo Shui Han [2009] No. 461. The Ministry of Finance and the SAT previously issued several tax circulars, including Cai Shui [2005] No. 35, Guo Shui Han [2006] No. 902, and Cai Shui [2009] No. 5, concerning individual income tax treatment of stock appreciation rights, stock options, and restricted stock. The new tax circular has provided more guidance on application of tax rules than provided in the previous tax circulars.

WHEN IS AN INDIVIDUAL TAXED?

Stock Appreciation Rights. An individual is taxed at the time when he or she receives payment from his or her employer with respect to a stock appreciation right. A "stock appreciation right" is the right to receive a cash payment based on the appreciation of stock. When an employee exercises the stock appreciation right, the company will pay the employee in cash equal to the difference between the grant price and market price of stock.

Stock Option. Unless a stock option is transferable at the time of grant and has a price on the public market, an employee is taxed when he or she exercises an option.

Restricted Stock. An employee is taxed when the restrictions on shares of restricted stock lapse or are relieved, which generally is the time when those shares are fully vested to the individual.

HOW TO COMPUTE TAX

The taxable income of an employee for stock appreciation rights is the amount of payment received with respect to those rights. "Taxable income of stock options" is the closing price per share less exercise price per share multiplied by the number of shares exercised. Taxable income of restricted stock is computed using the following formula:

> Taxable income = (closing share price on share registration date + closing share price on vesting date for current installment)÷2 x the number of shares vested in current installment – total payment by employee x (number of shares vested in current installment÷total number of shares received)

The vesting date is the date when restrictions on the restricted shares are relieved. The tax treatment of restricted stock seems favorable compared to that of stock options. Suppose an employee receives 300 restricted shares that are vested in three installments on the date of each anniversary of the award date. No payment is required for the employee to acquire those shares. Upon the award, the shares are registered under the employee's name with the relevant institution when the stock is $10 per share. One year later, 100 shares are vested when the stock is $20 per share. Applying the formula, the employee's taxable income derived from the restricted shares should be:

> Taxable income = ($10+$20)÷2 x 100 – 0 = $1,500

Suppose the employee immediately sells the 100 shares and receives $2,000 cash. The $500 difference presumably should be treated as gain on disposal of shares, which is subject to a flat tax rate of 20 percent. If the shares are issued by a nonresident enterprise and the employee is a non-PRC resident, the employee may not be subject to China tax on the gain.

A China Individual Income Tax return is filed monthly, and salaries and wages are taxed at progressive tax rates of 5 percent to 45 percent. Tax on income derived from stock appreciation rights, stock options, and restricted shares is allowed to be computed using a special formula to give the effect of spreading income over a calendar year in applying the progressive tax rates. When an employee receives incentive income from appreciation rights, stock options, or restricted stock for the first time in a calendar year, the following formula applies:

> Individual Income Tax = (incentive income÷number of months) x applicable tax rate – quick deduction) x number of months

The "number of months" in the formula is the months that an employee works in China in relation to the award of appreciation rights, stock options, or restricted stock, up to 12 months. If the employee subsequently receives such incentive income in the same calendar year, the following formula applies:

> Individual Income Tax = (total incentive income for the year÷number of months) x applicable tax rate – quick deduction) x number of months – tax previously paid on incentive income for the calendar year)

EXCEPTION

The favorable computation formula does not apply to the following situations. In those situations, an individual must combine any incentive income derived during that month with his or her other salary income to compute tax, which usually will result in higher tax liability.

- The stock appreciation rights, stock options, and restricted stock are awarded by a non-listed company.
- The incentive plan is adopted by a company before listing and employees receive incentive income after the company is listed.
- If an individual is an employee of an affiliate of the listing company issuing stock, the listing company directly or indirectly owns less than 30 percent stock of the affiliate or the affiliate is not a first-tier or second-tier subsidiary. In computing the ownership of the listing company in a second-tier subsidiary, if the listing company owns more than 50 percent of the first-tier subsidiary, the listing company is deemed to own 100 percent of the first-tier subsidiary. According to this exception, the employees of a third-tier Chinese subsidiary of a multinational company would not be eligible for the favorable tax treatment. Furthermore,

the local staff of China representative offices of foreign listing companies may also not be eligible for the favorable tax treatment because they are legally not employees of the foreign companies and are seconded to the representative offices by China human resource services companies. It is not clear whether the circular is intended to deny such tax benefits of PRC staff of foreign representative offices.

- The company fails to file required information with the tax authority in charge.

EMPLOYER'S FILING REQUIREMENTS

Companies listed in China that implement an equity-based incentive compensation plan are required to file the plan and various other documents with the tax authorities. If a company is listed outside China, its entity within China should file the incentive plan of the listing company with the tax authority in charge. A withholding agent should report to the tax authority in charge the information concerning receiving, transfer, and purchase of stock, including type, number, exercise price, market price, transfer price, list of people who receive equity-based incentives, taxable income, and tax payable.

LAWYER CONTACT

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