REPORT

EU/MUTRAP support to GDT/MOF in upgrading the taxation system to improve its ability to cooperate with the EU for fighting against international tax evasion.

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Overview

This document provides a review of Vietnam's regulatory provisions with regards to the GDT's priority BEPS issues. Detailed reviews of each of the issues are provided in the Annexes to this document.

As background, during meetings in Hanoi in January and March 2016 the EU-MUTRAP consultant discussed BEPS issues in Vietnam with representative form the ITD, Policy and Legal Depts. As a result of those meetings, the following BEPS issues were identified as representing the most important risks to Vietnam's tax base.

a) Excessive deductions of interest arising from the introduction of excessive debt into MNEs operating in Vietnam.
b) Transfer pricing.
c) Transfer pricing documentation and country by country reporting.
d) Permanent establishments.
e) Tax treaties.

Issues a), b) and c) are considered to create the most urgent risks.

This document also stresses that the effective implementation of rules to counter BEPS requires an operational capability to implement them. This is discussed further in Section f) below.

A brief discussion on the need to monitor BEPS behaviours of MNEs, and to respond accordingly, is contained in section g) below.

a) Interest deductibility

Excessive deduction of interest can arise due to a) an excessive rate of interest or b) an excessive amount of amount of debt.

The current rules (in Circular 66 and Article 9 (2)(g) Law on Enterprise Income Tax)) provide some protection against excessive rate of interest charged on a loan to a MNE operating in Vietnam. However, there is no protection against introducing an excessive amount of debt into a Vietnamese MNE, other than a very limited rule in Article 9 (2)(k)) Law on Enterprise Income Tax.

The GDT is currently undertaking an exercise to estimate the current risk, (the ratios of interest/EBITDA, debt/equity in the largest FDI subsidiaries). From anecdotal evidence, it is expected to be significant, especially as withholding tax rates are relatively low.

Main recommendations:

- Consider the options, in light of international experience, for introduction of new rules to limit the amount of interest payable by multinational enterprises. The main options are fixed interest/income ratio (recommended by OECD as a best practice approach), thin capitalisation rules and an arm's length approach. The EU-MUTRAP **consultant proposes adopting rules based on the BEPS proposal**, which are the most straightforward to implement.

- In addition, GDT may wish to introduce at the same time simple interest cap rules and a simple measure to counter hybrid instruments.

This issue is described in more detail in the paper entitled 'Note for GDT on Rules to Counter Excessive Interest Deductions', prepared by the EU-MUTRAP consultant, at Annex 1 below.

b) Transfer pricing

There are a number of issues relating to transfer pricing.

- There is uncertainty whether the **primary legislation** places the burden of responsibility regarding transfer pricing the taxpayer. This may mean that transfer pricing is outside self-assessment. It may also mean that penalties may not be enforceable with regards to transfer pricing adjustments.

  Our understanding is that the primary rule on transfer pricing, (Article 37 of Law on Tax Administration), states that 'The taxpayer shall pay the tax as per filing method fixed in the following cases
  … e) Fail to purchase, sell and exchange or finalize the value of goods and services according to common market value'

  This wording suggests that the mechanism for applying the transfer pricing rules is 'tax fixing', which, we understand, is akin to additional tax payable on a breach of the tax law. If this is the case, the onus is then on the GDT to apply the transfer pricing rules, and apply the additional tax, but not the taxpayer. It is then arguable that the application of the transfer pricing rules falls outside self-assessment, and any penalty for making an incorrect return may not apply.

- The current rules, in **Circular 66**, are outdated, and unlikely to enforce the key issues discussed under Actions 8-10 of the BEPS project relating to profit shifting arising from intangibles, risk-shifting and he use of highly capitalised- low substance entities in low tax jurisdictions. In addition, they are unlikely to implement the BEPS recommendations regarding the ability to recharacterise or disregard it transaction.

- **Circular 66** raises a number of additional issues that impact on its effectiveness and its alignment with international principles. A more detailed analysis of Circular 66 is contained in Annex 3.

- The time limits imposed on the conduct of audits are unrealistic for transfer pricing.

These issues are discussed in detail in the paper entitled 'Analysis of Vietnam's transfer pricing Regulations' (BEPS analysis), prepared by the EU-MUTRAP consultant, at Annex 2 below.

Main recommendations:

- The **primary legislation is amended or supplement** in order to introduce a short new transfer pricing provision compatible with international standards, the BEPS recommendations, and self-assessment.
- That **Circular 66 is amended or replaced** to align with best practice.
- It is highly desirable that the **audit time limit is amended** at least for the audit of multinational enterprises

There are a number of other issues related to transfer pricing.

- The audit time limit makes it important that significant amounts of information are made available to GDT in advance of the commencement of an audit. We recommend that **Form 01, which is submitted with the tax return, is expanded to provide further information relating to transfer pricing**. We recommend also that stronger penalties are introduced for failure to compile and keep transfer pricing documentation.
- In addition, in the medium term, legal instruments and mechanisms for the **exchange of information** needs to be strengthened.
- In order to address issues of capacity, and practical implementation of the rules in the light of difficulties in identifying comparables data, **we recommend that fixed margin safe harbours** are introduced in respect of a number of categories of transactions. Such a measure should increase voluntary compliance, provide certainty for taxpayers and reduce compliance and enforcement costs for the GDT and taxpayers. Margins could be fixed according to data in the possession of the tax administration.

The last issue is discussed further in the document 'Note on the use of tax administration data for comparability and safe harbours prepared by the EU-MUTRAP consultant, at Annex 4 below.

c) Transfer pricing documentation

The issue of the submission of information MNE taxpayers is very significant because: the time limits on conducting audits require that MNEs submit information relating to International transactions in advance of conducting an audit. It is also currently critical because international exchange of information mechanisms are not yet fully effective.

The current rules contained in Circular 66 are comprehensive, but compliance with these rules is inconsistent, partly because penalties for failure to create and keep such documentation are very low ($50-$300).

Main recommendations:

- Specific penalties for failing to maintain adequate transfer pricing documentation are introduced and that this is based on a percentage of turnover.
- In the longer term, that measures are taken to ensure exchange of information mechanisms are effective
- Until such measures are taken, that GDT considers the local filing in Vietnam of country by country reports for large MNEs (as defined by OECD in this context) in cases where exchange of information mechanisms are ineffective.

In the medium to long term, GDT may also wish to consider amending its transfer pricing requirements to incorporate the 'local file' and 'masterfile' as recommended under BEPS Action 13.

This issue is discussed further in the document 'Review of Vietnam's transfer pricing documentation requirements and the outcomes of the OECD's BEPS initiative, Action 13, prepared by the EU-MUTRAP consultant, at Annex 5.

Country by country reporting

The OECD's BEPS report (Action 13) introduces a requirement for the largest MNEs to file a country by country report. This would be submitted only to the tax jurisdiction of the ultimate parent or head office company, and then made available to other relevant tax jurisdictions through tax information exchange instruments. In some circumstances, a report of an MNE not ultimately headed in Vietnam could be required to be filed in Vietnam.

GDT will need to consider introducing new legislation to:

a) require MNEs which are ultimately headed in Vietnam to submit the report to the GDT; and,
b) allow GDT to require the local filing of a country-by-country report from an MNE that is not ultimately headed in Vietnam, in specific circumstances.

d) Permanent establishments

Vietnam's primary legislation on permanent establishments is contained in Article 2 of the Law on Enterprise Income Tax, and expanded in Circular 205, Articles 10 and 11. These provisions are relatively comprehensive and largely implement permanent establishment rules in accordance with the UN model treaty.

The first BEPS issue to consider is the ability to establish a permanent establishment in commissionaire arrangements, where the contract may be concluded in the name of the representative or agent, but for the account of the foreign enterprise. Article 2.3 (d) and (e) of the Law on Enterprise Income Tax establishes a permanent establishment where there exist 'agents for foreign enterprises', or when Vietnam-based representatives, 'are competent to conclude contracts in the name of foreign enterprises'.

