Proposed application of VAT to the healthcare sector in China
## Contents

- Quick snapshot of anticipated VAT issues by sector 4
- Background 6
- The healthcare sector in China – a growth trajectory 7
- Treatment of the healthcare sector under China’s current BT/VAT system 8
- International experience of healthcare under VAT/GST systems 9
- VAT issues likely to arise in China post the 2016 changes 10
  - Medical services 11
  - Supply of medicines 15
  - Clinical trials 16
  - Supply of medical devices 18
  - Disposal of assets of a healthcare business 18
  - Aged care 19
  - Insurance in a healthcare context 20
  - Developments in e-healthcare 21
  - How KPMG can help 22
- KPMG contacts 24
In this special report, KPMG China considers the issues which the healthcare sector in China is likely to face when transitioning from Business Tax (BT) to Value Added Tax (VAT), and in the longer term. China is in the process of transitioning from its previous bifurcated indirect tax system – under which VAT applied to the sale and importation of goods, and BT applied to the services sector – and moving to a unified VAT system applicable to all goods and services.

The transition from BT to VAT is expected to be completed for the healthcare sector in 2016. To date, the potential impact on the healthcare sector has received little publicity and attention.
## Quick snapshot of anticipated VAT issues by sector

<table>
<thead>
<tr>
<th>Sector</th>
<th>Current treatment</th>
<th>Potential VAT issues</th>
<th>Opportunities</th>
</tr>
</thead>
</table>
| Medical services providers: Hospitals and clinics | Exempt from BT    | • (Short term) Impact on their cost structure, as they will be unable to claim input credits if VAT exemption continues, and as more of their vendors become subject to VAT  
• (Short term) Difficult to differentiate VAT-exempt from taxable medical services  
• (Long term) VAT likely to apply to private sector | • Review cost structure – Maximise input VAT credits  
• Improve internal VAT management system to lower VAT risks                                                                                                           |                                                                                                         |
| Pharmaceutical/Biotechnology/Biopharmaceutical | Subject to VAT    | • VAT may be recoverable by customers in the long term if the services of private hospitals and clinics become subject to VAT  
• Clinical trials may be subject to VAT, or exempt where there is an overseas sponsor  
• The export of goods is generally zero-rated, but some input VAT may be irrecoverable (in China, the VAT refund rate for some products is lower than the standard rate) | • Review pricing strategies – Taking into consideration changes to the VAT treatment of customers  
• Review cost structure – Maximise input VAT                                                                                                                     |                                                                                                         |
| Medical devices/Drug distribution (retail/wholesale) | Subject to VAT    | • VAT may be recoverable by customers in the long term if services of private hospitals and clinics become subject to VAT | • Review pricing strategies – Taking into consideration changes to the VAT treatment of customers                                                                 |                                                                                                         |
| Private medical insurance                   | Qualified life, health and pension insurance > one year is BT-exempt; otherwise subject to BT | • VAT-exempt products should be differentiated from VAT taxable products  
• Different VAT implications for reimbursing claims to the insured party vs paying service providers directly should be considered | • Maintain input tax management processes  
• Improve internal VAT management system to lower VAT risks                                                                                                     |                                                                                                         |
| Others (e.g. aged care, elective cosmetic surgery and alternative medicines) | Subject to BT     | • Depending on the nature of the services, may be subject to different VAT rates | • Improve internal VAT management system to lower VAT risks  
• Need to clearly differentiate the pricing of different components subject to different VAT rates                                                              |                                                                                                         |
If international experience is any guide, the healthcare sector tends to have some of the most complex VAT problems. There are four main reasons for this:

1. The type of provider of healthcare services can have an impact on the VAT treatment. In many countries, the activities of government are zero-rated or exempt from VAT, whereas the activities of the private sector may be subject to VAT.

2. An added complication with the healthcare sector is that the consumer does not always pay the real price for the services they consume. Prices are often subsidised either by the government, or some or all of the costs may be community risk rated through insurance. As a form of taxation, VAT tends to work well when there is a single supplier and a single consumer. However, arrangements in the healthcare sector frequently have a tripartite nature – a service provider, a customer and a third party (i.e. government and/or insurer). This can create significant complexity.

3. Chinese consumers are increasingly demanding a broader range of healthcare services, and increasingly sophisticated technology is deployed in providing these services. The nature of the services provided to the consumer will have a material impact on the VAT treatment. For instance, there may be a strong policy basis to say that essential public hospital services delivered to needy consumers should be exempt from BT (and therefore VAT), but it is less clear whether the same policy outcomes should arise in respect of elective cosmetic surgery services provided by a non-profit institution, for example.

