China

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Q&A

Please provide a brief overview on how an ESOP in a start-up is usually structured in your jurisdiction (of particular interest: virtual or real participation programs, market practice with regard to vesting, participation (exits, proceeds and dividends) and voting rights).

China does not differentiate between ESOPs for start-ups and ESOPs concerning “other enterprises”.

Generally, PRC laws consider “stock options, equity options, restrictive stocks, stock appreciation rights, share awards and other discounts or subsidies received from employers due to subscription of shares and other negotiable securities" as “equity incentive income”. For the sake of the following we will understand ESOPs to refer to such “equity incentive income” only.

Compared to other developed/market-economy jurisdictions, ESOPs have thus far gained less traction in China and hence a “usual” market practice with regard to vesting, participation (exits, proceeds and dividends) and voting rights is as of yet less established. Stock options and restricted stocks are prevalent in China for ESOPs offered by listed companies, with the average vesting period being probably somewhere between three to five years.

It is subject to the decision to any employer to decide who shall be qualified to participate in an ESOP and for start-ups this is probably a broader range of staff while for more established enterprises, qualified employees would probably be restricted to senior executives and key

employees.
ESOPs offered by foreign (i.e. non-Chinese) listed companies must be registered with the locally competent department of the China State Administration of Foreign Exchange ("SAFE"), otherwise foreign exchange proceeds distributed under such ESOP may not be transferable to/from China.

Please provide an overview of the respective tax situation an employee finds him-/herself in when he/she participates in a real/virtual equity investment program (applicable taxes and approximate tax burden (a) at the time of the investment and (b) at the time when revenues therefrom are received).

Where ESOPs are offered by Chinese employers to their employees in China, China-sourced income derived by these employees from such ESOPs is generally understood to represent employment income for China Individual Income Tac ("IIT") purposes. Hence, if such income is generated in regard to employment in China by either domiciled or non-domiciled employees (basically most non-Chinese employees in China), it is subject to China IIT. In practice, the tax authorities' interpretation and implementation of the IIT-treatment of ESOP-income with a foreign-related aspect still varies widely across China and hence detailed consultation with the local in-charge tax authority is highly recommended.

"Income obtained from equity incentives” is generally the vesting benefit (e.g. the difference between the market price of the stock over the exercise price when an option is exercised) which is taxable as such in China if paid/received in regard to employment in China.

China IIT exposure for resident and non-resident employees is different and must be considered separately. Individuals who do not habitually reside in China (i.e. non-domiciled individuals) will generally be deemed residents for IIT purposes if they stay in China for 183 days or more within a calendar year (exceptions may apply under certain bilateral taxation agreements and also depending on certain positions assumed by individuals in China).

ESOP income received by China tax residents for their work in China is taxed separately from other employment income (referred to as “comprehensive” income under China IIT laws) at progressive rates and on an annual basis. If the ESOP income gained during one calendar year is paid in several installments during such year, these installments shall be aggregated for IIT purposes. The formula for IIT calculation is the following:

IIT payable = income from equity incentive * applicable tax rate – quick deduction

Brackets	Annual Taxable Income (after deductions) (RMB)	Tax Rate (%) / Quick Deduction (RMB)
1	≤ 36,000	3% / 0
2	36,000 ≤ 144,000	10% / 2,520
3	144,000 ≤ 300,000	20% / 16,920
4	300,000 ≤ 420,000	25% / 31,920
5	420,000 ≤ 660,000	30% / 52,920
6	660,000 ≤ 960,000	35% / 85,920
7	> 960,000	45% / 181,920

Non-residents also are taxed separately by applying progressive rates on such income, but the amount received is divided by six to determine the applicable rate, since non-residents' employment income is subject to tax brackets and rates on a monthly basis.

When a non-PRC entity affiliated with a PRC employer pays a non-China-domiciled employee China-sourced employment income, the employee or his local China-employer shall file a tax return and pay IIT in China and, irrespective of the China-employer filing/paying IIT in China, the China-employer must in any event report the ESOP income information to the Chinese tax authorities.

The China IIT declaration for any vesting benefits shall generally be made within twelve month from the date the vesting benefit is obtained.

Are there any tax advantages for an employee if the revenues based on the equity investment are reinvested in start-ups or other companies?

There are no tax advantages for an employee if their revenues derived from an ESOP are reinvested in start-ups or other companies.

In case of an ESOP being structured in the form of equity investment offered by a non-listed enterprise, the employee may apply for IIT payment deferral if the employer/company has recorded the details of the ESOP with the in-charge tax authorities and the statutory conditions for tax deferral are all satisfied (which are however rather high and complex to meet).

In case of an ESOP offered by a China-listed company and provided such ESOP is registered with the China tax authorities and meets all statutory criteria, a preferential IIT regime applies for the employee to income earned under that ESOP by taxing such income separately from other employment income to avoid a potentially otherwise higher progressive China IIT rate being applicable. In particular for high-earners, this "preferential" treatment will however mean rather little on the bottom-line of after-tax income.

Are there any tax advantages for the company if an ESOP is established in the company?

For companies there are no particular tax advantages to establish an ESOP. On the contrary, because of the rather cumbersome and complex filings/taxation procedures, in particular in a cross-border context, ESOPs are often seen by companies as to require high management and operational resources while often not being seen as the most attractive retention tool by employees.

Please highlight one pro and one con of the legal set up with regard to ESOPs in your jurisdiction.

See above reply under Sec. 4.