Article 11 1.2.2.(d) of Circular 205 states that a permanent establishment will exist where:

đ) That enterprise gives a person in Vietnam:

- An authority to habitually negotiate and conclude contracts in the name of the enterprise, <u>or conclude contracts in the name of that person</u>, which bind responsibilities or obligations to that enterprise.

This wording suggests that Vietnam's domestic rules on permanent establishments are able to address agents acting as a 'commissionaire', and that the risk from this type of BEPS issue is

quite low. In the longer term, GDT will need to update treaties in order to bring into force the BEPS recommendations on Article 5(5) of the Model Convention.

The second issue is the ability to counter abuse of the exceptions to a permanent establishment currently contained in Article 5(4) of the UN model convention, and implemented in Vietnam domestic rules in Circular 205 Article 11. 1.2.3. The BEPS project identified circumstances where exceptions of this type may preclude the creation of a permanent establishment in cases where the relevant function may, in fact, be a crucial driver of value. For example, the exception in Article 11 1.2.3 (a) that apply an exemption to 'enterprise uses facilities in Vietnam solely for the purpose of storage, display of its goods' may not be appropriate in the case of a warehouse that conducts very sophisticated functions that enable efficient stock-control.

It is recommended GDT considers carries out a more detailed analysis to establish the extent to which the current rules in the primary law and Circular 205 are able to address this BEPS issue, and to consider amending Article 1.2.3. in line with BEPS recommendation if needed.

This issue is not considered to represent a priority risk for Vietnam.

e) Tax treaties

The BEPS project made a number of recommendations designed to counter the abuse of text treaties. The main issue is to counter treaty shopping.

The review of Article 6 of Circular 205 suggests that Vietnam has relatively strong domestic measures in place to counter tax treaty abuse through treaty shopping. This includes a 'principal purpose test' (in Article 6 (2)) and a substance based approach to beneficial ownership (in Article 6 (3)).

It is likely that the current domestic provisions in Circular 205 provide reasonable protection against BEPS risk through 'treaty shopping'.

f) Operational Capacity

The successful implementation of the measures described above requires effective operational capacity. In Vietnam's context, the following issues are relevant:

- The development of a centralized system of risk assessment for large business taxpayer.
- The development of a capacity to identify, and audit under a single audit plan, all entities and branches that are part of the large business group.
- Governance arrangements to ensure consistency and high quality of MNEs audits, and consistency with internationally developed tax principles.
- The building of one or more centralised 'centres of excellence' to conduct complex MNE audits or support auditors undertaking such international audits. The building of such teams requires a programme of skills-building, as well as HR initiatives to ensure that auditors remain in post for sufficient time to be able to build the requisite experience.;

- Exchange of information legal frameworks, data availability and protection safeguards, and processes should be enhanced.

g) Responding to developments in BEPS behaviours

The dynamic nature of MNE BEPS behaviours means that processes need to be in place to monitor large taxpayer behaviour (for example within the LTO), and to feedback developments to the policy function.

In the longer term, GDT may wish to consider introducing disclosure rules such as those discussed under BEPS Action 12. Such rules require large taxpayers to disclose details of ‘aggressive’ transactions, arrangements or structures, thus providing the tax authority with the opportunity to react to such arrangements, including through legislation where needed.

Again in the longer term, GDT may wish to consider introducing specific anti-avoidance rules aimed at countering cross-border profit shifting, if experience of dealing with BEPS issues demonstrates it to be necessary. The UK, for example, introduced in 2015 a new ‘Diverted Profit Tax’, that is aimed at counteracting arrangements that are designed to a) avoid a permanent establishment in the UK, or b) result in more profit recognised in an affiliate than would be expected, given the ‘substance’ in that affiliate.

We can provide further details of such measures if that would be useful.

ANNEX 1

NOTE FOR GENERAL DEPARTMENT OF TAXATION ON RULES TO COUNTER EXCESSIVE INTEREST DEDUCTIONS

Background

This note considers options available to countries to address the issue of excessive interest deductibility and the relevant policy consideration.

The issue of excessive interest deductibility has been discussed by the OECD within Action 4 of the BEPS initiative. This note includes a summary of the recommendations made by the OECD under this BEPS Action.

Key recommendations

Tax administrations have found that profit- shifting by means of interest deductibility is a significant risk to the tax base, and, accordingly, introduce measures to counter this risk.

We recommend that the GDT examines the extent of the risk faced in Vietnam, the impact of existing rules, and the likely impact of introducing new measures.

We would recommend that GDT considers introducing a measure based on that recommended in OECD's BEPS Action 4. This is because:

- Of its clarity and ease of application – it is relatively straightforward to define interest expense and EBITDA
- It likely effectiveness in protecting the tax base
- It is in line with up-to-date international best practice, so predictable for business.

GDT may also wish to consider whether to introduce a specific 'anti-hybrid' rule, which would disallow interest deductions in Vietnam if, for whatever reason, the interest is not taxed in the hands of the recipient. In addition, the GDT may wish to consider a 'worldwide cap' rule.

Current position

We understand that Vietnam has no specific rules to counter cross-border profit-shifting by means of excessive interest deductions. This potentially represents a significant risk to Vietnam's tax base.

The GDT is considering options for introducing such rules.

Policy Considerations

Specific interest deductibility measures often compliment other tax and non-tax measures that may impact affect the risk. These include:

- Transfer pricing rules. Such rules often apply only to the price of loans (the rate of interest) but not to the amount of the loan. The risk of excessive deductibility arises from both the price and the amount of debt-funding.
- Withholding taxes. The imposition of withholding taxes may reduce the risk to the tax base from excessive interest deductions. The effect on withholding tax of treaties needs to be considered in this regards.
- Capital controls. Some countries have in place capital controls (or exchange controls) that may impact on the ability of MNEs to put in place debt-funding arrangements.

The impact of such rules should be considered.

In addition to these measures, we would recommend that Vietnam considers the extent of the existing risk to the tax base, and the possible negative effects of introducing specific measures. Specific measures are frequently based on a specified ratio – for example a debt/equity ratio, or a net interest/EBITDA ratio. When such rules are introduced, MNEs might view them as a safe harbour and, potentially, increase their debt financing up to the specified limit. For example, if an MNE subsidiary has an existing debt/equity ratio of 1.5/1 before the introduction of rules that limit debt to 2/1, the MNE will have an incentive to increase its debt funding to the new limit. Information from GDT's Form 02/QLT may be useful in understanding the extent of the current risk.

Another consideration is whether to introduce such rules for cross-border transactions only, or to include domestic transactions in scope. We understand that GDT wishes to restrict the rules to cross-border debt funding only.

Countries introducing or updating rules on interest deductibility typically also take into account:

- Their effectiveness in countering profit shifting through excessive interest deductions (tax revenue protection)
- Their clarity, transparency and predictability of application (to assist taxpayers comply with the rules with minimum compliance cost, to ensure they can be applied as objectively and consistently as possible, and to reduce risk of corruption)
- Their compatibility with internationally agreed standards (to minimise the risk of double taxation, or double non-taxation)
- Their ease of application (to reduce tax authority enforcement costs)

Policy Decisions

In introducing specific rules on interest deductibility, there are a number of policy decisions to be considered:

- Whether to introduce a rule based on a) a ratio of interest to income (as envisaged in BEPS Action 4) or b) a 'thin capitalisation' rule, based on a measure of acceptable debt.
- Whether to introduce supplementary anti-avoidance measures, such as an anti-hybrid rule.
- If an approach based on an interest/income ratio is adopted (as envisaged in BEPS Action 4), then the following policy decisions become necessary: the fixed ratio to apply (e.g. 10% or 20% interest/EBITDA); whether to adopt a group ratio rule; whether to apply to domestic as well as cross-border transactions; whether to provide an exemption for smaller taxpayers; whether to allow a carry-forward of disallowed losses.

