

# Rödl & Partner

NEWSLETTER CHINA

BROADENING HORIZONS

Issue:  
October  
2019

Latest news on law, tax and business in China

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Issue:  
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## → China Legal and Tax Day

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14 November 2019, Shanghai

We would like to invite you to our first “China Legal and Tax Day” in Shanghai on 14 November 2019.

We have planned a whole day of lectures and a closing panel discussion for you. Our experts are looking forward to stimulating discussions and exchange with you.

You may find the detailed program as well as all further information and the registration form on the following pages.

For further question, please feel free to contact our colleague, Elisa Guo.

### CONTACT

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8.30 – 9.00 a.m.

*Registration – Legal and Tax Day*



*Opening*

Roger Haynaly (Shanghai)

9.00 – 9.20 a.m.

*Welcoming Speech*

Dr. Thilo Ketterer (Stuttgart, Nuremberg)

(in English language)

LECTURES HELD IN GERMAN LANGUAGE

LECTURES HELD IN ENGLISH LANGUAGE

9.30 – 10.30 a.m.



*Watch Out –  
The new Corporate Social Credit System*

Dr. Martin Seybold (Beijing)  
Christina Gigler (Beijing)



*Spotlight on License Fees and other  
HQ Charges to China*

Vivian Yao (Shanghai)

COFFEE BREAK

10.45 – 11.45 a.m.



*„The War for Talents“ – Practical  
Usage of the Chinese Labor Law*

Bei Li (Shanghai)



*At a glance –  
Individual Income Tax for Expatriates in  
China*

Roger Haynaly (Shanghai)  
Monica Chen (Shanghai)

12.00 – 1.00 p.m.



*More Art than Science – Transfer  
Pricing Practice in China*

Judy Zhu (Shanghai)



*Mergers and Acquisitions –  
How to handle challenges and capabilities*

Sebastian Wiendieck (Shanghai)

LUNCH BREAK

2.00 – 3.00 p.m.



*Where are we now? –  
Data Protection and Cybersecurity in China*

Li Wang (Shanghai)



*What to expect when expecting goods –  
Customary Customs practices in China*

Frances Gu (Shanghai)

COFFEE BREAK



PANEL DISCUSSION  
*Should I stay or should I go?  
China through the eyes of a foreign investor*

3.15 – 4.15 p.m.

Sebastian Wiendieck (Shanghai)  
Dr. Martin Seybold (Beijing) Vivian Yao (Shanghai)

MODERATION

Dr. Thilo Ketterer (Stuttgart, Nuremberg)

(in English language)

From 4.15 p.m.

CLOSING RECEPTION AND NETWORKING

## AUF EINEN BLICK/AT A GLANCE

### DATUM/DATE

14.11.2019 | 8:30 am - 4:30 pm

### VERANSTALTUNGSORT/LOCATION

InterContinental Shanghai,  
No. 777 Zhangyang Road, Pudong,  
200120 Shanghai

### VORTRÄGE/LECTURES

1 Podiumsdiskussion, 8 Vorträge  
1 Panel discussion, 8 lectures

### GEBÜHR/FEE

Wir erheben eine Teilnehmergebühr (250 RMB inkl. VAT). Zahlbar im Voraus oder vor Ort am Veranstaltungstag.  
We charge a small attendance fee (250 RMB incl. VAT). Payable in advance or on site on the event day.

## ANMELDUNG/REGISTRATION

Bitte melden Sie sich bis spätestens 8. November 2019 für den Tax and Legal Day an. Die ausgefüllten Daten senden Sie bitte per E-Mail an Frau Elisa Guo.

Thank you very much for kindly communicating your attendance by November 8, 2019, at the latest. Please send your filled form per email to Ms. Elisa Guo.

