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People's Republic of China: IIT reform: Guidance issued on transition rules for preferential IIT policies

Overview

China's Ministry of Finance and the State Administration of Taxation jointly released guidance (Caishui [2018] No. 164 (Circular 164)) on December 27, 2018 that contains transition arrangements for various preferential individual income tax (IIT) policies that are available before the new IIT law enters into effect (on January 1, 2019).

Annual bonus

Under the old IIT law, an employee's qualifying annual bonus may be taxed separately from his/her regular salary income (which falls within the scope of "comprehensive income" for IIT assessment under the new IIT law) and was divided by 12 to determine the applicable tax bracket/rate.

Circular 164 grants a transition rule that applies through December 31, 2021. Under this rule, a resident individual may elect to have his/her qualifying annual bonus be taxed separately from other comprehensive income and divide the bonus amount by 12 to determine the applicable tax bracket/rate. Since the tax bracket/rate table for comprehensive income under the revised IIT law is designed on an annual basis, a modified “monthly” tax bracket/rate table will be used to compute the tax on the annual bonus.

Alternatively, a resident individual may elect to include the annual bonus in his/her comprehensive income for IIT assessment purposes.

As from January 1, 2022, all annual bonus income derived by a resident individual will have to be included in an individual’s comprehensive income for IIT assessment purposes.

Comments

During the three-year transition period from January 1, 2019 to December 31, 2021, Circular 164 allows a resident individual to have his/her qualifying annual bonus be taxed separately from his/her other comprehensive income or alternatively, the individual may include the bonus in his/her comprehensive income for IIT assessment purposes.

If a resident individual’s other comprehensive income in a tax year is higher than his/her annual deductions, the individual may benefit from the separate taxing method; otherwise, it may be more beneficial for the individual to include the annual bonus in comprehensive income for IIT assessment.

Employers should consider reviewing their compensation and benefits policies and communicate with employees in advance about the impact of Circular 164 in order to assist employees in making appropriate elections.

It should be noted that the transition arrangement in Circular 164 is applicable to only resident individuals; the rules applicable to non-residents are still to be clarified.

Income from equity incentive plans by listed companies

Under the old IIT law, an employee’s qualifying income from equity incentive plans (*e.g.* stock options, stock appreciation rights, restricted stock) operated by listed companies may be taxed separately from the employee’s regular salary income and divided by stipulated months (capped at 12) to determine the applicable tax rate.

For the period through December 31, 2021, Circular 164 provides the above income derived by a resident individual will be taxed separately from the individual’s other comprehensive income and the new tax bracket/rate table for comprehensive income will be applied for IIT assessment purposes.

Qualifying income from equity incentive plans operated by listed companies derived by a resident individual in a calendar year should be consolidated for IIT assessment.

The IIT policies for such equity incentive income after 1 January 2022 will be separately announced.

Comments

The issuance of Circular 164 addresses concerns about whether the separate taxing method would be retained after January 1, 2019. Circular 164 indicates that the tax authorities likely will formulate and announce new IIT policies on equity incentive plans following the expiration of the three-year transition period.

To qualify for the separate taxing method, affected companies still should submit the relevant documents to the tax authorities in a timely manner.

Similar to the transition arrangement on annual bonus income, the separate taxing method in Circular 164 applies only to resident individuals. The rules applicable to non-residents still are to be clarified.

Non-taxable benefits-in-kind (BIK) for foreign employees

Under the old IIT law, certain BIKs (including relocation, housing rentals, meals and laundry, home leave, language training and children’s education expenses) may be exempt from IIT for foreign employees working in China if they are paid on a reimbursement basis or if the expenses are settled directly by the employer at a reasonable amount.

Circular 164 provides that, for the period January 1, 2019 to December 31, 2021, foreign employees who are resident in China may opt to claim either the relevant additional itemized deductions (*e.g.* children's education, housing rental and continuing education) or continue to enjoy the non-taxable BIKs (*i.e.* housing rental, children's education and language training). Once an election is made, it may not be changed within a tax year.

As from January 1, 2022, foreign employees no longer will enjoy the non-taxable BIKs on housing rental, children's education and language training.