Measures to counter profit shifting by means of excessive interest deductions

Tax authorities introduce a number of types of measures to counter excessive interest deductions

1. 'Income-cover rules'. These rules restrict interest deductibility to a percentage of a measure of income (for example, to a 5 of EBIT or EBITDA). Such rules have been used in the US, Italy and Germany, and the BEPS 'best practice' approach employs this approach. This is discussed in more detail below.

2. 'Thin capitalisation rules '. Such rules restrict interest deductibility by reference to a maximum allowable amount of debt funding. Rules such as these typically apply one of two approaches:

    - Some countries apply a pure 'arm's length' approach. Under this approach, the restriction on interest is by reference to the amount of debt that a taxpayer would be able to raise from a third party independent lender (such as a bank). This approach is used by United Kingdom and South Africa. The application of such a rule requires advanced technical capacity, as the auditor needs to place himself/herself in the position of a bank, and take a view of the amount that bank would be willing to lend to the entity, on the assumption that it was 'standalone' (i.e. not part of a group).

    - More commonly, countries restrict interest by reference to a level of debt determined by a ratio such as a debt/equity ratio. Such an approach is less subjective and thus simpler to implement than that described in the paragraph above, and it is relatively easy for tax administrations to obtain information on the level of debt and equity in an entity (although there may be an issue concerning the definition of debt and equity for these purposes). On the other hand, a ratio

such as this may not reflect the economic reality, and it is open to manipulation by varying the amount of equity in a particular entity.

3. In addition, some country supplement general rules on interest deductibility with 'targeted rules'. Such rules apply to specific situations that carry the risk of tax loss. For example, countries may disallow an interest deduction if the interest receipt, in the hands of the lender, is not subject to tax. (Anti-hybrid rules).

4. Some additional information on the alternative approaches can be found in the OECD draft policy paper on thin capitalization rules. We would be happy to provide further details of these approaches if GDT would find that useful.

G20/OECD BEPS initiative: Action 4

This section describes the key features of the approach to countering excessive interest deductions recommended by the OECD

a) Key points:

The Final BEPS Report on the deductibility of interest was issued by the OECD on 5th October 2015. The Report describes a 'recommended approach', based on a **fixed ratio rule** which limits an entity's net deductions for interest (and payments economically equivalent to interest) to a percentage of its earnings before EBITDA. The approach incorporates a **group ratio rule**, which supplements the 'fixed ratio' rule.

At a minimum, the fixed ratio rule should be applied to all entities that are part of a multinational group.

b) The Fixed Ratio Rule

1) The **fixed ratio** rule limits the tax deduction in relation to **interest** to:

EBITDA x Y%

2) For these purposes, **EBITDA** is:

Tax measure of profit + net interest expense + depreciation + amortisation

3) **Tax measure of profit** is the profit for tax purposes. This excludes branch income (in cases where branch income is exempt from tax) and dividend income (in cases where such income is exempt from taxation). In situations in which there has been a transfer pricing adjustment, the tax measure of profit would be computed after that adjustment has been made.

4) **Net interest expense** is:

Interest expense – interest income.

5) **Interest** includes: interest on all forms of debt; payments economically equivalent to interest; and expenses incurred in connection with the raising of finance. These should include, but not be restricted to, the following:

- payments under profit participating loans
- imputed interest on instruments such as convertible bonds and zero coupon bonds
- amounts under alternative financing arrangements, such as Islamic finance
- the finance cost element of finance lease payments
- capitalised interest included in the balance sheet value of a related asset, or the amortisation of capitalised interest
- amounts measured by reference to a funding return under transfer pricing rules
- where applicable notional interest amounts under derivative instruments or hedging arrangements related to an entity's borrowings
- certain foreign exchange gains and losses on borrowings and instruments connected with the raising of finance
- guarantee fees with respect to financing arrangements
- arrangement fees and similar costs related to the borrowing of funds.

6) The recommended **'fixed ratio'** (Y% above) is between **10% and 30%.**

c) The Group Ratio Rule

1) It is recommended that the 'fixed ratio rule' is supplemented by a '**group ratio rule**'.

2) This rule would apply to entities with net interest expenses that exceed those allowed under the fixed ratio rule. In such cases, interest would be deductible up to the 'group ratio'.

3) The group ratio is:

Net interest expense of the group/ EBITDA of the group

4) 'Group' in this context is the worldwide group.

d) Additional elements and considerations.

1) It is recommended that entities that have a low level of net interest expense would be exempt from the rules. It is recommended that such a threshold should be based on the total net interest expense of all entities in the local (i.e. Vietnam) group.

2) Vietnam may also want to consider allowing a 'carry forward' to future years of any interest disallowed, or of 'unused capacity', in the current year. For example, if, in year 1, actual net interest is $150, but maximum allowable interest is $100, then $50 interest in Year 1 would be disallowed as a deduction. If, in year 2, actual net interest is $70, and maximum allowable interest remains at $100, then a total of $100 would be allowable as a deduction ($70 from year 2, and $30 brought forward from year 1).

   Similarly, Vietnam may also wish to consider a 'carry back' of disallowed interest or unused capacity.

   In order to prevent the build-up of large 'unused losses', it is recommended that a limit is placed on the number of years unused losses (or unused capacity) can be carried forward.

3) Some countries (e.g. Finland, Germany) include an 'equity-escape rule'. This dis-applies the fixed ratio rule in cases where the entity can show that it has an equity/assets ratio higher than that for the group as a whole.

4) It should be noted that 'Income cover' rules such as these would not normally be appropriate for financial institutions, which would be exempted from the rules.

ANNEX 2

ANALYSIS OF APPLICATION OF VIETNAM'S TRANSFER PRICING REGULATIONS TO ADDRESS SPECIFIC BEPS ISSUES

This document is in two parts:

1. The first part assesses the extent to which Vietnam's current transfer pricing regulations (in Circular 66) have the ability to implement the various recommendations on transfer pricing contained in BEPS Actions 8 – 10.
2. The second part contains some further observations and recommendations regarding Vietnam's transfer pricing rules.

The OECD's BEPS initiative developed specific outputs on transfer pricing documentation. These are described in a separate document, which also contains an assessment of Vietnam's current regulations on documentation.

PART 1 – OECD's BEPS Actions 8-10.

There were a number of outcomes under Actions 8-10. The key outcomes are:

a) Strengthening the Guidelines to ensure that, for transfer pricing purposes, risk is allocated to where value is created.
b) Strengthening the Guidelines to ensure that, for transfer pricing purposes, the right to a return on intangibles is recognized where value is created.
c) Guidelines on capital-rich and low-substance entities.
d) Revised Guidelines on recharacterisation of transactions for transfer pricing purposes.
e) Revised Guidelines on cost contribution arrangements
f) Revised Guidelines on the treatment of low value-added services.

These outcomes are discussed below.

a) The treatment of risk.

The revised Guidelines specifies that in cases where risks are contractually assumed by a party that cannot in fact exercise control over them, or does not have the financial capacity to assume them, those risks will be allocated to the parties that in fact exercise such control and have the financial capacity to assume the risks.
This guidance is aimed at countering profit shifting through the shifting of risk. For example, risk (and the profits associated with them) might be shifted to an entity in a low tax jurisdiction as part of a 'business restructuring' that may be wholly or partly tax-driven. In some cases, such restructuring may be entirely through revised contractual arrangements, with little or no shifting of the substance of the business operation.
The impact of the revised guidance is to make it clearer that shifting of risks to entities that do not have the capacity to manage those risk, or the financial capacity to bear them, will not be recognized for transfer pricing purposes. Instead, where there is a mismatch between the contractual allocation of risk and the management of that risk, or the capacity

to bear that risk, then, for the purposes of transfer pricing analysis, the risk is allocated to the entity that actually manages it, or has the capacity to bear it.

Implications for Vietnam

Circular 66 focuses on physical functions, and on the characteristics of products. It places little emphasis on risk.

It is unlikely that the current legislation is sufficiently effective to provide protection from artificial risk-shifting, as envisaged in the revised Guidelines following the BEPS initiative.

We would recommend that legislation is replaced, or revised, to place more emphasis on risk, which is central to a sophisticated transfer pricing analysis.

