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KPMG
cutting through complexity

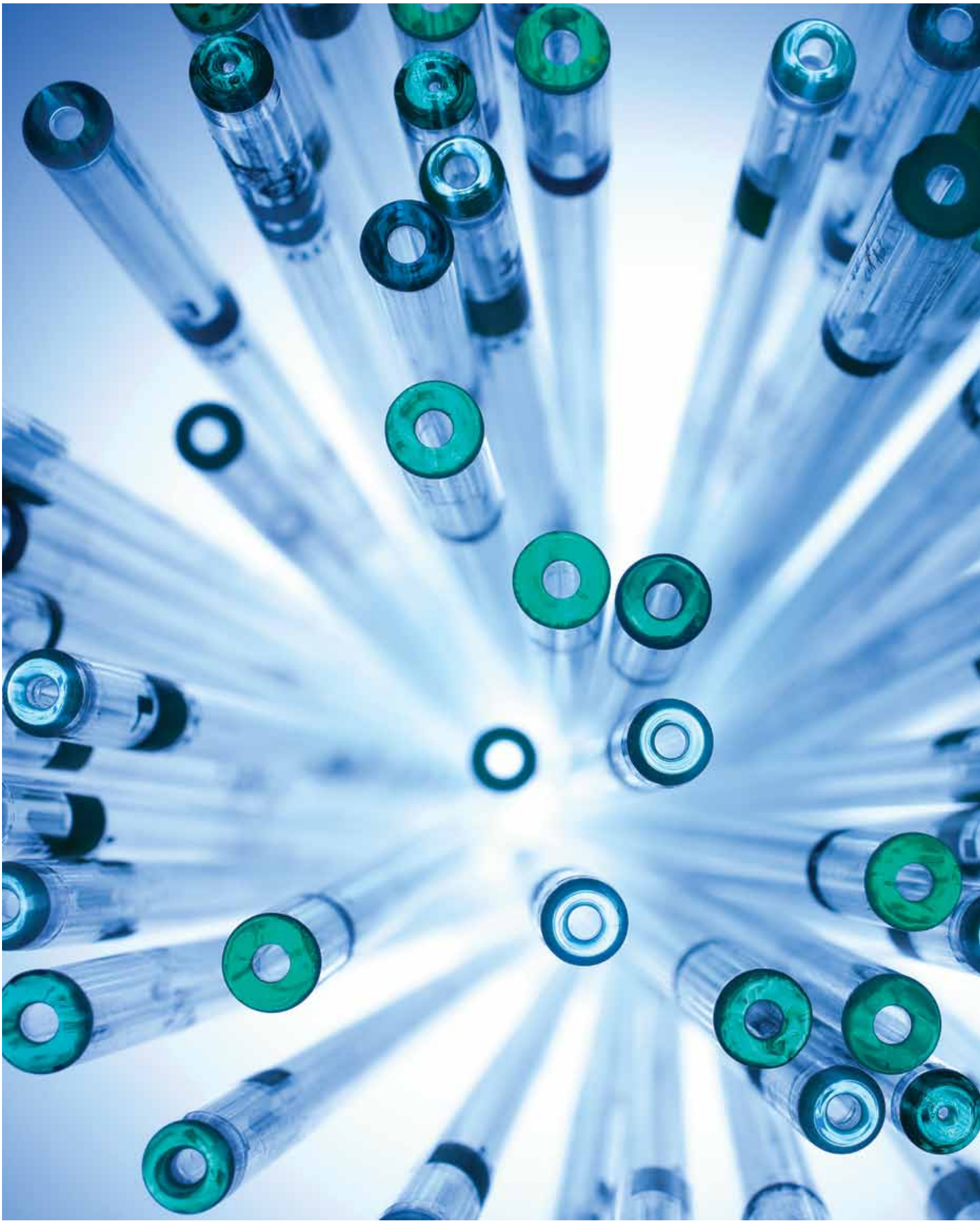
China Tax for **Healthcare & Life Sciences Industry**

China tax and customs planning for R&D activities of China's healthcare & life sciences industry

Introduction

China's healthcare & life sciences industry is currently experiencing significant growth with foreign multinational corporations (MNCs) continuously investing in the Chinese market. The implementation of healthcare reforms by the Chinese government and other regulatory bodies have and will continue to significantly impact business practices and operational costs of companies in this industry.

In our first issue, we highlight common tax and customs matters with an emphasis on R&D activities relating to daily business operations within China's healthcare & life sciences industry. We also explore potential tax planning ideas to optimise business models for companies in this particular industry with an objective to improve tax efficiency and expedite goods importation.