Comments

The three-year transition period on certain non-taxable BIKs is believed to address the concerns of foreign employees working in China and ensure a smooth transition to the new IIT law.

Employers with a large population of foreign employees may need to review the impact of Circular 164 on their existing compensation and benefit policies, communicate with foreign employees and make or adjust short and long-term plans, accordingly.

Enterprise annuities

Under the old IIT law, after an employee reached the statutory retirement age, any withdrawal from qualifying annuities may be taxed separately from his/her regular salary income.

Circular 164 provides that, under the new IIT law, such withdrawals still may be taxed separately from the taxpayer's other comprehensive income, and a tax bracket/rate table will be used, depending on the situation:

- New tax bracket/rate table for comprehensive income
    - Annual withdrawal
    - Lump-sum withdrawal due to emigration from China
    - Lump-sum withdrawal by an individual's designated beneficiary or legal successor after the individual's death
- Modified "monthly" tax bracket/rate table
    - Quarterly/monthly withdrawal
    - Lump-sum withdrawal in other situations

Severance pay

Under the old IIT law, severance pay generally was exempt from IIT if the amount was less than three times the local average wages. If the amount was higher than the threshold, only the excess was taxable and was taxed separately from the individual's regular salary income.

Circular 164 basically adopts the above taxing method under the new IIT law.

Deloitte's view

Circular 164 signals the government's intention to ensure a smooth transition to the new law. This is welcome news for businesses.

It is worth noting that some of the transition policies will expire in three years, so both employers and individuals should use this time to prepare for the upcoming changes and make plans accordingly. In addition, some policies provided by Circular 164 are applicable only to tax residents, with the tax treatment for non-residents still to be clarified. Affected parties should continue to monitor developments.

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Poland introduces exit tax on unrealized gains

Overview

As of January 1, 2019, important changes to the Polish Personal Income Tax Law and Corporate Income Tax Law came into force. One of them is the introduction of an exit tax on unrealized gains for both businesses and individuals. The below alert focuses only on the impact of this legislative change on individuals, both entrepreneurs and private persons.

Who is covered by exit tax?

Individuals may become liable to exit tax in two events:

1. **Transfer of their assets abroad** (while the individuals continue to own them), which causes Poland to lose its rights (fully or partly) to tax proceeds from the sale of these assets.
2. **Transfer of their tax residence**, which causes Poland to lose its rights (fully or partly) to tax proceeds from sale of assets owned by the individual.

In the second case (losing Polish tax residence), the exit tax would only apply to private individuals if they have been *Polish tax residents for at least five years* in the 10-year period preceding the change of tax residence.

What is covered by exit tax?

The exit tax applies to individuals solely if the fair market value of all assets mentioned above is equal to or greater than PLN 4 mln.

The exit tax applies to all assets owned within one's business activity. In the case of private assets (not related to any business activity carried out either individually or via a transparent partnership), only the following items are covered by exit tax:

- Shares in transparent partnerships;
- Shares in companies that are separate legal entities;
- Other securities;
- Derivatives; and
- Investment fund units.

In the case of transferring assets abroad, the exit tax is not applicable if they are transferred for a limited period of up to 12 months.

How is exit tax paid?

Individuals may be subject to exit tax according to one of the following rates:

- **19 percent:** If, in the case of disposal of the relevant assets, taxable income is normally established as a difference between proceeds and deductible costs incurred.
- **3 percent:** If, in the case of disposal of the relevant assets, the proceeds are normally taxed at a lump sum (with no costs being deducted for tax purposes).

The unrealized gains need to be reported in a separate tax declaration, and exit tax should be paid by the seventh day of the month following the month in which taxation is triggered.

Exit tax: Installment scheme/refund

It is possible to ask the Polish tax authorities to break down the exit tax liability into installments for a maximum period of five years. This option applies solely to individuals who are moving their assets or tax residence to one of the European Union/European Economic Area countries that have concluded respective agreements concerning mutual assistance for the recovery of claims relating to taxes, duties, and other measures with Poland.