## IHRE DATEN/YOUR DETAILS

Titel, Vor- und Nachname

Title, first and last name

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Position

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Unternehmen

Company

---

Adresse

Address

---

Postleitzahl, Stadt

Zipcode, City

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Telefon

Telephone

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E-Mail

email

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Bitte arrangieren Sie ein persönliches Meeting mit einem Experten zum Thema:

Please kindly arrange for a personal meeting with one of your experts regarding the following topics:

## KONTAKT/CONTACT

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## → Transfer Pricing

### Tax Authorities Examine Service Fees and Royalties to Overseas Parties

On July 23, 2019, the Tianjin Port Free Trade Zone tax bureau of the State Administration of Taxation (SAT) issued a notice on the examination of payments to overseas parties, requiring enterprises listed in the notice to submit relevant documents before July 31, 2019 to examine their large payments to overseas parties in 2017 and 2018.

SAT required the enterprises to submit the following documents:

- Description of payment to overseas parties in 2017 and 2018;
- Contract and agreement pertinent to large payment to overseas parties;
- Statistical table of large payment to overseas parties (containing filing example);
- Digital version of the contemporaneous Transfer Pricing (TP) documentation (applies for enterprises that have exceeded the appropriate thresholds);
- Other supporting documents.

It can be seen from the statistical table required by the SAT that this inspection focuses on the service fees and royalties paid to overseas parties. The statistical table requires the enterprise to provide the type, the specific name and the pricing policy of service/royalty, the country/region of the payee and the term of the contract.

In recent years, the payment of non-trade fees to related parties has been a main target for audits of the Chinese tax authorities. In 2017, the SAT issued Public Notice No. 6, proposing a whole set of special tax investigation adjustment procedures, from investigation filing procedure to mutual agreement procedure, aimed at strengthening the monitoring of related transaction profits. Notably, Public Notice No. 6 clearly specifies the TP management of intangible assets and related party service transactions. The Tianjin Port Free Trade Zone tax bureau starting to examine the service fee and royalty payment to overseas parties, can be seen as a practical implementation of the Public Notice No. 6. Therefore, taxpayers shall begin to pay full attention to the TP management of intangible assets and related party services stipulated in Public Notice No. 6.

#### TP MANAGEMENT OF INTANGIBLE ASSETS

According to notice No. 6, when determining the value contribution of enterprise and its related parties to intangible assets and the corresponding profit distribution, the global operation process of the group should be comprehensively analyzed, and the value contribution of all parties in the development, value enhancement, maintenance, protection, exploitation (DEMPE) and promotion of intangible assets should be fully considered. Notably, in addition to DEMPE functions proposed by OECD, Chinese tax authorities have added the "promotion" function, requiring taxpayers to fully consider the value contribution of the promotion activities performed by Chinese companies to intangible assets.

#### LEGAL AND ECONOMIC OWNERSHIP

In addition, the legal and economic ownership of intangible assets should be distinguished. An enterprise that only has legal ownership, but does not effectively contribute to the value of intangible assets, should not be entitled to participate in the profit distribution of intangible assets. If the enterprise pays royalties to a related party that only has the legal ownership of intangible assets, the full royalty shall not be tax deductible. In addition, Public Notice No. 6 also proposed that those who only provide funds but fail to perform relevant functions and assume corresponding risks should only get a reasonable return on capital costs. Thus, it can be seen that Public Notice No. 6 is consistent with the core idea of BEPS action plan, that is, the profit distribution should match the value contribution.

#### SPECIAL TAX ADJUSTMENT

In addition, Public Notice No. 6 also lists several cases where tax authorities can implement special tax adjustment on royalties. If, in the process of paying royalties, the fundamental value of intangible assets or the functions, risks and assets of the parties have changed, or Chinese companies contribute to the subsequent improvement of intangible assets value, the enterprise shall adjust the

royalty in due course. Besides, we would like to draw particular attention from loss-making or thin-profit enterprises to the fact that the tax authorities is entitled to implement special tax adjustment if the royalty paid by enterprises does not match the economic benefits they bring.

In practice, high and new technology enterprises that pay huge royalties are often questioned by tax authorities. We recommend that such enterprises prepare additional documentation in advance to demonstrate that the local R&D functions are different from that of the related parties, and that the license provided by related parties brings unique and significant value to the enterprise. If it fails to explain, the tax authorities may conduct special tax adjustment, or even revoke the high-tech qualification of the enterprise, and require the enterprise to return the tax benefits enjoyed in previous years and pay penalties.