In particular, it would be useful for the rules to specify that:

a) The reward for risk is based on the arm's length principle, and must take into account how economically significant risk is allocated in contracts between enterprises, and which enterprises in fact:
   - bear the financial risk (upside or downside consequences of risk outcomes)
   - perform the relevant risk control functions and risk mitigation functions,
   - have the financial capacity to assume the risk.

b) In cases where the contractual allocation of risk diverges from these factors, risk must be allocated to the enterprise (or enterprises) that perform the relevant risk control and risk mitigation functions, and has the financial capacity to assume the risk.

b) *The treatment of intangibles.*

As an outcome of the BEPS initiative, the OECD Transfer Pricing Guidelines have been revised in respect of the treatment of intangibles. The new guidance aims to counter profit shifting arising from the location or relocation of legal or economic ownership of valuable intangibles. For example, ownership of intangibles may be placed in a low-tax jurisdiction - any profit arising from them would be recognized and tax there.
The new guidance specifies that, in determining which entities should share in the reward arising from intangibles, a number of factors are relevant. Such factors involve the development, enhancement, maintenance, protection and exploitation of the intangibles, in addition to the legal arrangements and the conduct of the parties.
A number of issues are key in determining how entities should share in the reward arising from a valuable intangible:

- where the functions are carried out for the development, enhancement, maintenance, protection and exploitation of the intangibles
- where the management and control of those functions are carried out
- the assets contributed by each entity in the development, enhancement, maintenance, protection and exploitation of the intangibles
- where those assets are managed and controlled

- the risks assumed in relation to the development, enhancement, maintenance, protection and exploitation of the intangibles
- where those risks are managed and controlled.

The impact of the new guidance is to make it clearer that legal ownership of an intangible, and/or the financing of the development of an intangible, are, by themselves, not sufficient to justify the allocation of all (or even most) of the reward arising from it. As a result, the reward to, for example, an entity (which may be in a low tax jurisdiction) that has legal ownership of an intangible, but little capacity to manage and control the related functions, assets and risks, will be very limited, and perhaps zero.

Implications for Vietnam

Circular 66 places very little emphasis on intangibles.

It is unlikely that the current legislation is sufficiently effective to provide protection from profit-shifting arising from the location or relocation of intangibles, as envisaged in the revised Guidelines following the BEPS initiative.

We would recommend that the current rules are revised or replaced by legislation that makes it clear that the determination of the reward arising from an intangible should take account of where the functions (including assets and risks) involved in the development, enhancement, maintenance, protection and exploitation of the intangibles are carried out, and where those functions, assets and risks are managed and controlled.

Such revisions could also make it clear that legal ownership of an intangible, or the financing of the development of an intangible, are not sufficient, by themselves, to justify the allocation of all of the rewards arising from the intangible.

c) Guidelines on capital-rich entities, low-substance.

The revised OECD guidance also addresses the situation where a capital-rich member of a group of companies provides funding to other group members but performs few activities itself. A risk of profit shifting arises if, for example, a company located in a low tax jurisdiction is established substantial equity capital, which it then uses to make interest bearing loans to other group companies.

The revised guidance makes it clear that, if this enterprise does not in fact control the financial risks associated with its funding (i.e. make the key decisions related to the lending operations), then it will not be allocated the profits associated with the financial risks and will be entitled to no more than a risk-free return. The profits or losses associated with the financial risks would be allocated to the entity (or entities) that manage those risks and have the capacity to bear them.

Implications for Vietnam

Circular 66 focuses places little emphasis on risk, and makes no specific reference to the treatment of financial transactions.

It is unlikely that the current legislation is sufficiently effective to provide protection from artificial risk-shifting arising from capital-rich low-substance entities, as envisaged in the revised Guidelines following the BEPS initiative.

It is possible that new general provisions regarding risk (described at (a) above) might address this type of profit-shifting. We would recommend, however, that Vietnam considers adding a specific provision in the transfer pricing rules stipulating that, for transfer pricing purposes, the return to risk in relation to a financial transaction must take into account which entity manages and controls that risk, and, if an enterprise does not in fact control the financial risks associated with its financial activities, then it will not be allocated the profits associated with the financial risks and will be entitled to no more than a risk-free return.

d) Revised Guidelines on recharacterisation of transactions for transfer pricing purposes.

The revised Guidelines under BEPS Actions 8-10 address circumstances in which a transaction may be disregarded for the purposes of a transfer pricing analysis, and provides revised guidance. The objective of such guidance is to enable tax authorities to neutralize the profit-shifting effects of transactions that would not have occurred at arm's length. Such transactions would typically have made no commercial sense to one or both of the entities concerned.

The revised guidance allows a transaction to be disregarded, and if appropriate, replaced by an alternative transaction, where the arrangements made in relation to the transaction differ from those which would have been adopted by independent enterprises behaving in a commercially rational manner in comparable circumstances.
The effect of recharacterising a transaction in these circumstances would be to determine an arm's length result on the basis that the transaction had not occurred at all.

Implications for Vietnam

Circular 66 focuses on the pricing of transactions, and adjustments only to those prices. It is unlikely that the existing transfer pricing rules are wide enough in scope to allow a transaction to be disregarded or recharacterised.

We would recommend that Vietnam adds a new rule to the transfer pricing rules.

Such a rule might state that the transfer pricing provisions apply to the substance of the actual transaction between the related enterprises, except in cases the where the arrangements made in relation to the transaction, viewed in their totality, differ from those which would have been adopted by independent enterprises behaving in a commercially rational manner in comparable circumstances, thereby preventing determination of a price that would be acceptable to both of the parties taking into account their respective perspectives and the options realistically available to each of them at the time of entering into the transaction.

In such cases the actual transaction as structured by the taxpayer may be disregarded for the purposes of this Article, and if appropriate, replaced by an alternative transaction.

e) Revised Guidelines on cost contribution arrangements

Existing guidance on cost contribution arrangements (CCAs) allows MNEs to share the costs involved in the development of intangibles, or in provision of services. In both cases the, guidance requires that members of a CCA should divide costs in proportion to their expected benefits. With regards to intangibles, the members of the CCA are treated as though they have a right to a return from the intangible in proportion to their share of the costs.
The revised guidance issued under Actions 8–10 of the BEPS initiative is aimed at ensuring that the right to share in a return to an intangible that falls within a CCA meets the substance requirements of the guidance on intangibles described at b) above. In practice this means that a participant in a CCA would not acquire a right to a return to an intangible that falls within a CCA by reason of cost contributions only. The capacity to make the key decisions in relation to the CCA, and manage and control the relevant risks, is a vital condition for recognition of a right to a stake in the relevant intangible.

Implications for Vietnam

Vietnam's current transfer pricing rules do not contain a provision relating to cost contribution arrangements. It is thus not necessary to adopt the revised guidance in the rules, unless a specific provision on CCAs is to introduced.

We do not consider that a provision on CCAs is a necessary component of Vietnam's transfer pricing rules. Indeed, international experience is that CCAs have given risen profit-shifting risks.

f) *Revised Guidelines on the treatment of low value-added services*
The OECD BEPS Actions 8-10 introduced a proposed approach in relation to low value-added services.
The key recommendation is that charges for the provision of a low value-added service between related enterprises will be considered to be arm's length if a number of conditions are satisfied. These are:
- the amount is based on an allocation to each enterprise that receives low value-added services of the total group costs of providing the services; and
- the allocation of those costs is based on an appropriate allocation method; and
- the cost-plus method is applied to those costs; and
- the mark-up on those costs is 5%; and
- the enterprise maintains specified documentation and makes that documentation available to the [Vietnam] tax authority on request.

It should be noted that the approach's focus is on simplification rather than profit shifting, and, in effect, provides for a safe harbour.

Implications for Vietnam

As mentioned above, the revised guidance on low value-added services is focused on simplification, and is unlikely to address significant BEPS issues.

We do not recommend that this revised guidance is treated as a BEPS priority in Vietnam. However, we would recommend that revised or replacement rules on transfer pricing incorporate general provisions on transfer pricing aspects of services.