Individuals may also apply to the Polish tax authorities for a refund of exit tax paid, in case they transfer their assets/tax residence back to Poland within a five-year period.

Deloitte's view

The introduction of exit tax provisions in Poland follows the requirements resulting from the Council Directive (EU) 2016/1164 of July 12, 2016, laying down rules against tax avoidance practices that directly affect the functioning of the internal market. Nevertheless, the new Polish provisions are stricter and go further than the guidelines provided by the directive regarding the exit tax.

First of all, the directive obliges the EU countries to introduce the relevant provisions (including the provisions on exit tax) as of 2020. Poland has decided to introduce them a year earlier – as of January 1, 2019. Secondly, the directive lays down the rules for exit tax with respect to entrepreneurs transferring their assets or tax residence. However, the new Polish provisions impose exit taxes also on private individuals. Consequently, there are certain doubts regarding compliance of the new provisions with the EU law, especially since the European Court of Justice has already issued several rulings that deemed exit tax imposed on individuals as noncompliant with the EU laws (particularly from the free movement perspective).

In addition to the above, the way in which the exit tax provisions are worded is rather vague (*e.g.*, they establish two possible taxable events: transfer of assets, or transfer of tax residence; however, most of the further provisions refer solely to one of them – transfer of assets). Consequently, there are still a lot of questions on how the provisions will be executed in practice. There are also doubts regarding the application of double tax treaty provisions in the context of exit taxes (the exit tax allows for taxation of assets upon a change of residence, without any actual transaction taking place).

Our recommendation for international companies is to review the situation of their key management personnel who move internationally, particularly top executives. Individuals who may hold assets worth PLN 4 mln and who cease their Polish tax residence due to their move abroad, may need to settle exit tax in Poland due on their unrealized assets.

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United States:
IRS Notice 2018-97 provides initial guidance on application of IRC Section 83(i)Overview

Introduction

Internal Revenue Code (IRC) Section 83(i), as enacted by the 2017 Tax Act (P.L. 115-97, "the Act") on December 22, 2017, allows certain employees to defer recognition of income attributable to stock options or RSUs received in connection with the performance of services.

On December 7, 2018, the Internal Revenue Service (IRS) issued Notice 2018-97 (the "Notice") to provide initial guidance on certain aspects of Section 83(i). In particular, the Notice addresses:

- The requirement that stock option or RSU grants be made to not less than 80 percent of all employees who provide services to an applicable employer in the United States;
- The application of federal income tax withholding on the deferred income applicable to qualified stock; and
- An employer's ability to opt out of permitting employees to elect deferred tax treatment for their qualified stock even if the requirements under Section 83(i) are met.

The Department of the Treasury (the "Treasury") and the IRS anticipate further guidance will be issued in the form of proposed regulations and that the proposed regulations will incorporate guidance addressed in the Notice.

Background

Generally, Section 83 provides for the federal income tax treatment of property transferred in connection with the performance of services. The Act amended Section 83 to add Subsection 83(i), which allows a "qualified employee" to elect to defer the inclusion in income of the amount that would otherwise be included under Section 83(a) upon the transfer of "qualified stock" pursuant to the exercise of a stock option or the settlement of an RSU.

For an overview of Section 83(i), please refer to Deloitte's NewsFlash (distributed on January 15, 2018), US tax reform: Qualified equity grants by private companies under newly added Section 83(i).
URL: https://www2.deloitte.com/content/dam/Deloitte/us/Documents/Tax/us-tax-reform-new-section-83i.pdf

Initial Guidance in Notice 2018 – 97

Application of the 80-Percent Requirement: Per the Notice, the determination as to whether a corporation qualifies as an eligible corporation must be made on a calendar year basis. Thus, when determining whether a corporation satisfies the 80 percent requirement in a given calendar year, that corporation needs to consider both:

- Stock options or RSUs that were granted in that calendar year to employees who provide services to the corporation in the United States (or any possession of the United States); and
- The total number of individuals employed at any given time during the calendar year in question (without regard to excluded employees or part-time employees), regardless of whether the employees were employed by the corporation at the beginning or end of the calendar year.