4. China’s VAT system has multiple VAT rates – 6 percent, 11 percent and 17 percent. The current VAT rules for goods such as medicines mean that they may be subject to VAT at 17 percent or exempt from VAT. This depends not only on the status of the provider (as either a non-profit or for-profit), but also on whether the medicines are self-produced or not. Healthcare services are likely to be either exempt from VAT or subject to VAT at a rate of 6 percent.

The aim of this publication is to highlight a range of issues affecting the healthcare sector in the transition from BT to VAT. These issues impact not only tax, but also business issues such as pricing, contracts, IT systems and processes. Furthermore, this publication is intended to be forward-looking – it has been prepared and released ahead of the Chinese Government’s expected 2016 announcement regarding the transition from BT to VAT, which will affect the healthcare sector. Increasingly, the Chinese VAT system is adopting international models of VAT used in other countries, and therefore we have applied this knowledge to predict change over a five-year time horizon.
The healthcare sector in China - a growth trajectory

If history is any guide, China’s healthcare sector is expected to grow significantly over the coming years. Healthcare expenditure in China increased at an annual compound rate of 18 percent between 2006 and 2013.¹

The growth of the healthcare sector is a function of an increasingly affluent society demanding higher levels of care services; increased incidence of diabetes, cancer, heart and other chronic diseases as a result of dietary and pollution concerns;² as well as an ageing population.

In a recent report, McKinsey & Company predicted that healthcare spending in China would reach USD 1 trillion by 2020, up USD 357 billion in 2011.³ The Chinese Government is even bolder in its predictions, estimating that spending in the country’s healthcare sector will top USD 1.3 trillion by the end of this decade.⁴

When people think about the healthcare sector, many tend to focus mostly on those parts which are operated by the state. However, there are a myriad of different providers in the healthcare sector, including:

- Hospitals (public and private)
- Doctors, specialists, elective health service providers, technicians, carers and other service providers
- Pharmaceutical companies
- Medical device companies
- Aged care providers
- Insurers.

While the healthcare sector has traditionally been dominated by the state, this has slowly been changing. In 2007, foreign participants in the healthcare sector were required to utilise joint venture structures with at least 30 percent equity held by Chinese partners. However, China’s National Health and Family Planning Commission in 2014 opened the way for wholly foreign owned hospitals to be established in seven Chinese cities and provinces – Beijing, Shanghai, Tianjin, Guangdong, Jiangsu, Fujian and Hainan.⁵ While practical implementation difficulties have made this process slow, the trend is very much towards an opening of this sector to foreign and private investors.

An interesting statistic which highlights the growth potential is that healthcare consumed 5.6 percent of China’s total gross domestic product (GDP) in 2013, compared with 17.1 percent of GDP in the US, and 10 percent of GDP in many other developed countries. The gap between China and the developed world is expected to narrow in coming years.⁶


In this section of our report, we consider what impact this predicted growth and change in the healthcare sector will have in an indirect tax context. In the past, broad-based exemptions from BT have applied to the healthcare sector, so some might assume that this will remain unchanged under the VAT system which is expected to be implemented in 2016. However, this conclusion will likely prove to be either erroneous, short-lived, or at best, overly simplistic.

Before examining the changes which may be expected though, it is necessary to gain some insight into the current system. It is worth noting here that under the current system, the sale and importation of goods already fall within the scope of VAT – which means that the sale of medicines and other drugs, as well as medical equipment, fall within the scope of VAT. By contrast, the provision of services, including medical services, accommodation and insurance, are all currently within the scope of BT – and these services are expected to transition to VAT during 2016.

The table below provides a brief snapshot of the current BT/VAT treatment applicable to many aspects of the healthcare sector:

<table>
<thead>
<tr>
<th>Non-profit sector</th>
<th>For-profit sector</th>
<th>Source</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Medical services</strong></td>
<td>Exempt from BT</td>
<td>Exempt from BT</td>
</tr>
<tr>
<td><strong>Medicines sold by pharmaceutical companies or sold at pharmacies</strong></td>
<td>17% VAT</td>
<td>17% VAT</td>
</tr>
<tr>
<td><strong>Medicines produced and used in relation to diagnosis of patients (e.g. dispensed at hospitals)</strong></td>
<td>Exempt from VAT</td>
<td>Exempt from VAT for a period of three years from the date of granting the business licence, provided the income is used to improve medical services conditions</td>
</tr>
<tr>
<td><strong>Medical devices</strong></td>
<td>17% VAT</td>
<td>17% VAT</td>
</tr>
</tbody>
</table>
International experience of healthcare under VAT/GST systems

As noted previously, China’s VAT system is very much heading in the direction of international models of VAT/ Goods & Services Tax (GST), albeit retaining some distinctive characteristics. As such, an understanding of the way in which VAT/GST applies to the healthcare sector internationally can often serve as a guide.

