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Legal Commentary

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Tax Law

New Individual Income Tax Policy on Dividends and Bonuses from Listed Companies

Yang CHEN | Fang JI | Bing XUE

On November 16, 2012, the Ministry of Finance (the "**MOF**"), the State Administration of Taxation (the "**SAT**"), and the China Securities Regulatory Commission jointly issued the *Notice on the Implementation of the Differentiated Individual Income Tax Policy on Dividends and Bonuses Received from Listed Companies* (Caishui [2012] No. 85, hereinafter referred to as the "**Notice**"). The Notice provides that the individual income tax ("**IIT**") on dividends and bonuses received from listed companies will be levied differently based on the relevant stock-holding periods. For stocks with a holding period of no more than one month, all the dividends and bonuses shall be subject to the IIT. For stocks with a holding period above one month but not exceeding one year, 50% of the income shall be subject to the IIT. For stocks with a holding period of more than one year, 25% of the income shall be subject to the IIT, and the applicable IIT rate will remain at 20% as stated in the Individual Income Tax Law (the "**New Tax Policy**"). The Notice will take effect on January 1, 2013.

1. Current Individual Income Tax Policy on Dividends and Bonuses

The IIT Law stipulates that the dividends and bonuses income shall be taxable in full at the rate of 20%. In 2005, the MOF and the SAT issued the *Notice on the Individual Income Tax Policy on Dividends and Bonuses* (Caishui [2005] No. 102) and the *Supplementary Notice on the Individual Income Tax Policy on Dividends and Bonuses* (Caishui [2005] No. 107) (together the "**Current Policy**"), which state that as of June 13, 2005, only 50% of the dividends and bonuses actually received by individuals from listed companies should be subject to IIT. Listed companies as stated in the Current Policy refer to those that are listed on the Shanghai and Shenzhen Stock Exchanges. Therefore, the effective IIT rate on the dividends and bonuses received from listed companies is currently 10%.

2. New Tax Policy of Differentiated IIT Treatment on the Dividends and Bonuses received from Listed Companies based on the Stock-holding Period

The Notice changes the Current Policy that imposes a 10% effective IIT rate on the dividends and bonuses distributed by listed companies irrespective of the stock-holding period. In contrast, the Notice provides differentiated IIT treatment based on the relevant stock-holding period in order to promote long-term investment. The comparison table below illustrates the impact of the New Tax Policy on stocks with different stock-holding periods:

Stock-holding Period ("SHP")	Current Policy Effective Tax Rate	New Tax Policy Effective Tax Rate	Change in Effective Tax Rate
SHP ≤ 1 Month	10%	20%	Increased by 100%
1 Month <SHP≤ 1 Year	10%	10%	Unchanged
SHP > 1 Year	10%	5%	Reduced by 50%

In addition to the changes in effective tax rates, attention should also be drawn to the following points in the New Tax Policy.

(1) Scope of Listed Companies

Same as the Current Policy, listed companies as stipulated in the Notice refer to those that are listed in the Shanghai and Shenzhen Stock Exchanges. As such, for the dividends and bonuses received by individuals from unlisted or overseas listed companies, IIT should be levied at a rate of 20% on the total income.

(2) Stock-holding Period

As the stock-holding period affects IIT treatment on dividends and bonuses, the calculation thereof is of great importance. Pursuant to the Notice, a stock-holding period is the holding period from the time when an individual acquires the stocks of a listed company from public issuance and transfer market to the day immediately before the day of transfer. This period is counted on the basis of calendar year and calendar month. A stock-holding period of one-year is the continuous holding of stock from a certain day in a certain month of the preceding year to the day immediately before the same day in the same month of the current year. A stock-holding period of one month is the continuous holding of stock from a certain day of the preceding month to the day immediately before the same day in the current month. When the stocks are transferred, the stock-holding period is calculated on a first-in, first-out basis. For example, the stocks acquired earlier in one's stock account are deemed to be transferred earlier.

(3) Withholding of Individual Income Tax

Both the Current Policy and the New Tax Policy require listed companies to act as IIT withholding agents regarding dividends and bonuses distributed. Since the New Tax Policy brings about differentiated tax treatments based on the relevant stock-holding period, special IIT withholding arrangements are listed below:

- For stocks with a holding period of more than one year as of the record date: the listed companies shall withhold the IIT at the effective tax rate of 5%;
- For stocks with a holding period of up to one year as of the record date that have not yet been transferred: a two-step approach shall be undertaken as follows:
  - The listed companies shall first withhold the IIT at the effective tax rate of 5% upon the distribution of the dividends and bonuses;
  - Upon the transfer of the stocks, the securities depository and clearing corporation shall calculate the taxable income based on the actual stock-holding period. As for the part in excess of the tax already withheld, the securities company may deduct the amount from the individual's monetary account and remit the same to the securities depository and clearing corporation. This will in turn remit the withheld IIT to the distributing listed companies within 5 working days of the following month. The listed companies will be responsible for the filing and payment of the withheld IIT to the competent local tax authorities within the statutory filing period in the month when the withheld IIT is received. If the balance in the individual monetary account is insufficient, the securities companies will notify the relevant individual to put up enough funds.