## TP MANAGEMENT OF RELATED PARTY SERVICE TRANSACTIONS

According to the Public Notice No. 6, related party service transactions should be beneficial ones that comply with the arm's length principle and can bring direct or indirect economic benefits to service recipients. Public Notice No. 6 explicitly listed six non-beneficial services as follows:

- Duplicate services that have already been purchased or implemented on their own;
- Shareholder activities;
- Services that only aim to obtain additional income due to affiliation to the group;
- Services that have been compensated in other related party transactions;
- Services that have nothing to do with the functions performed and risks undertaken by the service recipient, or that do not meet its business needs;
- Other services that do not bring economic benefits or that a third party is un-willing to purchase or perform.

We suggest that enterprises review whether the service fee paid to overseas parties belongs to the category of non-beneficial services mentioned in the Public Notice No. 6, and make timely adjustment to avoid the risk of special tax adjustment.

## CLASSIFICATION OF SHAREHOLDER ACTIVITIES

It is crucial to note that, compared with OECD, the SAT holds a stricter definition of shareholder activities – in Public Notice No. 6, shareholder activities also includes "financial, tax, human resource and legal activities serving the need for group decision-making, supervision, control, and compliance". However, in practice, the parent company of an international group often charge such fees from its subsidiaries. Enterprises are required by the Tianjin Port Free Trade Zone tax bureau to select from service type options in the statistical table. The options include group management (i.e. human resource, finance, software services, etc.). We estimate that the tax authority will closely examine whether such management services belong to the non-beneficial services stipulated in Public Notice No. 6.

## CONCLUSION

In recent years, China's tax authorities have significantly increased their monitoring of profits from cross-border transactions and introduced a series of anti-tax avoidance regulations. We suggest that enterprises should pay close attention to the regulation updates and review the appropriateness of related party transactions accordingly. In addition, the enterprise shall prepare and submit compliance documents as required by regulations and ensure the consistency of data. For example, in the current inspection of the Tianjin Port Free Trade Zone tax bureau, enterprises need to provide the contemporaneous TP documentation, and the tax bureau may cross-compare the information in various compliance documents.

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## → Individual Income Tax

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### Losing the Job and Pay Tax on Compensation?

Recently a court case regarding the individual income tax (“IIT”) treatment on a compensation payment caused discussion in China. The compensation payment was made by a company in Shanghai who terminated a fixed-term labor contract with a former employee. According to the prevailing Chinese labor contract law, when a fixed-term labor contract expires, if the employer refuses to renew the contract with the same conditions currently offered and thus terminates the employment relationship, the employer is obliged to provide the employee with a statutory compensation which is calculated based on the employee’s current salary level and his/her length of employment with the company.

As a tax preferential policy with wide awareness in China, severance payment provided to an employee up to three times of the local annual average salary of the past year (“Tax-exempted amount”) is exempted from Chinese IIT, only the exceeding portion should be subject to taxation. That means in Shanghai, a severance payment below RMB 315,528 can be provided to an employee as IIT exempted in 2019.

In the court case the compensation to be paid is below the local Tax-exempted amount, then was it paid without personal tax burden? The answer is NO. The employee in the court case made 3 appeals against the tax authority’s assessment but ended up with an unchanged result.

It seems to be an unjustifiable result, which is however, justified by the tax authority. According to the relevant tax regulation, a severance payment which is applicable to the preferential tax treatment is defined as a compensation from dissolution of a labor contract. Referring back to the

labor contract law, situations under dissolution of a labor contract do not include termination of a fixed-term labor contract that expires. Therefore, compensation for terminating a fixed-term labor contract when it expires does not fall into the scope of severance payment which is applicable to the tax preferential treatment, and as a result, it is subject to Chinese IIT as regular salary income.

Whether or not it is reasonable, the court case has set out a definite example for the IIT treatment on a compensation from labor contract termination. The IIT treatment is not relevant to the employer’s company cost but would have substantial influence on the employee’s personal tax burden.

With an eye on the human capital and the employer brand, there are various options to optimize the personal tax burden of an employee in such case. For this purpose, both labor and tax aspects should be considered, e.g. to avoid damages to the employer’s brand.