As a very general proposition, many countries choose to zero-rate or exempt the provision of basic healthcare services. There may be different reasons behind this:

- From a policy perspective, basic healthcare is seen as a necessity, and given the regressive nature of VAT, providing concessions is seen as appropriate in ensuring fair and equitable outcomes, especially for the aged, poor or infirm.

- In many countries, the primary provider of healthcare services is the government itself, or alternatively, the government heavily subsidises many healthcare services. As such, applying VAT to the healthcare sector is unnecessary because it simply involves money ‘churning’ within the government. Churning is where money raised by the government (e.g. VAT revenue) is then effectively given back to consumers through subsidised services.

Even though the predominant treatment of healthcare sectors internationally involves zero-rating or exemption, distinctions do arise in the following areas:

- Some countries exempt healthcare from VAT, whereas others zero-rate it. Zero-rating means that healthcare providers can obtain a VAT refund on their costs and expenses, whereas exemption does not.

- The scope of any concessions from VAT for healthcare services can differ. For example, some countries provide concessions for very basic health services only (e.g. hospital visits), whereas others provide broader-based concessions. In some countries, the status of the medical practitioner (e.g. whether they are employed or contracted by the healthcare services provider) may influence the applicability of any VAT concessions.

- The scope of any concessions from VAT for medicines and drugs can also differ. For example, some countries zero-rate or exempt only prescribed medications, whereas others may also zero-rate or exempt over-the-counter medications.

- Some countries zero-rate or exempt healthcare-related insurance products on the basis that encouraging their citizens to take out insurance lessens the financial burden on the community generally.
VAT issues likely to arise in China post the 2016 changes

Having examined the current BT/VAT treatment in China, as well as international experience, we now look at the likely VAT treatment in China after the implementation of the VAT reforms. Again, it must be emphasised that this publication is predictive in nature, as it has been written prior to the release of the VAT reform policies. Moreover, certain predictions we make are not likely to arise in the short term, i.e. at the time the VAT reforms are initially announced; instead, they are seen as longer term changes.

The analysis below in relation to situations where VAT liabilities may arise assumes that the provider of the relevant healthcare service is registered as a general VAT taxpayer. Under the VAT pilot programme, registration as a general VAT taxpayer is required in the services sector where the turnover of the business exceeds RMB 5 million per annum. Lower thresholds ranging from RMB 500,000 to RMB 800,000 apply to taxpayers who sell or import goods.\(^7\)

Registration as a general VAT taxpayer effectively means that:

- Output VAT is payable on taxable transactions at the prevailing VAT rate applicable to the service – either 6 percent, 11 percent or 17 percent
- Input VAT credits may generally be claimed upon holding a special VAT invoice
- Special VAT invoices may be issued and received.

Where the annual turnover is below RMB 5 million, registration is ordinarily made as a small-scale VAT taxpayer, though in certain circumstances, an election to register as a general VAT taxpayer can still be made. Where an entity is registered as a small-scale VAT taxpayer, this means that:

- Output VAT is payable on taxable transactions at 3 percent
- No input VAT credits may be claimed
- No special VAT invoices may be issued or received.

\(^7\) ‘Implementation Regulations for the Provisional Regulations of the People’s Republic of China on Value-added Tax’, Article 28, http://www.gov.cn/gongbao/content/2012/content_2121706.htm
Medical services

Will there be an exemption from VAT for medical services?

As noted in the table on page 8, the current position in China is that ‘medical services’ are exempt from BT. This outcome arises irrespective of whether the provider is a non-profit institution or a for-profit institution (see Article 8 of the BT Implementation Rules and Article 2(7) of Guobanfa [2010] 58). Interestingly though, this has not always been the case. Pursuant to Circular Guoshuihan [2006] 480, profit-making medical institutions were liable for BT on the medical services they provided, but this circular was subsequently abolished by SAT Announcement [2011] No. 2.

Short-term outlook

The tendency of policymakers so far has been to retain existing BT exemptions and concessions, and apply them in the VAT system, especially where those exemptions and concessions apply to services delivered at a business-to-consumer (B2C) level. Consequently, we would expect that at least initially, medical services should be exempt from VAT for both the non-profit and for-profit sector.

One possibility the policymakers may consider is applying zero-rating for medical services provided by the non-profit sector, and VAT exemption for medical services provided by the for-profit sector. This approach has already been applied in the international transportation sector, where Chinese domestic airlines benefit from VAT zero-rating, and foreign airlines qualify for VAT exemption. The distinction between zero-rating and exemption is that in the former case, related input VAT credits can be claimed and refunded, whereas in the latter case, they generally cannot be. Drawing such a distinction may create the perception of China favouring domestic entities over foreign entities, which in turn, may harm the competitiveness and outlook for foreign investment in the sector.
Longer term outlook

Longer term, we would predict that a VAT exemption is likely to be a permanent feature covering (at least) non-elective services provided by the non-profit sector. From a policy perspective, such an exemption serves to ensure minimal ‘churning’; for this reason, many other countries with a VAT system have decided that those medical services delivered by the state will be exempt from VAT. China is expected to do the same.