In addition, if GDT wishes to adopt safe harbour rules, the approach to low value added services could be adopted in the form of a safe harbour in Vietnam.

ANNEX 3

NOTE ON VIETNAM'S CURRENT TRANSFER PRICING RULES

This note provides a brief overview of the review (under the current EU/MUTRAP initiative) of Vietnam's transfer pricing rules (contained in Circular 66).
This memo should be read in conjunction with:

- The review of the effectiveness of Circular 66 to deal with specific BEPS issues
- The detailed review of Circular 66 provided to GDT in January 2016.
- A discussion paper on the use of tax administration data to create fixed margins/safe harbours
- A discussion paper on transfer pricing documentation
- A discussion paper on measures to counter interest deductibility

KEY ISSUES

The current rules contained in Circular 66 raise a number of issues:

- They are unlikely to fully provide Vietnam with prevention from the profit shifting issues raised in the OECD's BEPS initiative
- There are a number of areas in which the rules divert from internationally accepted principles, thus risking disputes with treaty partners and double taxation, or double non-taxation
- There are some issues that may limit the effectiveness of the rules
- The Circular in some areas lacks clarity
- We understand that some taxpayers challenge the compatibility of Circular 66 with the primary legislation.

GDT may wish to consider significant amendments, or replacing the rules.

We have provided for guidance a) illustrative transfer pricing legislation; b) transfer pricing regulations recently introduced by Nigeria.

A) General observations on Circular 66

Circular 66 is detailed and comprehensive. However, we have a number of general observations.

a) It is largely rule-based legislation (as opposed to principles based). This means that it attempts to specify rules to be followed in specific circumstances. For transfer pricing, this is a difficult approach, given the very wide range of transactions and circumstances within the scope of such rules. Most country transfer pricing rules give emphasis to general principles (e.g. arm's length principle and comparability) that are to be applied in all circumstances within the scope of the rules.

b) In some instances, the rules appear over-detailed.
c) The rules focus on actual prices, which are likely to restrict their application to more complex transfer pricing issue. For example, it is far from clear that the rules are able to take a 'substance over form' approach, or reallocate risk on an arm's length basis, or re-characterise or (in exceptional cases) disregard transactions.

The effect of these issues is that:
a) some provisions that may create unnecessary complexity, but do little to add to clarity or effectiveness;
b) and the rules may not be sufficiently effective to address more complex transfer pricing issues arising from issues such as risk-shifting, intellectual property planning or business restructuring.

A. Specific BEPS issues

A number of specific BEPS issues are discussed in the note 'xxx'. This note recommends that the current rules may not adequately deal profit-shifting risks arising from:
- Non arm's length allocation of the return to risk
- Non arm's length allocation of the return to intangibles
- High capitalized, low function, entities
- Transactions that make no commercial sense.

B. Other issues

In addition to the specific issues BEPS issues mentioned above, the review has identified a number of other issues that may impact on the effectiveness of the rules, or their compatibility with international standards incorporated in treaties.
The key issues in this regard are:
a) Circular 66 focuses on the **price** of related party transactions, and requires taxpayers to use arm's length prices in actual transactions and then make any required adjustments to the actual price used in the actual transaction.
   This may create practical difficulties for taxpayers, who may assess their related-party transactions during the course of an accounting period, or even at the end of an accounting period, and then make pricing adjustments (which are reflected in the accounts) at intervals during the year, or at the end of the year, or make an adjustment to the computation of income or profit to be subject to income tax.
   Most country transfer pricing rules require taxpayers to file a return of profit in accordance with the arm's length principle. This allows them to make adjustments either in their accounts or in their tax return in order to apply the arm's length principle, even where their actual pricing is not arm's length.

   As mentioned above, the focus on making adjustments only to price may prohibit the recharacterising or disregarding a transaction.

b) Article 9 (2) specifies the circumstances in which the tax authority offices may 'assess prices for tax calculation and declaration'. These are specific, and raise a number of issues:

- They could in some circumstances restrict the ability of the GDT/PTOs to apply the Circular
- They may provide taxpayers with the opportunity to make legal challenges against such assessments
- They could create unnecessary and difficult conditions that the GDT/PTO must fulfil. For example, the Article specifies that the GDT/PTO may need to demonstrate an 'inconsistent manner', or that the taxpayer has 'purposely misapplied' the rules. These may be difficult to apply.

The legislation would be more objective, and easier to apply, if the Circular authorized the GDT/PTOs to make adjustments to profit with regards to transfer pricing when the taxpayer's return (or filing) of taxable profit is 'understated as a result of non-arm's length pricing of related party transactions'.

c) The **definition of related parties** in Article 3 of Circular 66 includes situations that depart from international principles, and is likely to bring into scope transactions between independent enterprises that have no ownership connection, and whose accounts will not be consolidated at any level.

d) Article 7 specifies the **data and documentation that used in evidence of comparability analyses** must derive from specifies 'official sources'. This approach may unnecessarily reduce the pool of relevant data that taxpayers and the GDT/PTOs may use in transfer pricing analyses. It may also create uncertainties on benchmarking non-Vietnamese entities.

e) The rules also allow the use of **confidential data in the possession of the tax authority** – sometimes referred to as 'secret comparables'. Such an approach may create problems with the application of treaties; unnecessary compliance and enforcement costs; uncertainty for taxpayers; and prevent taxpayers from fully considering, and defending, an adjustment proposed by GDT/PTOs.

   We have discussed the potential for using confidential tax authority data for conducting comparability analyses. Such data is potentially very valuable, especially given the difficulties encountered in identifying reliable comparables data from other sources. In the light of this, we discussed the opportunities for employing data to set 'fixed margins', which would take the form of a safe harbour. **A separate discussion paper on this issue has been provided**.

f) Circular 66 does not make a clear distinction between an '**arm's length range' and a 'statistical approach'**. The latter is often relevant where a database search is used, and a relatively large number of comparables are identified. This approach frequently applies an 'interquartile range'.

   Certainty of application of the rules would be enhanced if these concepts are clarified in the rules, and guidance is provided on the circumstances in which each is approach is appropriate, and how it is to be applied.

g) Circular 66 provided comprehensive **documentation requirements**. There is no urgent need to revise these. It is noted, however, that Action 13 of the OECD's BEPS initiative provided revised guidance on transfer pricing documentation, and GDT is

considering whether to adopt these recommendations. A separate discussion paper is provided on this.

h) Circular 66 includes in scope **domestic as well as international transactions**. This may create excessive or unnecessary compliance costs for smaller taxpayers or in respect of low-risk transactions, and unnecessary enforcement costs for GDT/PTOs.

   GDT may wish to consider whether to exclude some domestic transactions (for example between taxpayers subject to the same rate of tax on profit).

C. Interaction between Circular 66 and primary legislation

During the workshop with auditors in January, it was mentioned that taxpayers had challenged the application of Circular 66 on the grounds of incompatibility with the primary legislation. We recommend that this be reviewed.

Annex 3 - A

Illustrative Transfer Pricing Legislation

The framework below, which contains an illustrative content and structure of transfer pricing primary legislation, should not be regarded as finalised legislation. Vietnam would need to adapt its wording, content and structure to take account of specific tax policies, as well their statutory language and conventions.

Application and scope

1. The taxable profit of an enterprise that conducts one or more transactions with a related enterprise shall be computed on the basis that those transactions are conducted at arm's length.

2. A transaction is conducted at arm's length if it is conducted under the same conditions (including the price paid or payable) that would be expected in comparable transactions between non-related enterprises.

3. Two enterprises are related to each other if:
- one enterprise controls the other, or
- both enterprises are controlled by the same person or persons, or
- one enterprise is resident in Vietnam and the other is resident in a low tax jurisdiction (as defined).