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## → Residence Permit

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### New Practices in Permanent Residence and Work Permit Application in China

According to the ministry of public security of China, starting from August 1, 2019, certain former pilot immigration policies have been implemented

nationwide in China. The new policies will significantly loosen the restriction for foreigners to obtain a permanent residence in China or a work-type



residence permit with a longer valid period. For foreigners who would like to obtain a permanent residence in China, following four criteria should be fulfilled. The applicant has:

- worked for four consecutive year;
- lived in China for no less than six months a year;
- an annual salary of no less than six times the local average salary of the place where they are located in the preceding year; and
- paid annual individual income tax of more than 20 per cent of their annual salary.

Foreigners who have applied for an over one-year work-type residence permit for two consecutive times without any violation of laws and regulations may apply for a work-type residence permit with a 5-year validity at most for the third time.

A wide range of foreigners may fall into the above two groups, as the criteria are commonly accessible in practice. At least, they do not need to go through a complicated application procedure only for the extension of a resident permit every year, as long as they have a relatively stable work in China.

Applicants who want to have a permanent residence may need to pay attention to the documentation requirements when making the application, especially for the tax payment standard.

Recently, in some work permit application cases, some immigration authorities have requested a screenshot of the official tax filing system in the local tax authority, to show the income type, taxation bases and tax amounts of the applicant together with his/her personal information on the same page, in addition to the traditional tax clearance certificates as the supporting documents. Because on the tax clearance certificates no taxation bases are indicated and it is difficult to identify the general tax rate of the applicant, as we can assume.

However, such practice has met obstacles from some local tax authorities, since the tax clearance certificate is the only official certification to be issued by the tax authority for tax payments. It could be easily solved if the two authorities, the immigration authority and tax authority,

could share information, instead of requesting the applicants to pass on screenshots manually, which is neither efficient nor practical. With the implementation of the new policies, such practical obstacle may occur more often than before. It would be expected that the authorities could make progress in the solution shortly.

For foreigners who would like to apply for a long-term 5-year work-type residence permit, it is required in practice that the validity of the work-type residence permit in application should be covered by a valid employment contract. As far as we know, most foreigners who firstly work in China would enter into an employment contract with a 3-year period. So it could happen that after they apply for a 1-year work-type residence permit for twice, only 1-year validity period is left in their employment contract. Under such circumstance, they may still obtain a 1-year resident permit even if for the third time. Therefore if they plan a long-term employment in China and would like to benefit from the new policies directly, a timely discussion with their Chinese employer for an advanced extension of their employment contract might be necessary.

It is imaginable that there will be some uncertainties in terms of the implementation of the new policies. In view of the large groups of foreigners covered by the new policies, we could expect the authorities concerned to come up with feasible solutions in a timely manner, and we will keep a close eye on the progress.

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## → Social Credit System

### An Overview of China's Corporate Social Credit System

The Corporate Social Credit System of China (SCS), although in public discussion and discourse only over the past few months or years, is in fact

not a very recent development, but has already been introduced in 2014, when the Chinese government authorities started to publish numerous

regulations, laws and policies defining and explaining the SCS. Until today, nearly 1,500 government documents have been published by central and local level government authorities within the framework of the SCS.

Without question, the SCS is the most comprehensive system made by a government in order to introduce a self-regulating marketplace. However, as especially German news understandably report about the SCS from a Western perspective, this article tries to show a neutral viewpoint on this topic and to give a broad over-view of the status. This article has its main focus on the Corporate SCS, which is by far more developed than the SCS for individuals.

In the framework of the SCS, both government authorities as well as private companies (e.g. Alibaba and Tencent) collect data on the behavior of individuals and companies registered in China. Based on these data individuals and companies are rated on a basis of specific parameters and defined requirements of the government. The SCS basically covers all aspects of doing business in China (e.g. tax, customs, product quality, environmental protection, pricing and licensing, data transfer etc.). The goal and idea behind the SCS is to share the data between different parts of the system and also the public in order to monitor and guide market participants' behavior. A good rating leads to rewards and can mean lower tax rates, easier market access or better credit conditions, whereas a bad rating leads to sanctions, such as penalty fees, court orders or even blacklisting. Reward mechanisms are however less developed than sanction mechanisms so far.