(4) Dividends and Bonuses on Restricted Stocks

Before the release of restrictions on the restricted stocks, dividends and bonuses received shall be subject to the IIT at the 10% effective tax rate. After the release of restrictions on the restricted stocks, the IIT shall be levied in accordance with the New Tax Policy and the stock-holding period shall be calculated from the date of release.

(5) Dividends and Bonuses Received by Securities Investment Funds

Pursuant to the current tax collection and administration policies,[1] listed companies shall withhold the IIT when distributing dividends and bonuses to securities investment funds. Securities investment funds shall not withhold the IIT when distributing the dividends and

[1] *Circular of the Ministry of Finance and the State Taxation Administration on the Tax Issues Related to Securities Investment Funds* (Caishuizi [1998] No 55) and *Circular of the Ministry of Finance and the State Taxation Administration on the Relevant Issues concerning the Taxation of the Open-end Securities Investment Funds* (Caishui [2002] No. 128).

bonuses to individual investors. , In accordance with the above stipulations, listed companies shall also withhold the IIT when distributing dividends and bonuses to securities investment funds based on the stock-holding periods of the funds.

(6) Possible Situations of the Acquisition and Transfer of Stocks

The Notice also lists the possible situations of the acquisition and transfer of stocks. In addition to the acquisition or transfer of stocks through stock exchanges, based on agreements, by court order or by legal inheritance/partition of family property, stocks can also be obtained through the following: acquisitions, exercise of stock warrants, conversion of convertible debts, issuance of stocks, allotment of stocks, stock dividends or using reserve funds to increase capital, holding stocks transferred from an agency share transfer system to the Main Board (or the SME or GEM Board), stocks received as a result of the merger or spin-off of listed companies, and other means of stock acquisition from public issuance and transfer markets. Stocks can also be transferred by way of transferring stocks in acceptance of a tender offer, exercising cash options and transferring stocks to the third party that offers the cash option, subscription to ETF shares by stocks, and any other situations that are stock transfers in substance.

(7) Effective Date of the Notice

The Notice will take effect on January 1, 2013. More specifically, the differentiated IIT treatment applies to dividends and bonuses distributed by listed companies with a record date on or after January 1, 2013. For stocks that are held by individuals prior to the effective date of the Notice, the stock-holding period shall be calculated from the date of actual acquisition of the stocks.

3. Impacts of the New Tax Policy on Investments in the Stocks of Listed Companies

It is apparent that the New Tax Policy aims to encourage long-term investment in the stocks of listed companies. The New Tax Policy also intends to direct investment from short-term speculation to blue-chip companies that have a relatively low stock price but distribute more dividends. In addition, the New Tax Policy will promote the development of securities investment funds since it applies to dividends and bonuses received by those types of funds from listed companies, and securities investment funds usually hold stocks for a longer period of time, which is more likely to benefit from the reduced 5% effective tax rate.

However, the effect of the New Tax Policy on individual investors may be rather limited. Many individual investors derive most of their income via the capital gains arising from the disposition of stocks, and they may hardly benefit from the New Tax Policy. In the event of a possible market downturn, the investment risk associated with the long-term holding of stocks may far exceed the tax benefit brought about by the New Tax Policy. Furthermore, the tax impact of the New Tax Policy is limited to dividend and bonus income, while the IIT is still exempt from the transfer of stocks. As a result of the difference in tax burden, individual investors may still prefer to invest in companies that seldom distribute dividends and bonuses but have a high stock price. In addition , companies that choose not to distribute dividends and bonuses may be able to use their profits for potential investment projects that may benefit their respective companies and increase their stock prices. Therefore, investors may more inclined to invest in these companies due to their high stock prices.

All things considered, investors should be made aware of the New Tax Policy, and take all factors, including the profitability, development prospects, and dividends policy of the listed companies into consideration when making prudent investment decisions.

Important Announcement

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If you have any questions regarding this publication, please contact any of the following Han Kun lawyers:

Contact Us

Beijing Office
Tel.: +86-10-8525 5500
Suite 906, Office Tower C1, Oriental Plaza
No. 1 East Chang An Ave.
Beijing 100738, P. R. China

Wenyu JIN Attorney-at-law
Tel.: +86-10-8525 5557
Email: wenyu.jin@hankunlaw.com

Shanghai Office
Tel.: +86-21-6080 0909
Suite 5709, Tower 1, Plaza 66, 1266 Nanjing West Road,
Shanghai 200040, P. R. China

Yinshi CAO Attorney-at-law
Tel.: +86-21-6080 0980
Email: yinshi.cao@hankunlaw.com

Shenzhen Office
Tel.: +86-755-3680 6500
Suite 4709, Excellence Times Plaza, 4068 Yitian Road, Futian District,
Shenzhen 518048, P. R. China

Jason WANG Attorney-at-law
Tel.: +86-755-3680 6518
Email: jason.wang@hankunlaw.com