Whether an exemption from VAT is likely to apply in the longer term in the for-profit sector is less clear. Generally speaking, consumers of medical services in the for-profit sector may be more affluent, and may demand and be prepared to pay for a higher level of service. In due course, the government may decide to apply VAT to these services.

Impact where VAT exemption applies

It should be noted that if medical services are exempt from VAT, at least in the short term, the VAT reforms are likely to have an adverse impact on the cost structure of those healthcare providers. While most expenses of those in the healthcare sector are already subject to VAT (e.g. the purchase of equipment and medicines), some of their major capital expenses have been subject to BT at rates of either 3 percent or 5 percent (e.g. real estate and construction, and interest on borrowings); however, they will soon become subject to VAT at rates of 6 percent, 11 percent and 17 percent. VAT exemption generally means that any related input VAT credits cannot be claimed, or in the terminology which is commonly used in China, “transferred out”. The higher VAT rates compared to BT rates generally means that the amount of tax embedded in those costs rises.

A further issue which will arise if VAT exemption applies to medical services is whether no input VAT credits can be claimed, or merely some. In that regard, the existing China VAT rules effectively provide a special concession by which full input VAT credits can be claimed for the purchase of fixed assets, provided at least some income is subject to VAT. Given that many medical services providers are intensive users of fixed assets, it may be worthwhile for them to carefully reflect on whether at least some of their income is subject to VAT rather than all being exempt from VAT, so they can claim credits for fixed assets.

The scope of exemption from VAT

Assuming that medical services will qualify for exemption from VAT, the next question which arises is the scope of any such exemption. Again, experience with other sectors which have already transitioned to VAT would suggest that the VAT rules will most likely be drafted on the same basis as the current scope of exemption from BT. In that regard, the types of ‘medical services’ which are currently exempt from BT are set out in Circular Caishui [2000] 42 as follows:

“Medical examination, diagnosis, treatment, rehabilitation and preventive healthcare, midwifery and family planning services, and the related medication/drug prescription, provision of medical materials, usage of medical instruments, provision of ambulance services, associated ward accommodation and meal supply, provided by medical institutions to patients.”
The definition of ‘medical services’ is certainly broad in the context of the activities ordinarily associated with a visit to a hospital or doctor. The following are examples of problems which have arisen in other countries, and similar complexities are likely to arise in China too:

- In a well-known UK House of Lords case of Dr Beynon and Partners [2005] STC 55, it was held that doctors who personally administer medicines to patients perform a single supply of medical care which is exempt from VAT, rather than separate supplies of medicines (zero-rated) and medical care (exempt). In a Chinese context, the issue is perhaps slightly different given that there are already provisions in the VAT rules which deal with the supply of medicines and other drugs. However, if the VAT treatment or VAT rate of the supply of medicines and the supply of medical services differ, then the Chinese VAT rules would seem to require the highest VAT rate to apply to the whole consideration paid, unless there is a separate allocation of the price between the different components.

- A similar example which could arise in China is where an optometrist carries out an eye examination and prescribes glasses or lenses for a patient. The issue is whether the supply of the glasses or lenses as goods should be differentiated from the supply of the optometry service. A comparable problem arose in Australia in the case of FCT v Luxottica Retail Australia Pty Ltd [2011] FCAFC 20.

- Taking this one step further, consider the position of a doctor or a hospital which prescribes medication to a patient for later home use, and the doctor’s surgery or hospital has a pharmacy attached to it. In these circumstances, it would seem to be clearer that there is a separate supply of medicines from the supply of medical services. This issue is discussed further on page 15 under the heading ‘Supply of medicines’.

- The boundaries between those medical services which are exempt and those which are not may be difficult to draw. For example, at what point does elective treatment cease to be regarded as a ‘medical service’ – say, a patient seeking treatment for purely cosmetic reasons? What about dentistry, radiology, ambulance services, physiotherapy, sports massage, the costs of participating in a first-aid course, and any other related health services – do these qualify as being ‘medical services’? What about alternative, experimental or relatively non-traditional forms of treatment – do these qualify as being ‘medical services’? Similarly, does the setting in which the service is provided matter – for example, an elderly or frail patient who is able to afford the help of a nurse to provide home care?

