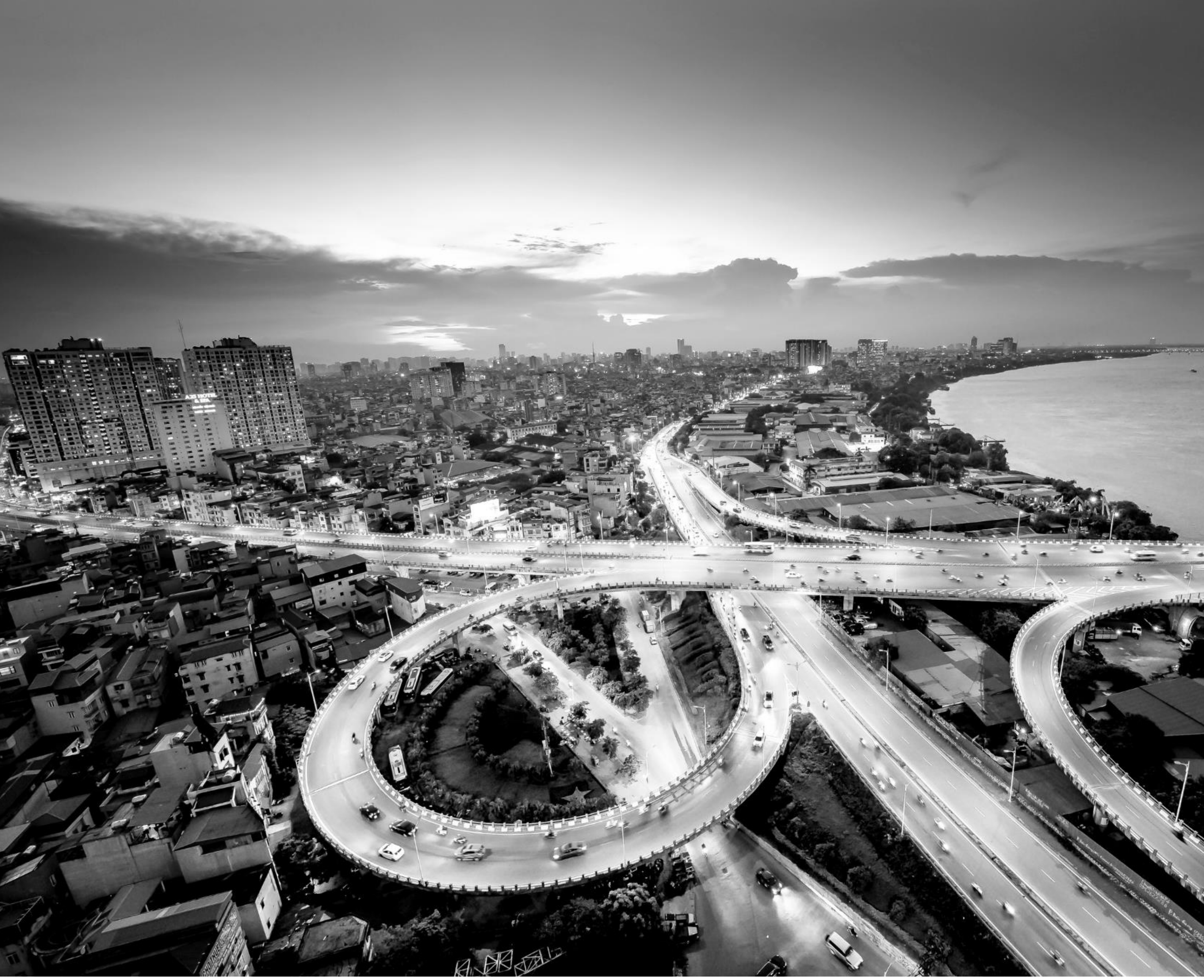
Tax and Transfer Pricing Aspects of Providing Intra-Group Management Services in Vietnam



INTRODUCTION

In this article, we will discuss tax and transfer pricing aspects of providing intra-group management services to Vietnamese subsidiaries of a multinational enterprise and some practical tips and recommendations for taxpayers to manage Vietnamese tax risks and related compliance obligations.

Transfer Pricing Aspects of Intra-Group Management Services in Vietnam

Transfer pricing is among one of the most important and challenging tax issues for multinational enterprises (MNEs) providing intra-group management services to group companies in Vietnam. The Vietnamese tax authorities have increased their scrutiny and enforcement of transfer pricing rules in recent years.