4. One enterprise controls another if:
- one enterprise directly or indirectly owns x% or more of the other's share capital, or has a direct or indirect voting right derived from x% or more of the other's share capital, or to receive any financial return in respect of x% or more of the other's share capital;
- one enterprise is, by whatever means, able to determine management decisions of the other. The rights or powers attributed to the controlling enterprise includes the rights or powers of any family member or partners.
5. This [Article] shall not apply in respect of a transaction between:
- [enterprises that are carried on by persons that are both resident on VIETNAM and subject to the same rate of income or company tax]
- [enterprises that are members of a group of companies whose total external (consolidated) turnover is less than CUs XXX].

6. The provisions of this Article apply to the attribution of profit to a permanent establishment on the assumption that permanent establishment(s) and the head office of an enterprise are treated as separate enterprises that deal with each other at arm's length.

7. An enterprise refers to any commercial activity carried on by an individual, partnership or legal person.

8. A transaction refers to any form of commercial activity including, but not limited to, the transfer or goods, the provision of services, the provision of any form of financial service

(including the lending of money), the transfer of intellectual property rights or any form of lease or rent of property.

Comparability and methods

9. Two transactions are comparable if there are no significant differences between them that would materially affect the conditions (including price) under which they are conducted, or, where such differences exist, a reasonably accurate adjustment is made to eliminate the effects of such differences.

10. In considering whether two transactions are comparable, the following factors are to be considered:
(a) The characteristics of the property or services that are the subject of the transactions;
(b) The functions undertaken by each enterprise with respect to the transactions (taking into account assets used and risks assumed);
(c) The contractual terms of the transactions;
(d) The economic circumstances in which the transactions take place; and
(e) The business strategies pursued by the enterprises in relation to the transactions.

11. In order to establish the conditions (including price) of transactions between related enterprises, the most appropriate method from the list below shall be used.
(a) Comparable Uncontrolled Price Method, which compares the price charged for property or services transferred in a transaction between related enterprises to the price charged for property or services transferred in a comparable transaction between non-related enterprises.
(b) Resale Price Method, which compares the resale margin earned by a purchaser of property from a related enterprise to the resale margin earned in comparable purchase and resale transactions, where the purchase of property is from a non-related enterprise.
(c) Cost Plus Method, which compares the mark up on those costs directly and indirectly incurred in the supply of property or services in a transaction between related enterprises with the mark up on those costs directly and indirectly incurred in the supply of property or services in a comparable transaction between non-related enterprises.
(d) Transactional Net Margin Method, which compares the net profit margin relative to an appropriate base (e.g. costs, sales, assets) that an enterprise achieves in a transaction with a related enterprise with the net profit margin relative to the same base achieved in comparable transactions between non-related enterprises.
(e) Contribution Profit Split Method, which allocates to each of the related enterprises participating in a transaction the portion of the profit (or loss) derived from the transaction that non-related enterprises would expect to earn from engaging in a comparable transaction.
(f) Residual Profit Split Method, which allocates an arm's length remuneration for specific functions performed by related enterprises in connection with a transaction between them using one of the approved methods described in subparagraphs (a) to (d) above, then secondly allocates the residual profit using profit split method using the method described at subparagraph (e) above.
(g) Another method that results in a more reliable application of the arm's length standard than methods (a) to (f) above, provided that the use of such a method is agreeable to both the relevant taxpayer and the Vietnam.

Arm's length range

*12.	Where the application of the most appropriate method results in a number of indicators that are all comparable, and equally comparable, to the relevant transaction between related enterprises, then those results shall constitute an arm's length range, [provided that the highest point in the range is no more than 25% greater than the lowest point in the range].*

*13.	Where the application of the most appropriate method results in a number of indicators for which the degree of comparability of each to the relevant transaction between related enterprises, and to each other, is uncertain, or the highest point in the range exceeds 25% of the lowest point in the range, a statistical approach shall be used. Where such an approach is used, a range [from the 35th to the 65th percentile] shall be considered to be an arm's length range.*

*14.	Where the relevant indicator employed in determining the taxable profit of an enterprise is within the arm's length range, then no adjustment to taxable profit shall be made.*

*15.	Where the relevant indicator resulting from a transaction between related enterprises falls outside the arm's length range, then the taxable profit of the taxpayer shall be computed on the basis that the relevant indicator equates to the median of the arm's length range [or on the basis that that the relevant indicator equates to the most appropriate point in the arm's length range].*

*16.	For the purposes of paragraphs 11 to 13 above, an indicator is a price, resale margin, cost mark-up, net profit ratio or a split of profit.*

17. For the purposes of determining whether two transactions are comparable, the allocation of risk between related enterprises must take into account a) how economically significant risk is allocated in contracts between those enterprises; and b) which enterprises bear the financial risk; which enterprises perform the relevant risk control and risk mitigation functions; and which enterprises have the financial capacity to assume the risk.

In cases where the contractual allocation of risk diverges the factors described 8.b) above, risk shall be allocated to the enterprises that perform the relevant risk control and risk mitigation functions, taking into account the financial capacity to assume the risk.

18) The provisions of this Article apply to the substance of the actual transaction between the related enterprises, except in cases the where the arrangements made in relation to the transaction, viewed in their totality, differ from those which would have been adopted by independent enterprises behaving in a commercially rational manner in comparable circumstances, thereby preventing determination of a price that would be acceptable to both of the parties taking into account their respective perspectives and the options realistically available to each of them at the time of entering into the transaction. In such cases the actual transaction as structured by the taxpayer may be disregarded for the purposes of this Article, and if appropriate, replaced by an alternative transaction,

ANNEX 4

NOTE ON USE OF TAX ADMINISTRATION DATA FOR COMPARABILITY AND SAFE HARBOURS

Background

During our meetings in Hanoi in January, we discussed the use of data in the possession of the GDT in seeking or imposing an adjustment to taxable profit in respect of transfer pricing. We discussed issues about the use of data that cannot be revealed to the taxpayer subject to audit. Typically, such information is provided by taxpayers in a tax return or during the course of an audit, and the tax administration has a duty to keep this data confidential. When such data is used to seek or impose a transfer pricing adjustment it is referred to as 'secret comparables'. The OECD Guidelines on Transfer Pricing make it clear that secret comparables should not be used in this way, because taxpayers are unable to defend or counter the tax administration's contentions. Secret comparables may be useful, however, in conducting risk assessment and case selections.

Key issues

Data in the possession of the GDT, but which cannot be disclosed to taxpayers, could be used to set 'fixed margins', similar to those used in a safe harbour.

Such an approach could provide benefits to the GDT, and to taxpayers.

A number of safeguards would be appropriate, which are discussed in this paper.

The use of secret comparables in a safe harbour

At the January meetings we discussed whether 'secret comparables' could be used to establish prices, margins or ranges in the context of a safe harbour, (or fixed margin approach) and we undertook to provide further analysis.
A safe harbour provides a mechanism to allow the tax administration to specify financial indicators that it considers acceptable transfer pricing purposes. For example, it may specify that a cost-plus margin of, say, 5% is considered an acceptable margin for the provision of certain types of services. Safe harbours typically have the following features:

- They apply to a specified category of transaction
- They specify a method that the tax authority considers appropriate and acceptable to such transactions
- They specify a level of a financial considered acceptable. This may be, for example, a price, gross profit margin or a net profit margin, or a range of such margins

- They are most suitable for transactions which are able to be benchmarked - normally involving functions that do not involve using valuable intangibles or assuming exceptional risk.

Safe harbours have a number of advantages for taxpayers and tax administrations:

- They reduce the need for taxpayers and tax administrations to carry out comparability and benchmarking analyses in every case and thus the need to find comparability data. This is an especially significant factor in countries and regions where comparability data is hard to find
- They reduce taxpayer compliance costs and provide taxpayers with certainty of treatment for some transactions
- They reduce the enforcement costs of tax administration, releasing resources away from auditing more routine and low risk issues. Auditing such case would be restricted to checking that the transaction in point meets the safe harbour condition.

Care needs to be taken in setting a ‘safe harbour’ price or margin to ensure it approximates an arm’s length price:

- If it is too low, then tax revenue may be lost, and MNEs will gain a tax advantage over independent enterprises
- If it is too high, taxpayers may choose not to adopt it. In cases where a taxpayer adopts such a safe harbour, counterparty tax administrations may seek an adjustment.