- The place or setting in which services or products are marketed and sold may also affect the VAT treatment. For example, Chinese herbal medicine which is supplied to patients in a hospital would likely qualify for VAT exemption. However, if those same herbs were sold at a pharmacy or store outside of a hospital environment, or sold for culinary purposes, then an exemption would likely not apply.

- The scope of ‘medical services’ specifically refers to services which are provided by medical institutions to patients. This raises the question of whether any likely exemption from VAT would only apply to B2C supplies of medical services, and not business-to-business (B2B).
For example, it is unclear whether a ‘medical service’ is supplied when pathology services are provided by a pathology company to another medical institution. There are examples in other countries, such as Australia, where the concessional treatment applicable to certain medical services only applies when they are provided to the end-consumer, and not in a B2B context. We understand that policymakers in China are considering applying VAT exemption for B2C transactions only, and not B2B transactions.

- There are numerous examples which highlight the need for medical services providers to consider the full list of the various fees and charges they impose. Even though the vast majority of their fees may qualify for VAT exemption, it is often those non-recurring or occasional fees which can trigger the most difficult VAT issues. Examples include fees to access or receive copies of medical records; fees charged to a patient for a ‘no-show’ (that is, a fee charged for not showing up to their appointment); and fees charged for additional meals or accommodation provided to family members of a patient during a hospital stay. In addition, what if the surgeon is a contractor of the hospital and not an employee? Would the hospital charge the surgeon a theatre hire room charge, and if so, would this be within the scope of VAT exemption, or would it be deemed a supply of accommodation?

These examples highlight a basic proposition that when it comes to VAT, the devil is in the detail. While the exemption for ‘medical services’ may initially appear broad, it is necessary to carefully consider each of the revenue items involved on a line-by-line basis.

Non-profit vs for-profit

As noted in the table on page 8, there are currently distinctions between the BT treatment of the non-profit and for-profit sectors. In particular, there are distinctions in terms of the length of time and the conditions under which exemption applies to medicines which are self-produced and used in the diagnosis and treatment of patients.

One issue which commonly arises is the implications of converting from non-profit status to for-profit status. This may occur if, for example, an initial public offering (IPO) is contemplated.

We anticipate that in the longer term, this will become a more significant issue if certain types of medical services provided by the for-profit sector become subject to VAT, while those in the non-profit sector remain exempt from VAT (or possibly zero-rated). Similarly, the conversion from non-profit status to for-profit status is likely to have an impact on the exemption from VAT which applies to the sale of self-produced medicines. While switching from being exempt from VAT to being subject to VAT may seem simple in theory, in reality it can give rise to various transitional VAT issues, such as:

- Whether input VAT credits can be claimed for stock on hand
- Whether VAT applies to invoices issued (but which remain unpaid) as at the date of conversion from non-profit status to for-profit status, or whether VAT applies to invoices issued after the date of conversion in respect of services provided beforehand
- The need to obtain the equipment to issue special VAT invoices and to obtain special VAT invoices from suppliers.
Supply of medicines

As noted earlier, there are specific rules already in place to deal with the supply of medicines, since they are within the scope of the current VAT system. In broad terms, the supply of medicines will be subject to VAT at a rate of 17 percent in the following common situations:

- The supply of medicines by a pharmaceutical company to a hospital, doctor or other healthcare provider
- The supply of medicines at a pharmacy to a member of the public.

By contrast, there is an exemption from VAT in the following situations:

- The supply of medication and drugs produced and used by non-profit medical institutions in relation to the diagnosis of their patients – Article 1(3) of Circular Caishui [2000] 42
- The supply of medication and drugs produced and used by for-profit medical institutions in relation to the diagnosis of their patients, but only for a period of three years from the date of the granting of their business licence, and where the income is used directly in the improvement of their medical services conditions.
- These exemptions are intended to ensure that hospitals are not required to pay VAT on the supply of medicines which are provided as part of a medical service which is exempt from BT.

Given that VAT already applies to the vast majority of medicines which are sold in China – that being, over-the-counter medicines – little is expected to change in this area. However, what is expected to change in the future is the enforcement surrounding the above exemptions from VAT. At present, it is understood that in practice, VAT is typically not paid by either non-profit or even many for-profit hospitals in relation to the medicines they provide to patients. In future, greater enforcement may be expected around:

- Medicines which are supplied by non-profit and for-profit institutions which they purchase from pharmaceutical companies, compared with self-produced medicines
- The three-year time limit for for-profit institutions
- Pharmacies which are physically connected to, or situated in, hospitals and doctors’ premises.

Given that many hospitals in China derive a significant part of their income from marking up the prices of medicines, and the government is known to be trying to reduce this dependency, it would not be surprising to see the VAT rules being more strictly enforced in this area.