One important characteristic of the SCS are the so-called "joint sanctions". This means that sanctions are not only levied by one authority based on the rating it is directly responsible for, but also in response to negative ratings in all other fields. For example, a rating as a dis-trusted taxpaying company not only leads to tax-specific sanctions, but may also effect approvals or land use rights of the company or travel restrictions of the legal representative of the company.

The timeframe in which a rating is updated is not uniformly regulated. Some ratings change in real time, some are updated every few months, while some are updated only once a year. Nevertheless, a blacklisting or rating can happen at any time.

Please note that the Corporate SCS only applies to companies which are registered in China. This means that the rating starts from zero at the moment when the company is successfully registered in China.

## WHAT IS THE CONCRETE IMPACT FOR COMPANIES?

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While the implementation status of the SCS is far from its full potential and still varies between different locations and industries, many of the system's mechanisms are already operational today. Even now, companies with a bad rating are facing higher inspection rates and targeted audits. Affected companies may have to deal with restrictions for the issuance of any sort of government approval and restrictions from public procurement. Moreover, bad ratings may also lead to an exclusion from certain preferential policies, such as subsidies.

In any case, the Chinese government aims a full implementation by the end of 2020. However, this does not mean that the uncertainties of the system will be fully resolved by then. At the end, the SCS is an evolving system, which will be continuously amended and improved, likely also based on changing economic and political goals.

## IS THERE A POSSIBILITY TO REDUCE THE IMPACT?

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Not really. The SCS applies to all companies registered in China.

However, once the company is confronted with a bad rating, there is the possibility to object against the rating. To reset its negative rating a company shall submit a "credit restoration commitment letter". Depending on the type of the rating, additional materials may be necessary. The deadline for restoration is not consistent, but varies from case to case. In addition, standard administrative remedies may apply.

## IS THERE ANYTHING POSITIVE ABOUT THE SCS?

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In theory, one positive aspect could be that there is an equal enforcement of the regulations among Chinese companies and foreign-invested companies, as the ratings are mostly algorithm-based and therefore do not distinguish between domestic or foreign-invested companies as long as they are registered in China. Thus, in principle the SCS creates a more level playing field, because the data is processed automated and can eliminate arbitrariness. But, it cannot be ensured that the system will not be applied in a biased way. Also, some requirements are naturally more difficult to fulfil for foreign-invested companies. At the end, Chinese companies might at least have an advantage in understanding the subtleties of the system, as first the regulations are mostly only published in Chi-

nese language and second it will be easier for Chinese companies to communicate with the authorities to clarify certain points.

As second aspect, although the SCS also introduces new requirements, the majority of the requirements have been existing before. Thus, most of the requirements should not come as a surprise. The difference now is however the stricter and faster enforcement of the requirements and the interchange of information between various authorities.

## CONNECTION BETWEEN COMPANY RATINGS AND INDIVIDUAL RATINGS

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The Individual SCS is still in a pilot stage compared with the Corporate SCS and is not systematically applied at the moment. However, the two systems are somehow interlinked for legal representatives and responsible personnel. There exists no official definition of “responsible personnel”, so one must expect that the application will vary from place to place and authority to authority. For the time being, other personnel cannot influence or be influenced by the Corporate SCS.

## WHAT COMPANIES SHOULD DO

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In the following section we would like to provide recommendations on how to avoid penalties by the authorities in the first place and on how to prevent any damages against your company or brand.

1. Companies should in general establish or improve their internal compliance system and make sure that deadlines and formalities in all kinds of aspects regarding their business in China are fulfilled (e.g. tax declaration, audit, payment of social insurance etc.), as most of the rating requirements are merely concerned with strict compliance with market regulations. Only a small, nevertheless not un-important set of requirements, creates other challenges not connected to internal compliance, for instance relating to the company`s business partners. Based on the SCS, a business partner with a bad rating will also impact the rating of the company. Thus, business partners need to be carefully chosen. Unfortunately, the respective regulations do not specifically define the term “business partner”, which leads to uncertainty in practice. Based on experience so far, some authorities have considered suppliers and service providers as business partners. However, this may vary from authority to authority.
2. Companies should try to find the exact ratings and requirements applicable to them, as the applicability is different for each company depending on various factors, such as industry

sector, product portfolio, import and/or export, manufacturing or trading etc.

