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Tax Control on Individuals Transferring Shares

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In Brief

» Recently, State Administration of Taxation issued the Administrative Measures for Individual Income Tax on Income Derived from Share Transfer (Trial Implementation), which clarified various key concepts in relation to share transfers by individual shareholders.

» The Measures take effect from 1 January 2015 and are intended to enhance the tax monitoring on investment income derived by high-income individuals.

» The individual shareholders and companies are advised to take a close look at the Measures and ensure they are in compliance with the reporting and withholding obligations and sufficient documents are well retained in case of a tax audit.

In detail

On December 7, 2014, State Administration of Taxation ("SAT") issued the Administrative Measures for Individual Income Tax ("IIT") on Income Derived from Share Transfers (Trial Implementation) (hereinafter referred to as "Measures"), which clarified IIT treatment and reporting requirements for transferring Chinese companies' shares by individual shareholders. The Measures take effect from 1 January 2015.

The key points of the Measures are summarized as follows.

» Scope of the Measures

In the Measures, "share(s)" means share(s) in Chinese enterprises or organizations (hereinafter referred to as "invested enterprises"), excluding sole proprietorships and partnerships, held by individual shareholders. In addition, the Measures do not apply to transfer of China-listed shares, restricted stock and other shares governed by special regulations.

» Calculation of Taxable Income Derived from a Share Transfer

The taxable income derived from a share transfer by an individual (including foreign individuals) should be subject to 20% IIT in China and is calculated as follows:-

Taxable income = Gross share transfer income - original cost of the shares - reasonable expenses incurred for the transfer

If the transaction is not settled in RMB, the foreign currency should be converted into RMB based on the median exchange rate on the settlement date.

Share Transfer Income

Gross share transfer income includes various forms of economic benefits received, including cash, tangible assets, securities & etc. All payments related to the share transfer, including penalties, compensations, subsequent income obtained after fulfilment of certain conditions & etc. should be included for IIT purposes.

Chinese tax authorities are empowered to reassess the gross income if the taxpayer fails to provide relevant documents or if the gross income is "significantly low" without a "justifiable reason".

The share transfer income is considered as "significantly low" in any of the following circumstances:-

- The reported income is lower than the net assets value represented by the shares transferred (in particular, fair market value must be used if the invested enterprise owns land use rights, real estate, intellectual property, exploration or mining rights, equity investment & etc.)
- The reported income is lower than the original investment cost; or lower than the purchase price and related taxes paid for the acquisition of the shares;
- The reported income is lower than the share transfer income obtained by the same or another shareholder in the same enterprise under the same or similar conditions;

- The reported income is lower than share transfer price of enterprises in the same industry under the same or similar conditions;
- The shares are transferred without considerations and justifiable reasons; and
- Other circumstances specified by tax authorities.

The following circumstances can be considered as having “justifiable reasons”, if the share transfer income is considered as “significantly low”:-

- The lower share transfer price is due to national policy adjustments;
- The shares are inherited or transferred to spouse, parents, children, grandparents, grandchildren, siblings, or any person of whom the transferor is a legal dependent;
- The shares are transferred internally by enterprises' employees, which cannot be transferred to external parties according to laws or company’s Articles of Association and sufficient documents are in place to support the reasonableness and authenticity of the transfer price; and
- Other reasonable circumstances with valid documents.

In case of “significantly low” income without “justifiable reasons”, the re-assessment methods can be adopted by Chinese tax authorities in the following sequence:-

- Net asset method – If the aggregate of land use rights, real estate, intellectual property, exploration or mining rights, equity investment & etc. exceeds 20% of the total assets of the invested enterprise, reference can be made by tax authorities to the asset appraisal report issued by a qualified appraisal firm, which can be used as a reference for any subsequent transfers within six months after the initial transfer, provided that the net assets of the invested enterprise has not changed significantly.
- Comparable method – By reference to the share transfer price in the same invested enterprise or in the same industry under the same or similar conditions.
- Other reasonable method.

Original cost of shares

The original cost of shares shall be determined as follows:-

- For shares acquired in cash – the total amount of the actual price paid plus reasonable taxes/expenses incurred directly related to the acquisition;
- For shares acquired by non-monetary means – the total amount of the assessed price by the tax authorities plus reasonable taxes/expenses incurred directly related to the acquisition;
- For shares obtained from the abovementioned family members or legal dependents with no cost – the total amount of the original cost paid by the previous shareholder plus reasonable taxes/expenses incurred in relation to the transfer;
- For shares converted from capital surplus / surplus reserve / retained earnings, for which the individual shareholder has already paid the IIT – the total amount of the converted amount plus reasonable taxes/expenses;
- Other situations where tax authorities should assess the original cost based on a reasonable method with an aim to avoiding double taxation on the same income for IIT purposes.

If the shares are acquired through multiple transactions, a weighted average method should be adopted to determine the original cost of the shares transferred.

» **Tax Declaration and Withholding Obligation**

The transferor is the taxpayer and the transferee is the withholding agent.

Pre-transfer reporting

- The transferee should report the transaction to the competent tax authorities within 5 working days after the transfer agreement is signed.
- The invested enterprise should report board resolutions and minutes of shareholder meetings to the competent tax authorities within 5 working days after the relevant meeting is held.

Tax reporting

The transferor and transferee should perform tax filing with tax authorities within 15 days of the month subsequent to the month in which the share transfers are effected.

Post-transfer reporting

The invested enterprise should report the change of individual shareholders' ownership to the tax authorities within 15 days of the following month.

WTS observation

» The Measures clarified various key concepts in relation to share transfers by individual shareholders, including assessment on taxable income, determination of original share cost, tax reporting and withholding obligations, etc.

» The Measures indicates the enhanced tax monitoring by Chinese tax authorities on investment income derived by high-income individuals.

» The individual shareholders and companies involved are advised to take a close look at the Measures and ensure they are in compliance with the reporting and withholding obligations and sufficient documents are well retained in case of a tax audit.

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