Related enforcement has recently increased as a result of certain high-profile cases, in order to ensure that free gifts and samples which are commonly provided by pharmaceutical companies to hospitals and doctors are subject to output VAT as a ‘deemed sale’. Similarly, the treatment of commissions, rebates and other promotional or incentive arrangements provided by pharmaceutical companies to hospitals and doctors has also attracted greater attention. So too have the fees paid by pharmaceutical companies to doctors for speaking at events. In some cases, this may lead to output VAT liabilities for the doctors or hospitals, while in other cases they may impact the VAT liabilities of the pharmaceutical companies.
Clinical trials

An issue which is related to the supply of medicines is the expected treatment of clinical trials. What commonly occurs is that a hospital or doctor is paid a fee or other remuneration for conducting the clinical trial, which is sponsored by a pharmaceutical company. In some cases, the pharmaceutical company which is sponsoring the clinical trial is based outside of China.

The current position is that BT applies to the services of the hospitals and/or doctors at the rate of 5 percent, as the BT charging provision applies where either the supplier or the recipient is in China. However, this is expected to change when the VAT reforms are expanded in 2016. The current VAT rules provide for exemptions or zero-rating from VAT for many types of exported services, and so it may be anticipated that clinical trials carried out by hospitals and/or doctors in China for the benefit of sponsors who are overseas pharmaceutical companies will qualify for VAT exemption.

Where clinical trials are carried out for local sponsors (e.g. the local Chinese subsidiary of an overseas pharmaceutical company), these services would be expected to attract 6 percent VAT. The challenge which those local sponsors have encountered under the current BT system is to ensure they receive invoices from the hospitals or doctors which are carrying out the clinical trials. At present, this may be due to uncertainties in terms of how to segregate taxable from non-taxable income. The VAT reforms may bring additional clarity in this area, and may compel hospitals and doctors to provide special VAT invoices for these services.
Supply of medical devices

The supply and importation of medical devices is currently subject to VAT at a rate of 17 percent. This effectively means that the VAT on the purchase of those medical devices and equipment for use by hospitals, doctors and other medical services providers is a real cost because those purchasers are currently within the BT system and therefore cannot generally claim input VAT credits.

A further issue which can arise in practice is where a medical device business supplies certain equipment free of charge to hospitals, on the understanding that related materials will be needed in its application. For example, equipment necessary for certain implants may be supplied free of charge, with the hospital then reliant on purchasing the implants themselves from that supplier.

These activities can give rise to deemed sales issues for VAT purposes, though there may be the opportunity to mitigate exposure through the careful structuring of transactions.

When the healthcare sector transitions to VAT, the purchase of medical devices and equipment will still be a real cost for VAT purposes where they are used by medical services providers whose services are exempt from VAT. This will only change if, and to the extent that, medical services providers provide taxable and/or zero-rated services, in which case input VAT credits could be claimed.

Disposal of assets of a healthcare business

As noted at the outset, there is expected to be significant growth and expansion of the healthcare industry in China over the coming years, including greater ownership by both foreign investors and Chinese private investors. Even though some services provided by healthcare facilities (such as for-profit hospitals) may be exempt from VAT, VAT issues will arise where healthcare facility assets are disposed of to new investors.

Many countries with VAT or GST systems provide for a concession applicable to the sale of a business, or in some cases even the sale of a part of a business, as a going concern. In China though, any such concession is significantly more limited.

SAT Announcement [2011] 13 provides that the transfer of the entire or partial tangible assets together with related creditor’s rights, liabilities and manpower in an asset reorganisation, is not within the scope of VAT. A similar concession currently exists in a BT context. In practice, applying these concessions to the sale of part of a business, or where certain assets or liabilities may be excluded from the sale, may not be straightforward.

However, the opportunity often exists to structure these transactions in such a way that they stay outside the scope of VAT.

Related to this is the need to separately account for VAT on the sale of inventory, as well as the need to separately identify the disposal of fixed assets purchased either pre-2009 or prior to the taxpayer obtaining VAT taxpayer status, and where no input VAT credit was claimed on the purchase (in which case, 4 percent VAT applies; 50 percent of the tax amount can be exempted or taxpayers may elect to use the 3% VAT rate). This is compared to the disposal of fixed assets purchased post-2009 or post-VAT reform, where an input VAT credit was claimed on the purchase (in which case, VAT at the normal rate of 17 percent applies).

Given that the underlying healthcare business activities may be exempt from VAT, any VAT which applies to the sale of assets or of the business as a whole, will be a real cost. Furthermore, unlike the position in many other countries, China’s VAT rules generally do not allow for refunds of excess VAT credits (except for exporters). As such, significant cash flow issues can also arise, especially during the start-up phase of a business.
One area which is likely to become subject to increased focus over the coming years is the VAT treatment associated with aged care. The Chinese traditional value of ‘filial piety’, which sees many elderly people living with their children, is likely to change over the coming years, for a range of reasons. Public services for the aged are expected to grow significantly because of the combined effects of an ageing population, the long-term effects of China’s one-child policy (albeit discontinued from 2016), an increasingly affluent society demanding better services, and a general shift away from these more traditional values by some families. What is likely to emerge is an array of specialised aged care providers, where the elderly can access a broad range of healthcare and accommodation services.