3. Companies are advised to contact the respective authorities in order to find out about their own rating for each authority. Platforms such as the National Credit Information Sharing Platform (全国信用信息共享平台), CreditChina (www.creditchina.gov.cn), the National Enterprise Credit Information Publicity System (www.gsxt.gov.cn) or several private platforms (e.g. Qichacha etc.) publish certain company data. However, the data is only available in Chinese and in each case not comprehensive.
4. Companies should also check if there exist any false companies using their company name and influencing their rating by using their name. In some cases, obvious mistakes, for instance of the authority itself (e.g. spelling mistakes) could be resolved in a timely manner. However, most important for the negotiations with the authorities is to be well prepared and know about its own requirements. General complaints are likely to be dismissed by the authorities, whereas there might be room for negotiations on a decent and well-explained criticism on a specific point. As the system until now still struggles with gaps and lack of data-sharing between different authorities, there is still the possibility to actively approach and communicate with the authorities on the enforcement of specific requirements.
5. Companies should not refuse a government inspection, as this might lead to a significant downgrading in the rating system.

For better or worse, companies registered in China will have no choice but to deal with the SCS. It is not yet too late for taking action, but the earlier the affected companies act, the better.

## OUTLOOK

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Currently, a consortium comprised of Huawei, Alibaba, Tencent, VisionVera and Taiji Computer Corporation is working on a new meta-database, which is supposed to collect all relevant data on one central database only. Up to now, there exist several different databases, but none of them collects a complete set of data, which makes it very burdensome for companies to collect all relevant information. A test version of the new meta-database shall be released in September 2019.

In general, foreign-invested companies with internal compliance systems of international standard might be in a good position to fulfil a majority of the requirements or might at least be able to adjust certain internal processes according to

the SCS, as they may already feature a relatively advanced compliance structure. However, the biggest challenge will be to know exactly what must be done to secure and keep a high rating and to successfully delete a potentially bad rating.

It is not yet too late for taking action, but it can be assumed that the regulations and enforcement measures will improve over time and the gaps and starting points for negotiations will become smaller and smaller.

## CONTACT FOR FURTHER INFORMATION



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## → Highlights

### Recent Important Regulation Highlight

#### SAT ISSUES “MEASURES FOR NON-TAX RESIDENTS TO ENJOY TREATY BENEFITS”

In October 2019, the State Administration of Taxation published the new version of “Measures for Non-Tax Residents to Enjoy Treaty Benefits”, which will take effect since January 2020. The new version significantly simplifies the compliance process for non-tax residents to enjoy treaty benefits. According to the new version, taxpayers may evaluate their qualification of enjoying treaty benefits and make tax filing with taking treaty benefits into account by themselves, without any pre-approval from the Chinese tax authority. Taxpayers should keep proper documentation for potential inspection by the Chinese tax authority.

#### CHINA ADOPTS THE FIRST RESOURCE TAX LAW

The first Chinese Resource Tax Law was adopted on August 26, 2019, which will enter into force on September 1, 2020. Compared with previous regulations, when levying the resource tax on energy, metal, non-metal, water, gas and salt resource, the new law simplifies the collection period and standardizes the tax items and rates. The new tax law stipulates that the taxpayer can choose to declare the tax on a monthly or quarterly basis, and the time limit for filing is changed from 10 to 15 days.

#### VAT REFUND FOR SOME ADVANCED MANUFACTURING INDUSTRIES

Recently, the Chinese SAT issued the Announcement No. 84 to clarify the regulations concerning the refund of period-end uncredited VAT for some advanced manufacturing taxpayers. Since 1 June 2019, some advanced manufacturing taxpayers who meet certain conditions may apply to the competent tax authorities for a refund of incremental uncredited tax from July 2019 and subsequent tax declaration periods.

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