Confidential data in the hands of the tax authority would be very useful in setting a safe harbour price or margin. Such data would not need to be published or revealed to taxpayers using the safe harbour.

In order to ensure that a safe harbour is not used inappropriately, and does give rise to double taxation or double non-taxation, it is important that:

- Taxpayers are able to opt out of the safe harbour in cases where they consider that the safe harbour does not give rise to an arm’s length result for their specific circumstances. In such cases, the taxpayer would be required to return and justify (and document) an arm’s length result.
- A safe harbour price or margin is subject to discussion, and potential revision, in cases where the transaction in question is the subject of discussions under a treaty (for example, where the treaty partner seeks a transfer pricing adjustment in respect of the transaction).

Safe harbours may be appropriate in respect of a wide range of transactions, including the following types:

- Manufacturing, especially in cases where the manufacturer does not have a right to valuable intangibles, or take extraordinary risk
- Sales and distribution, including sales agents, again in cases where the function does not exploit valuable intangibles, or non-routine risks
- Provision of services

ANNEX 5

REVIEW OF VIETNAM'S TRANSFER PRICING DOCUMENTATION REQUIREMENTS AND THE OUTCOMES OF THE OECD'S BEPS INITIATIVE, ACTION 13

This note:

- Discusses Vietnam's specific needs for information and documentation from MNEs
- Reviews Vietnam's current transfer pricing rules (contained in Part B, Article 7, 2 Circular 66)
- provides details of the typical features of country transfer pricing documentation rules (Annex A).
- describes the main features of the revised OECD guidance on transfer pricing rules introduced as an outcome of BEPS Action 13.

Key issues

- In order to address constraints arising from the 70-day limit for conducting audits, GDT may wish to consider: a) specific penalties for failure to maintain required documentation; taxpayer questionnaires; informal interviews with the largest MNEs.
- The OECD's revised guidance on the content and form of transfer pricing documentation is more comprehensive than that currently contained in Circular 66. GDT might consider whether to adopt this approach in revised rules.
- It is also recommended that GDT considers a) lighter documentations requirements, or exemptions, for smaller taxpayers and/or for low-risk domestic transactions; b) requiring documentation to be in place at the time of the tax return, rather than at the time of the transaction.
- GDT may also consider whether, and how, to adopt country-by-country-reporting requirements. This will require introducing new legislation to a) require MNEs which are ultimately headed in Vietnam to submit the report to the GDT; and b) allow GDT to require the local filing of the report in specific circumstances (discussed below).

Vietnam's specific needs for information and documentation from MNEs

In common with other tax authorities auditing MNEs, GDT requires comprehensive information and documentation in order carry out risk assessment, case selection and effective audit.

The GDT faces a specific factor in auditing MNEs: the requirement to complete the audit within a period of 70 working days. This presents practical difficulties. International experience is that transfer pricing audits typically take very much more time than 70 days. (An OECD report on the administration of transfer pricing[1] found that the average elapsed time to complete an audit is 540 days).

For the longer term, we would suggest that the 70-day limit is removed for the audit of MNEs. In the shorter term, the GDT strategy is to gather as much information as possible in advance of the commencement of audit.

Such information may be sourced from:

a) Transfer pricing documentation, which must be presented to the GDT 'upon request for inspection and auditing purposes'. This is discussed in more detail below, where it is stressed that an effective penalty for failure to keep documentation or to present it to the GDT is needed.
b) Form 01, which provides a useful source of information for risk assessment and case selection purposes. We have suggested that this Form is expanded in order to provide more detailed information than at present.
c) Other sources, such as taxpayer-specific or sector-specific questionnaires, or taxpayer interviews. These are also discussed below.

In addition, procedures such as 'safe harbours' and 'APAs' encourage compliance with transfer pricing rules outside of audits.

Questionnaires and interviews

Some tax administrations send a **questionnaire to selected taxpayers**. Such questionnaires may be issued to specific taxpayers, or a group of taxpayers selected by sector, size etc. The content of a questionnaire may be tailored to specific taxpayers or of a more general nature.

This approach has been used by countries including Australia, New Zealand, Singapore and South Africa. They are often used during a risk assessment process, prior to commencement of an audit.[2]

If used in Vietnam, it will be necessary to establish whether existing legislation enables the GDT to require taxpayers to complete a questionnaire when asked to do so. Article 7. 2.1. of Circular 66 may require this. In the absence of statutory authority, it is possible, however, to issue questionnaires on an informal basis.

The GDT may wish to consider whether questionnaires could be used to obtain pre-audit information from specific taxpayers or groups of taxpayers.

A related approach is to conduct **informal interviews and meetings** with taxpayers prior to an audit. These can be used as an opportunity to assess risk, and to obtain basic information about the taxpayer's business operations and transfer pricing. Again, such an approach could focus on taxpayers from a specific sector, or of a particular size etc., or on taxpayers

[1] http://www.oecd.org/site/ctpfta/49428070.pdf

[2] A discussion on questionnaires can be found at: https://www.saica.co.za/integritax/2001/927_Transfer_pricing_questionnaire.htm

identified as potential candidates for audit. The Kenya tax authority has used such an approach, which it found to be useful – and also to have a significant impact on voluntary compliance.

Vietnam's current transfer pricing rules (contained in Part B, Article 7, 2 Circular 66)

The main features of Vietnam's current transfer pricing rules are:

- A requirement for enterprises to record and store information, documents and evidence related to transfer pricing methods.
- Such information must be presented to the GDT on request for 'inspection and audit purposes', within 30 days of a written request (which may be extended).
- It must be prepared at the time of the transactions, and updated as needed.
- A detailed list of relevant information that taxpayers are required to keep.

There are a number of observations concerning these rules:

- The list of required information and documents is quite comprehensive, and is likely to be sufficient for most taxpayers. It is noted however that the OECD last year released revised guidance on transfer pricing documentation, under Action 13 of BEPS. This is described in more detail below. The information required under the revised OECD guidance is more comprehensive than that currently required under Circular 66. GDT may wish to consider amending the documentation requirements in order to adopt these rules. There are advantages to both the taxpayer and the tax administration in adopting internationally standardised requirements.
- There are low specific penalties for failure to maintain this information and documentation – between $50-$300). Given that GDT may require such information at a pre-audit stage (in order address the time limit on conducting audits), GDT may wish to consider introducing a strengthened specific penalty for failure to maintain this information and documentation. Such a penalty may be at a flat rate, or a percentage of turnover of the relevant entity. Given the importance need for proportionality, we suggest a penalty based on the turnover of the taxpayer.
- The rules specify that documentation must be 'prepared at the time of the transaction'. This may create difficulties for taxpayers, which often test and document the arm's length nature of a transaction after it has been conducted (perhaps at year end) and then make appropriate adjustments. It is more common for documentation to be required to be in place at the time that the relevant tax return is made.
- The volume of the requirements may be over-burdensome for smaller taxpayers. GDT may wish to consider introducing exemptions, or lighter regulations, for smaller taxpayers or where the enterprise, and all its related enterprises, are tax resident in Vietnam and subject to the same rate of income tax on their profit.

For information, an outline of typical rules on transfer pricing documentation is attached at Annex A.

Main features of the revised OECD guidance on transfer pricing rules introduced as an outcome of BEPS Action 13.

OECD's revised guidance on transfer pricing documentation envisages three types of documents:

- A 'Masterfile' which provides tax administrations with high-level global information regarding global business operations. This would be made available to all relevant country tax administrations.
- 'Local files', which are specific to each relevant tax administration. These identify relevant related party transactions, the amounts involved in each transaction, and the company's analysis to determine that the conditions of those transactions meet the requirements of the country transfer pricing rules.
- A 'country by country' report, which details in tabular form for each tax jurisdiction in which the MNE does business, information regarding revenue, profit and tax payable. It also provides details of the number of employees, and capital and assets employed, in each jurisdiction, as well as the business activities conducted in each country.