Difficult VAT issues can arise where a package of services is subject to different VAT treatments or different VAT rates – for example, a package comprising accommodation, meals and services. At one extreme, the provision of accommodation to an elderly person who lives unassisted may readily be regarded as being a supply of residential housing which is expected to attract VAT at a rate of 11 percent. However, at the other extreme, the provision of accommodation, meals and services in connection with palliative care for an elderly resident is more likely to be regarded as the supply of a medical service which is exempt from VAT. In between this, elderly people may require increased support services as their needs increase, more specialised or on-call services within their accommodation, and the ability to shift between different levels of accommodation or care as their needs change. The need to disaggregate each of these services into their distinct components causes difficulties from a VAT perspective.
There are two separate categories of issues which can arise in the context of insurance in the healthcare sector:

1. The VAT treatment of healthcare-related insurance products which are sold to consumers
2. The VAT issues which can arise in the context of claims made for costs and expenses relating to healthcare.

In August 2013, KPMG China produced a detailed publication entitled *Proposed Introduction of VAT for the Insurance Sector in China*, which examines many of the VAT issues arising for the insurance sector. More specifically in a healthcare context, we note the following BT treatment which currently applies to healthcare-related insurance products:

<table>
<thead>
<tr>
<th>Insurer</th>
<th>Types of insurance</th>
<th>BT treatment</th>
</tr>
</thead>
<tbody>
<tr>
<td>Private</td>
<td>Life insurance &gt; one year</td>
<td>Exempt (under <em>Caishui 2001 [118]</em>), but subject to approval</td>
</tr>
<tr>
<td></td>
<td>Health insurance &gt; one year</td>
<td></td>
</tr>
<tr>
<td></td>
<td>Pension insurance &gt; one year</td>
<td></td>
</tr>
<tr>
<td></td>
<td>Other types of health-related insurance</td>
<td>Subject to BT at 5%</td>
</tr>
<tr>
<td>Public: The China Social Health Insurance scheme (“Yibao”)</td>
<td>There are no specific types</td>
<td>Exempt from BT</td>
</tr>
</tbody>
</table>

It is currently expected that most forms of general insurance will be subject to VAT at a rate of 6 percent when that sector transitions to VAT in 2016. It is similarly expected that the existing categories of BT exemption for insurance products will be exempt from VAT. That is, we would expect that private health insurance policies with a duration of more than one year will be exempt from VAT, as will Yibao.

While the VAT treatment of healthcare-related insurance products may not differ markedly from the current BT treatment, there may be a greater impact on claims. Put simply, where a person chooses to have their healthcare costs paid for by an insurer, different outcomes may arise depending on whether the insurer settles the cost directly with the provider, or reimburses the insured.

Where an insurer settles a healthcare-related cost which is subject to VAT directly with the provider, then the insurer will typically expect to get a special VAT invoice and wish to claim an input VAT credit. By contrast, where the insurer reimburses the insured for the cost, no input VAT credit may be claimed. The clear incentive will be for insurers to pay for claims which are subject to VAT directly to the providers, and in the process, they will demand special VAT invoices so that credits can potentially be claimed. Similar considerations are likely to arise in the context of employers paying healthcare costs directly, rather than reimbursing employees. Of course, for healthcare costs which are exempt from VAT, it should not make any difference to the insurer whether it settles the claim directly, or reimburses the insured.
Developments in e-healthcare

The digital economy is revolutionising the world economy, including the healthcare sector. It enables remote diagnosis (i.e. virtual medical consultations), the maintenance of electronic health records, and 3D digital printing of prostheses and other medical devices.

These developments change both the traditional operating models of businesses in the healthcare sector, and produce difficult (and previously unforeseen) VAT issues. For instance, consider what happens when private medical services are provided remotely by a doctor who is outside China, or where medical devices are imported into China via 3D digital printing: in each case, the challenge for policymakers is that the Chinese VAT system has relatively lax enforcement and collection of taxes on digitised services which are provided outside China, with the VAT rules generally precluding foreign suppliers without a physical presence in China from registering and paying VAT.

