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Transfer of Restricted Stocks of Listed Companies by Individual under a Limited Liability Partnership Structure

By David Yu and Clare Lu

On 31 December 2009, approved by the State Council, the Ministry of Finance, State Administration of Taxation, and the China Securities Regulatory Commission, jointly issued the "*Notice Regarding Individual Income Tax ("IIT") Treatment on Individual Income Derived from the Transfer of Restricted Stocks of Listed Companies*" (Cai Shui [2009] No. 167, or "Notice 167"). Notice 167 clearly states that, with effect from 1 January 2010, income derived from the individuals' transfer of restricted stocks of listed companies shall be levied IIT at 20% as "yields from property assignment" (or "capital gain"). Since limited liability partnerships ("LLPs") are usually considered as "conduit" entities, LLPs are generally not subject to income taxes. Assuming that there are no legal impediments for a LLP to initiate a listed company, does Notice 167 apply to individual partners of the LLP, who transfers the restricted stocks of the listed company indirectly through LLPs?

IIT Taxability on LLPs and Local Practices

Under the prevailing tax regime, income derived by individual partners from the business operation of the partnership (including LLPs) should be assessed IIT at the five-grade progressive rates from 5% to 35%, while interests and dividends derived from the invested companies should be calculated separately from business operation of the partnership and be assessed IIT at 20% as interest and dividends collected by the individual partners.

Currently, it is unclear on tax treatments on income derived from share transfer by individual partners under PRC tax regulations. According to some local practices, individual partners in charge of the operations of LLPs shall pay IIT at the five-grade progressive rates of 5% to 35%; while other partners shall pay IIT at the rate of 20%, regardless of the income category.

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The Application of Notice 167 to LLPs

In light of the above, Notice 167 requires that income derived from "direct" transfers of restricted stock by individuals be assessed IIT of 20% as capital gain. In our experience, practically, Notice 167 is inapplicable towards general partners of LLPs because such partners usually are limited liability companies. In regard to the tax consequences of individuals (commonly the limited partners) who obtain income through the transfer of restricted stock via the partnership, Notice 167 still does not provide clear guidance. Considering that such income derived from the transfer of restricted shares is essentially "capital gain", taxing such income as "income derived from business operations" might result in a relatively high tax burden for an individual partner. Thus, we feel that it is more reasonable to collect IIT at the rate of 20% (with reference to "interest or dividend income") on gains from share transfer obtained by individual limited partners through LLPs.

From the perspective of investors, in considering the feasibility to initiate a listed company by of LLPs, performing taxes study on LLP (as well as its partners), choosing the location in which to form a LLP, comprehensive communication with local government authorities is necessary so as to avoid potential risks or losses caused by a lack of legal clarity.

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