Key China tax issues

China is set to become a crucial player in the healthcare & life sciences industry. According to the Ministry of Health, China will generate healthcare opportunities worth over USD 500 billion by 2014-2015. As outlined in China's 12th Five-Year Plan and other supporting regulations, China is expected to become a global drug innovation hub given its considerable advantages such as: a large pool of clinical trial applicants; a surplus of professional talent; an increasing number of international standard multi-centre trial bases; and strong support from local governments.

As one of the industries listed in the *High and New Technology Areas with Key Support by the State* and *Guidance for Development of Prioritised Key Areas of High Technology Industries*, the Chinese government has outlined the following key tax incentive policies applicable to R&D activities, with an objective to encourage companies in China's healthcare & life sciences space to carry out R&D activities continuously and improve their R&D capabilities:

- Preferential corporate income tax (CIT) rate at 15 percent for recognised Hi-tech enterprises
- Preferential CIT rate at 15 percent for recognised advanced technology service enterprises
- Bonus deduction of R&D expenses incurred for the development of new technologies, products and technological processes
- Value added tax (VAT) exemption/zero rate for income from technology transfers, development and related consultation and service provisions
- VAT exemption for qualified offshore outsourcing service income, e.g., knowledge processing outsourcing (KPO).

However, considering the overall strategy on a group level, although MNCs in the healthcare & life sciences industry have set up R&D centres or R&D divisions in China, these are mainly providing contract R&D services to the group company; they do not own the intellectual property of the products or technology they are researching and developing. As a result, other tax incentive treatments are not available to most foreign invested R&D activities apart from VAT exemption/zero rate for qualified outsourcing services and a preferential CIT rate for recognised advanced technology service enterprises. Therefore, the current and plain *Contract R&D* model will not effectively improve the tax efficiency of the MNCs in China.

MNCs may consider improving their current business model to more effectively enjoy the tax incentive treatments. For example, expanding the scope of the current R&D activities to include innovation or improvement

of the manufacturing process. It should be noted, however, that not all innovation or manufacturing process improvements will qualify as R&D activities and the relevant expenses may be be eligible for a bonus deduction. The feasibility of respective innovation or improvement solutions will be subject to further detailed assessments.

Considering the resource advantages in China, MNCs can alternatively consider arranging the R&D centres or R&D divisions in China to lead certain R&D projects for part of their non-core business within the group and allow these R&D centres and divisions to have ownership over the intellectual property in order to reach the qualifications of the proposed tax incentive treatments. Alternatively, MNCs could enter into extensive strategic alliances or joint research/developments with Chinese partners, e.g., domestic companies, academic institutions and medical institutions, during the R&D process to move these projects forward and achieve a winning outcome for both parties. Of course, in addition to the ownership of intellectual property, R&D centres should also satisfy other conditions and obtain the approval from relevant government authorities in order to enjoy the preferential CIT rate.

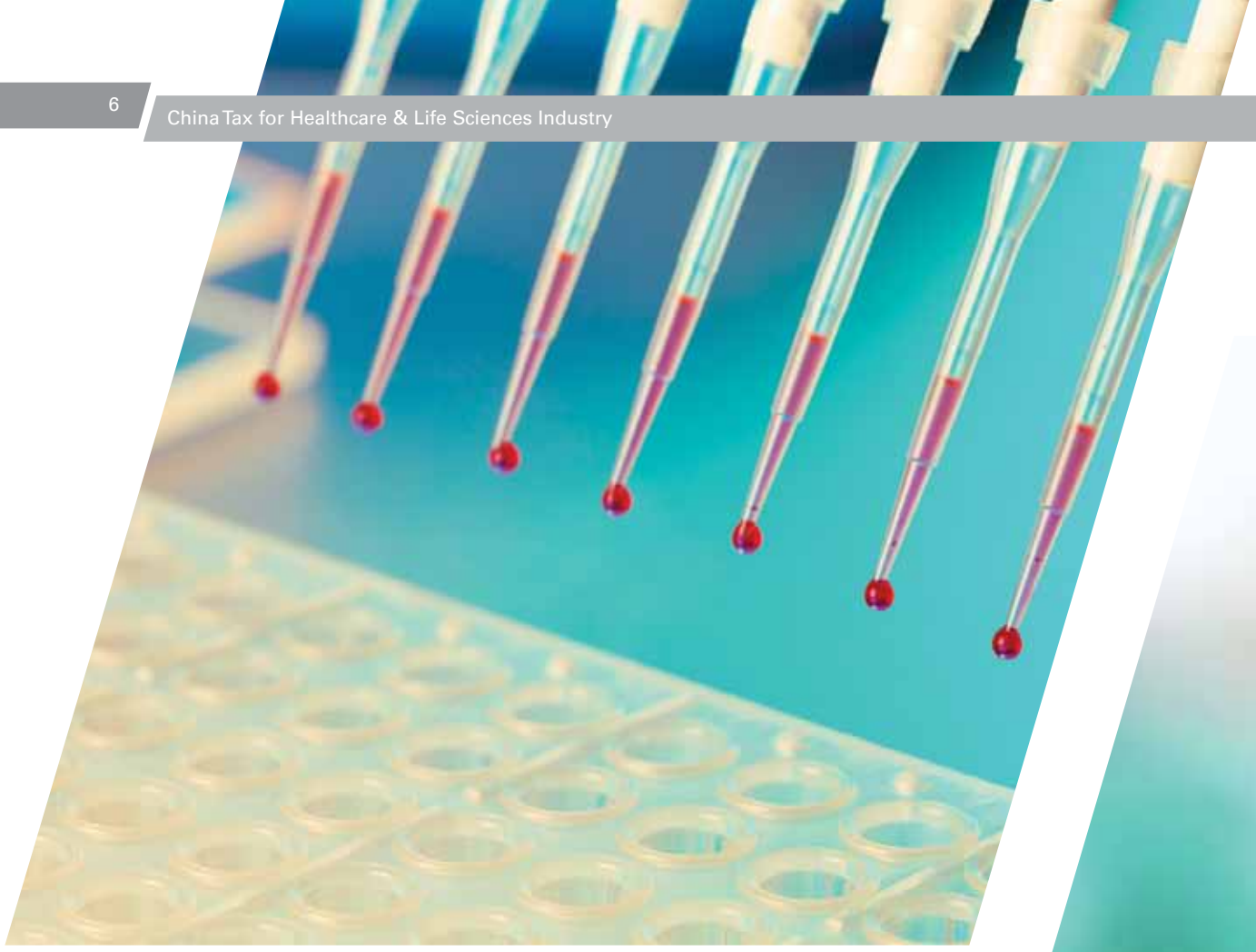
In light of the above, considering that potential improvement may be available for the existing business model for tax planning purposes, it is advisable that MNCs in the healthcare & life sciences industry review the current or proposed R&D arrangements to explore the feasibility of any improvement or optimisation opportunities.