As addressed by the OECD/G20 initiatives surrounding Base Erosion and Profit Shifting (BEPS), the growth of the digital economy poses challenges for international taxation. This is not limited to the healthcare sector, nor is it unique to China. KPMG China is publishing a separate publication focusing on indirect tax risks for the digital economy and it raises many issues which will also be relevant to the healthcare sector.
How KPMG can help

The key challenge in operating under China’s VAT system is how to convert complex rules into a series of business processes, which can be implemented by a broad range of stakeholders such as medical professionals, finance teams, IT professionals, insurers, brokers and agents. Ultimately, simple business rules need to be written, transactions coded in accounting systems, escalation procedures agreed upon, and processes automated as far as possible. This requires experience.

KPMG has a dedicated team of Tax and Advisory professionals experienced in implementing these reforms, both in China and internationally. We typically break up the work into three phases:
Here is a sample of how KPMG China can assist:

**Preparation**

The key business issue to understand is the overall financial impact on the healthcare business in China. As part of the initial preparation phase, we would generally undertake a review of the major revenue and expense items to determine how VAT will have an impact on those items. Similarly, we recommend a review of major (or sample) contracts to ascertain whether VAT can be passed on, and if it cannot be passed on, the impact and duration of any VAT that needs to be absorbed. This review process would help the business understand whether:

- VAT will apply to each revenue item, and if so, at what rate
- VAT exemptions or other concessions can be claimed
- The amount of any major expenses currently includes BT and the likely impact once VAT is introduced
- There are any areas of ambiguity which should be raised for consideration with the Ministry of Finance and State Administration of Taxation, and how those areas will be interpreted and implemented locally with your in-charge tax official.

From this process, we can then seek to generate an overall ‘financial impact assessment’ to enable you to understand the real financial impact, and to take steps to address areas where there may be VAT exposure, or an opportunity.

**Implementation**

Based on our experience advising other businesses paying VAT, perhaps the most critical step is to convert technical VAT rules into a series of processes and procedures that can be followed and easily applied by non-tax professionals. For example:

- If VAT is to be applied to certain revenue items but not to others, what coding can be applied to ensure ease of implementation by finance staff and the entry of correct VAT treatment in your systems?
- If certain types of services or products are exempt from VAT, what processes and documentation are needed to apply for them, and how can you ensure that related input VAT credits are identified and transferred out in your systems?
- From a systems perspective, how can you ensure that special VAT invoices are only issued under the right circumstances? How can you ensure that special VAT invoices you require are obtained promptly, validated and subsequently coded into your systems to produce the correct data for your VAT returns?

Implementation also includes training for key finance staff to ensure a proper understanding of the implications of the VAT reforms on the business, and that simple business rules are applied to ensure compliance.

**Compliance**

Finally, once the VAT reforms are implemented, the accuracy of systems and processes may need to be tested and verified. A small breakdown in a single process or control can lead to significant VAT liabilities, interest and penalties.

Typically, monthly VAT returns must be filed with the tax authorities for each branch. KPMG China can assist with their preparation, or otherwise review them or conduct regular sense checks.

Experience also shows that the VAT rules are rarely stagnant – typically, the rules are modified several times following their initial introduction. Furthermore, the healthcare sector is extremely dynamic, with new sources of revenue arising, all of which can result in substantially different and previously unforeseen VAT implications.
KPMG contacts

Healthcare sector contacts

Jenny Yao
KPMG National Healthcare Sector Leader
KPMG China
E: jenny.yao@kpmg.com
T: +86 (10) 8508 7074

Grace Xie
KPMG National Healthcare Sector Leader for Tax, Central China
KPMG China
E: grace.xie@kpmg.com
T: +86 (21) 2212 3422

Thomas Li
KPMG National Healthcare Sector Leader for Tax, Northern China
KPMG China
E: thomas.li@kpmg.com
T: +86 (10) 8508 7574

Grace Luo
KPMG National Healthcare Sector Leader for Tax, Southern China
KPMG China
E: grace.luo@kpmg.com
T: +86 (20) 3813 8609

Indirect Tax contacts

National

Khoon Ming Ho
Partner in Charge, Tax
KPMG China & Hong Kong SAR
E: khoonming.ho@kpmg.com
T: +86 (10) 8508 7082

Lachlan Wolfers
National Leader, China, Indirect Taxes
KPMG China
E: lachlan.wolfers@kpmg.com
T: +852 2685 7791

Northern China

Shirley Shen
Tax Partner
KPMG China
E: yinghua.shen@kpmg.com
T: +86 (10) 8508 7586

Central China

John Wang
Tax Partner
KPMG China
E: john.wang@kpmg.com
T: +86 (21) 2212 3438

Southern China

Jean Jin Li
Tax Partner
KPMG China
E: jean.j.li@kpmg.com
T: +86 (755) 2547 1128

Hong Kong

Lachlan Wolfers
National Leader, China, Indirect Taxes
KPMG China
E: lachlan.wolfers@kpmg.com
T: +852 2685 7791