

CHINA LEGAL BRIEFING* 163

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- 1 Law of the People's Republic of China on Enterprise Bankruptcy (2006)**
- 2 Supplementary circular of the State Administration of Taxation on Certain Issues Regarding Paying of Individual Income Tax Relating to Individual Stock Option Income (Guoshuihan [2006]902)**

Law of the People's Republic of China on Enterprise Bankruptcy (2006)

中华人民共和国企业破产法（2006年）

Issued By	Standing Committee of the National People's Congress
Subject	Enterprise Bankruptcy
Promulgated on	August 27th 2006
Effective From	June 1st 2006
Source	www.gov.cn

The law of the People's Republic of China on Enterprise Bankruptcy (2006) (the "Law") is promulgated in order to regulate the procedures of enterprise bankruptcy, fairly liquidate the credits and debts, safeguard the legitimate rights and interests of creditors and debtors and maintain the market order. The Law shall come into effective as of 1 June 2007.

The Law consists of 136 articles and 12 chapters in total, namely, General Provisions; Application and Acceptance; Custodian; Assets of Debtors; Bankruptcy Expenses and Community Debts; Declaration of the Creditor's Rights; Meeting of Creditors; Rectification; Bankruptcy Liquidation; Legal Liabilities; and Supplementary Provisions.

The current bankruptcy rules, promulgated in 1986 on a test basis, are widely regarded as outdated as they fail to give sufficient protection to creditors and only touch on those state-owned enterprises. The new Law will apply to all kinds of enterprises and financial institutions. All the country's companies and enterprises, whether state-owned or private, will have to follow a unified bankruptcy law.

The Law aims to protect both creditors and workers of insolvent enterprises. The Law embodies the notion of putting people first, as it fully considers worker's interests. At the same time it accords with standard international practice in better protecting lenders' interests. The Law also shows that China began to standardize the bankruptcy of financial institutions on the legal level.

Where an enterprise legal person fails to pay off its debts, and that if its assets are not enough to pay off all the debts or if it is obviously incapable of paying off its debts, its debts shall be liquidated in accordance with the provisions of the present Law. Where an enterprise legal person is under the aforesaid circumstance or it is obviously likely that it is incapable of paying off its debts, it may be subject to rectification in accordance with the provisions of the present Law. The bankruptcy case shall be under the jurisdiction of the people's court where the relevant debtor is domiciled. Where the procedures for hearing a

bankruptcy case are not prescribed in the present Law, they shall be subjected to the relevant provisions of the PRC Civil Procedure Law.

After a debtor is announced bankrupt, the debtor shall be therefore recognized as the bankrupt person and the debtor's property shall be deemed as the insolvent property. The creditor's rights against the debtor when the people's court accepts an application for bankruptcy shall be recognized as the credit of bankruptcy.

Any special matter in the bankruptcy of a state-owned enterprise within the time limit and scope as prescribed by the State Council before the present Law comes into force shall be handled in accordance with the relevant provisions of the State Council.

Where such financial institutions as commercial banks, securities companies or insurance companies is under any of the circumstances as prescribed in Article 2 of the Law, the financial supervision organ under the State Council shall file an application with the people's court for rectification or bankruptcy liquidation of the financial institution.

Where a financial institution is under bankruptcy, the State Council may, according to the present Law and other relevant laws, formulate the corresponding measures for implementation. The liquidation of the organizations other than enterprise legal persons as prescribed by other laws, which falls within the category of bankruptcy liquidation, shall be subject to the procedures as prescribed by the present Law.

Supplementary Circular of the State Administration of Taxation on Certain Issues Regarding Paying of Individual Income Tax relating to Individual Stock Option Income (Guoshuihan [2006] 902)

国家税务总局关于个人股票期权所得缴纳个人所得税有关问题的补充通知(国税函[2006]902号)

Issued By	State Administration of Taxation
Subject	Individual Income Tax
Promulgated on	September 30th 2006
Effective From	September 30th 2006
Source	www.chinatax.gov.cn

The Supplementary Circular of the State Administration of Taxation on Certain Issues regarding Paying of Individual Income Tax relating to Individual Stock Option Income (Guoshuihan [2006] 902) (the "Circular 902") is promulgated in order to provide further

clarifications on the application of the Circular on Issues of Imposition of Individual Income Tax on Individual Stock Option Income (Caishui [2005] No. 35) (the “Circular 35”).

Circular 35 applies to stock options in respect of shares listed on the China and overseas stock markets regardless of whether the employer granting the stock option plan is a listed company or not. This clarifies that the income derived from the exercise of stock options granted by the employer in respect to its holding company or headquarters listed overseas is caught by Circular 35. On the other hand, it also clarifies that Circular 35 does not apply to stock options relating to shares of any private companies.

In the situation where the employee chooses to dispose the share options acquired at a discount, the net proceeds derived from the transfer of share options is the difference between the amount received from the sale and the amount paid for the purchase of the share options (the “purchase price”). Should the employee decide to exercise the discounted share options, the purchase price can be added onto the exercise price in determining the taxable income.

Where an employee exercises stock options without actually purchasing the underlying stock, and instead receives a cash payout equivalent to the difference between the market value at exercise and the grant price (i.e. “phantom stock option plan”), the income should be recognized as “salary and wages” and, therefore, subject to IIT in accordance with the preferential calculation method stipulated by Circular 35.

The source of stock option income is determined with reference to the period from grant to vest of the stock options. For a foreign individual working in China, his/her Chinese source stock option income should be determined with reference to the number of months he/she works in China over the period from option grant date to vest date. This is in line with the recommendations of the OECD.

Where the employees are granted stock options which are readily tradable on the stock market, the difference between market value of the options on grant date and any amount paid for the stock options will be taxable at the date of grant in accordance with the formula set out in Circular 35. Subsequent disposals of the said options will be subject to IIT as income from transfer of property but subsequent exercise will be exempt from IIT.

Circular 902 modifies the original calculation formula as laid down in Circular 35. Where the employee exercises stock options more than once in a calendar year, the new formula described below requires the option income be calculated on an annual basis, although the tax should still be payable on a monthly basis once the option is exercised:

IIT payable on stock option income =

$(A / B \times \text{Applicable Marginal Tax Rate} - \text{Quick Deduction}) \times B - C$

A = Accumulated stock option income received in the calendar year concerned

B = Total number of months (with maximum of 12) in which the accumulated stock option income (i.e., A) can spread over. It is calculated based on summation of stock option income multiplied by the vesting period spent in China, divided by the total amount of option income

C = Accumulated IIT paid in the calendar year on stock option income

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