The Notice specifically notes that considering stock option or RSU grants on a cumulative basis (*i.e.*, including grants made in prior years) is not a good faith interpretation of the 80 percent requirement and, thus, is excluded from the transition rule.

The Notice implies that a corporation that intends to offer qualified stock will need to review annually whether the 80 percent requirement has been satisfied, looking at stock option grants and RSU grants separately. This process will require determining the total number of employees during the calendar year, since the Notice emphasizes this assessment should not be done "as of" a certain date in the year.

Federal Income Tax Withholding: Section 83(i) provides an election to defer the inclusion in income of the amount that would otherwise be included under Section 83(a) upon the transfer of qualified stock pursuant to the exercise of a stock option or the settlement of an RSU. If a qualified employee makes a timely "inclusion deferral election", then the employee would defer the income for up to five years for federal income tax purposes. However, the timing of income inclusion for taxes related to the Federal Insurance Contributions Act (FICA) and the Federal Unemployment Tax Act (FUTA) may not be deferred. As a result, FICA and FUTA will continue to be due at the time stock options are exercised or RSUs are vested or settled, under the same requirements as are generally in effect, resulting in different tax points for federal income tax and FICA/FUTA.

The Notice confirms that qualified stock under Section 83(i) is considered wages for income tax withholding purposes. Deferral stock (*i.e.*, qualified stock subject to a deferral election) is treated as wages at the end of the deferral period in an amount equal to the amount included in income under Section 83 for the taxable year that includes such date. Moreover, such stock is subject to income tax at the maximum rate in effect (*i.e.*, 37% for 2019), with no adjustment at the request of the employee (*e.g.*, through Form W-4 withholding allowances), and is to be treated as a noncash fringe benefit. Under these rules, employers are liable for withholding federal income taxes from deferral stock, even if another entity transfers the stock.

The Notice provides that as part of the income deferral election, employees must agree that all deferral stock will be deposited into an escrow account established by the employer before the end of the calendar year in which the Section 83(i) election is made and remain in escrow until either:

- The company has withheld sufficient shares to cover income taxes due at income inclusion; or
- The company has otherwise recovered the corresponding income tax withholding from the employee.

If the company and the employee do not agree to deposit the deferral stock into an escrow account, the employee is not a qualified employee within the meaning of Section 83(i)(3). Future guidance may establish alternative or substitute mechanisms to ensure the company's income tax withholding requirements are satisfied, but such mechanisms may be more restrictive than those described above.

A corporation that intends to make stock option or RSU grants that are eligible for Section 83(i) will need to consider implementing an escrow arrangement. Alternatively, by declining to establish an escrow arrangement consistent with the requirements in the Notice, a corporation may preclude its employees from making Section 83(i) elections.

Designation of Stock as Not Eligible for Section 83(i) Election: The Notice acknowledges that while employees may make the election for deferred tax treatment of qualified stock under Section 83(i), the corporation is responsible for creating the conditions that would allow employees to make this election. In response to concerns raised by employers about inadvertent adoption of Section 83(i) arrangements, the Notice confirms that whether to make grants of qualified stock is within the control of the corporation, because the corporation can decline to establish an escrow arrangement or specify in a stock option or RSU grant documentation that the stock received will not be eligible for an election under Section 83(i).

In light of the confirmation that employers can determine whether to offer grants of qualified stock, companies should consider whether to add specific language regarding ineligibility for Section 83(i) to award agreements or plan documentation for all US employees.

Deloitte's view

As a next step, employers should:

- Continue to watch for additional guidance from then Treasury or IRS. Proposed regulations are anticipated and will incorporate the guidance in this Notice.
- Consider how initial guidance in this Notice might affect the company's decision on whether to offer grants of qualified stock to eligible employees.
- Review processes in place to track the application of the 80 percent requirement, as well as the establishment of an escrow arrangement, as applicable.

Read more about Deloitte Tax LLP's insights on US tax reform and to view upcoming events.
URL: https://www2.deloitte.com/us/en/pages/tax/articles/tax-reform-global-mobility-human-resources-considerations.html?id=us:2sm:3na:gis:awa:tax:020819&sfid=7011O000002Dnrg

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