The requirement on MNEs to submit the Masterfile and the local file in each country would be imposed by country legislation such as that illustrated in Annex A. The documents envisaged to be included in the local file and the Masterfile are summarised in Annex B below. The requirement to maintain this documentation would be in addition to any requirement to submit an annual transfer pricing return.

Country-by-country report

The OECD's BEPS report (Action 13) envisaged that the country by country report would be submitted only to the tax jurisdiction of the ultimate parent or head office company, and then made available to other relevant tax jurisdictions through tax information exchange instruments (such as treaties and the Multilateral Convention). It is envisaged that the country by country report would be required only from the largest MNEs – those with a global consolidated turnover in excess of €750m.

However, the Report also envisages local filing in specific circumstances. This is:

- a jurisdiction fails to provide information to another jurisdiction that fulfils the 'confidentiality' 'consistency' and 'appropriate use' conditions, because
- (a) it has not required Country-by-Country Reporting from the ultimate parent entity of such MNE groups, or
- (b) no competent authority agreement has been agreed in a timely manner under the current international agreements of the jurisdiction for the exchange of the Country-by-

Country Reports or (c) it has been established that there is a failure to exchange the information in practice with a jurisdiction after agreeing with that jurisdiction to do so.

Where these conditions are fulfilled, the BEPS Report (Action 13) allows a jurisdiction to require local filing of a country-by-country report from an MNE that is not ultimately headed in that jurisdiction. Notwithstanding these Action 13 conditions, GDT may wish to consider requiring the local filing of a country-by-country report in wider circumstances.

GDT will need to consider introducing new legislation to

a) require MNEs which are ultimately headed in Vietnam to submit the report to the GDT; and

b) allow GDT to require the local filing of a country-by-country report from an MNE that is not ultimately headed in Vietnam, in specific circumstances.

ANNEX A

Typical Transfer Pricing Documentation Rules.

The wording in the box below illustrates typical transfer pricing documentation rules.

Illustrative Transfer Pricing Documentation Rules

1. An enterprise that conducts one or more transactions with a related enterprise shall maintain sufficient documentation to verify that the measure of the enterprise's taxable profit has been computed on the basis that the conditions (including pricing) of those transactions are consistent with the arm's length principle and comply with the requirements of Article XXX (transfer pricing rule).

2. The information described in sub-paragraph 1 shall be in place at the time the enterprise files the relevant tax return, [or xx days following the filing of the relevant tax return] and shall be made available to TAX AUTHORITY within XX days following the day the TAX AUTHORITY makes a request.

3. The obligation of the enterprise under sub-paragraph 1 does not affect the authority of TAX AUTHORITY to request further information during the course of an audit.

4. The volume, detail and complexity of the information required to be maintained by an enterprise in order to comply with sub-paragraph 1, and the costs incurred in compiling and maintaining that information, need not be out of proportion to the arm's length measure of the value of the relevant transactions.

5. The requirements of paragraph 1 above shall not apply in cases where the enterprise demonstrates that the consolidated third party revenue of the enterprise, together with its related enterprises, is less than CU XXX ($1m?), or where the enterprise, and all its related enterprises, are tax resident in COUNTRY and subject to the same rate of income tax on their profit.

6. The information mentioned at paragraph 1 above shall include: [List of required documents]

7. The documents listed in Section 6 above shall be maintained in all cases, where the enterprise conducts transactions with an entity in a low tax jurisdiction [as defined].

ANNEX B

LOCAL FILE

• A description of the management structure of the local entity, a local organisation chart, and a description of the individuals to whom local management reports and the country(ies) in which such individuals maintain their principal offices.

• A detailed description of the business and business strategy pursued by the local entity including an indication whether the local entity has been involved in or affected by business restructurings or intangibles transfers in the present or immediately past year and an explanation of those aspects of such transactions affecting the local entity.

• Key competitors.

For each material category of controlled transactions in which the entity is involved;

• A description of the material controlled transactions (e.g. procurement of manufacturing services, purchase of goods, provision of services, loans, financial and performance guarantees, licenses of intangibles, etc.) and the context in which such transactions take place.

• The amount of intra-group payments and receipts for each category of controlled transactions involving the local entity (i.e. payments and receipts for products, services, royalties, interest, etc.) broken down by tax jurisdiction of the foreign payer or recipient.

• An identification of associated enterprises involved in each category of controlled

transactions, and the relationship amongst them.

• Copies of all material intercompany agreements concluded by the local entity.

• A detailed comparability and functional analysis of the taxpayer and relevant associated enterprises with respect to each documented category of controlled transactions, including any changes compared to prior years.

• An indication of the most appropriate transfer pricing method with regard to the category of transaction and the reasons for selecting that method.

applicable, and an explanation of the reasons for this selection.

• A summary of the important assumptions made in applying the transfer pricing

methodology.

• If relevant, an explanation of the reasons for performing a multi-year analysis.

• A list and description of selected comparable uncontrolled transactions (internal or external), if any, and information on relevant financial indicators for independent enterprises relied on in the transfer pricing analysis, including a description of the comparable search methodology and the source of such information.

• A description of any comparability adjustments performed, and an indication of whether adjustments have been made to the results of the tested party, the comparable uncontrolled transactions, or both.

• A description of the reasons for concluding that relevant transactions were priced on an arm's length basis based on the application of the selected transfer pricing method.

• A summary of financial information used in applying the transfer pricing methodology.

• A copy of existing unilateral and bilateral/multilateral APAs and other tax rulings to which the local tax jurisdiction is not a party and which are related to controlled transactions described above.

Financial information

• Annual local entity financial accounts for the fiscal year concerned. If audited statements exist they should be supplied and if not, existing unaudited statements should be supplied.

• Information and allocation schedules showing how the financial data used in applying the transfer pricing method may be tied to the annual financial statements.

• Summary schedules of relevant financial data for comparables used in the analysis

and the sources from which that data was obtained.

MASTERFILE

Organisational structure

• Chart illustrating the MNE's legal and ownership structure and geographical

location of operating entities.

Description of MNE's business(es)

• General written description of the MNE's business including:

- Important drivers of business profit;

- A description of the supply chain for the group's five largest products and/or service offerings by turnover plus any other products and/or services amounting to more than 5

percent of group turnover. The required description could take the form of a chart or a diagram;

- A list and brief description of important service arrangements between members of the MNE group, other than research and development (R&D) services, including a description of the capabilities of the principal locations providing important services and transfer pricing policies for allocating

services costs and determining prices to be paid for intra-group services;

- A description of the main geographic markets for the group's products and services that are referred to in the second bullet point above;

- A brief written functional analysis describing the principal contributions to value creation by individual entities within the group, i.e. key functions performed, important risks assumed, and important assets used;

- A description of important business restructuring transactions, acquisitions and divestitures occurring during the fiscal year.

MNE's intangibles

• A general description of the MNE's overall strategy for the development, ownership and exploitation of intangibles, including location of principal R&D facilities and location of R&D management.

• A list of intangibles or groups of intangibles of the MNE group that are important

for transfer pricing purposes and which entities legally own them.

• A list of important agreements among identified associated enterprises related to intangibles, including cost contribution arrangements, principal research service agreements and licence agreements.

• A general description of the group's transfer pricing policies related to R&D and intangibles.

• A general description of any important transfers of interests in intangibles among associated enterprises during the fiscal year concerned, including the entities, countries, and compensation involved.

MNE's intercompany financial activities

• A general description of how the group is financed, including important financing arrangements with unrelated lenders.

- The identification of any members of the MNE group that provide a central financing function for the group, including the country under whose laws the entity is organised and the place of effective management of such entities.
- A general description of the MNE's general transfer pricing policies related to financing arrangements between associated enterprises.

MNE's financial and tax positions

- The MNE's annual consolidated financial statement for the fiscal year concerned if otherwise prepared for financial reporting, regulatory, internal management, tax or other purposes.
- A list and brief description of the MNE group's existing unilateral advance pricing agreements (APAs) and other tax rulings relating to the allocation of income among countries.