Key China Customs issues

With the diversified development of foreign invested R&D centres in China, customs issues regarding imported drugs (including reagents) has become a major issue. Drug importation has been a key area of customs administration, especially the drug importation price between related parties. For drugs imported purely for testing purposes that are provided for free by overseas suppliers (as these drugs do not have an actual transactional value), Customs is required to determine their dutiable value based on the transactional value of identical or similar goods. Many companies have experienced challenges on the dutiable value by Customs and the delay of goods clearance. For a long time, pharmaceutical companies have been concerned about how to solve the this problem. Currently, Shanghai Customs is actively exploring ways to solve this challenging issue through pilot price registration. Price registration is a supplementary approach to the pre-import price review, and is focused on filing the price of the drugs with Customs and seeking approval in advance; this is to allow for smooth customs clearance and to potentially mitigate the customs audit risk after importation. Related information and documents should be disclosed to Customs when conducting the price registration to ensure the reasonableness of the price. As the price registration is a new measure promoted by Shanghai Customs this year, it requires companies to carry out further investigations to correctly determine how to apply in order to secure Customs approval.

In order to encourage and promote scientific research and technological development, the Chinese government has exempted the R&D equipment/supplies imported by foreign invested R&D centres from import duty, VAT and and Consumption Tax. The policy is effective from 1 January 2011 to 31 December 2015. While it is uncertain whether the policy will still be effective after 2016, KPMG has learnt that the policy is likely to extend after 2015. Foreign invested R&D centres should keep an eye on further developments of relevant policies in this area.

On 6 July 2013, China's Minister of Commerce, Gao Hucheng, and Swiss Councilor and Minister of Economy, Johann Schneider-Ammann, signed 'The People's Republic of China and Swiss Confederation Free Trade Agreement' ('the FTA'). Switzerland became the first country in continental Europe to sign a FTA with China. The FTA come into effect second half of 2014. According to the FTA, the majority of goods exported from Switzerland into China will enjoy zero tariffs immediately. For some special goods, the tariffs will be gradually reduced during a transitional period of five to 10 years. For some limited goods, the transitional period will be up to 15 years. Out of the 79 types of drugs listed in Chapter 30 of the Customs Import and Export Tariff, the tariff for 78 types will be reduced and 32 types will enjoy zero tariff from the implementation date.We recommend pharmaceutical companies prepared for the changes brought by the FTA, including the implementation of rules of origin, and the preparation for Customs procedures to ensure they benefit from the FTA.



Summary

The Chinese market is becoming the focus of the global healthcare and life science industry while R&D activities are an essential part of the development of the whole industry. Therefore, it is crucial that MNCs proactively monitor the policy changes on the tax and customs front in China and explore tax planning opportunities, which will aid the success of its business development in China.

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