From a transfer pricing perspective, the following need to be addressed to minimize scrutiny on intercompany service transactions.

1. The management services transaction should be structured in line with arm's length principles.
2. Sufficient practical documentation should exist to support the arm's length nature of the service fee paid.
3. Transfer pricing documentation needs to be maintained to demonstrate compliance with the Vietnam transfer pricing requirements.

Each of these aspects is discussed in more detail below.

How should a management services transaction be structured?

Once a determination that a Vietnam taxpayer has received an intra-group service is made, it is necessary to assess whether the amount of the charge for such service, if any, is in accordance with the arm's length principle (i.e., the amount charged is consistent with what would have been earned and acceptable as a fee between independent enterprises in comparable circumstances). The service fee can either be in the form of a direct charge (where services can be clearly identified solely for the benefit of the Vietnamese taxpayer) or an indirect charge using a cost allocation and cost apportionment methodology.

This allocation should be made based on an appropriate service utilization measure that is easy to verify and support (e.g., turnover, staff employed, etc.). In determining the appropriate arm's length service charge, relevant consideration should be given to the value of such services to the recipient and how much a comparable unrelated enterprise would be willing to pay for those services in comparable circumstances, as well as the costs to the service provider.

The most commonly used method for pricing intra-group service fees is the cost-plus methodology.

When utilizing this methodology, general transfer pricing principles provide that the cost base should include:

- Direct costs, (e.g., cost of materials and cost of labor expended directly to render the services;
- Indirect costs, (e.g., depreciation, repair and maintenance, etc.) which may be allocated among several products or services categories; and
- Operating expenses (e.g., marketing, general and administrative expenses, etc.).

As an alternative, service fee pricing can be computed using other methods (e.g., fixed-fee basis or percentage of revenue) but these types of transaction values tend to be more heavily scrutinized by the General Department of Taxation (GDT) in Vietnam.

In an arm's length transaction, an independent enterprise would normally seek to charge for services in such a way as to generate a profit, rather than merely rendering services at cost.

Based on internationally accepted transfer pricing principles, the "mark-up" associated with low value-added services (i.e., routine services) is typically five percent.[1] Where the services are, however, considered high value-added services, a higher mark-up would typically be applied. High value-added services tend to refer to services such as sales and marketing, strategic planning, or business development or those types of services that require special expertise to perform and are thus performed by experts such as finance directors or regional financial controllers.

Is there sufficient practical documentation in place to support the arm's length nature of the service fee paid?

Where a determination is made that a service fee should and will be charged, it is important to have proof that these charges

[1] OECD Transfer Pricing Guidelines, 2022, Chapter VII, D.

are necessary and reasonable. Intercompany service fees need to be supported by valid invoices, intercompany agreements, or other relevant supporting documentation.

Companies should maintain appropriate evidence to substantiate the genuineness of the charges and to demonstrate that the Vietnamese taxpayer, in fact, needed, asked for and agreed to pay for these services, as well as to demonstrate that the Vietnamese taxpayer benefited from the services. If and when possible, it is preferrable to demonstrate both qualitatively or quantitatively the benefit derived from the services obtained. For example, showing a decrease in service recipient's cost base, an increase in revenue, increased quality control, or other potential impact to Vietnam company's operations.

Vietnam has a specific and direct economic benefits test that places the onus on a Vietnamese taxpayer to prove that benefits have resulted in Vietnam from the provision of the management services. In practice, the test can be subjective with no clear guidance in the regulations or precedent. If a taxpayer cannot show that benefits have been received from the intragroup services, the tax authorities can disallow THE management service fees as a deductible expense. This is particularly true in the cases of taxpayers who report negative operating results.

Transfer Pricing Documentation

The Vietnam Transfer Pricing ("TP") Guidelines ("Vietnamese TP Guidelines") [2] apply to Vietnamese taxpayers, including Vietnamese branches of foreign companies, who are payers of corporate income tax in Vietnam and conduct transactions with related parties. Unless a Vietnamese taxpayer qualifies for one of the following exceptions, [3] the business is required to maintain contemporaneous records at the time intra-group management services transactions are provided.[4]

- The taxpayers have revenue below VND 50 billion and the total value of related-party transactions is less than VND 30 billion in a tax period.
- The taxpayer has concluded an Advance Pricing Agreement (APA) and is submitting annual APA report(s).
- The taxpayer has less than VND 200 billion in revenue, performs simple functions, and has earnings before interest and tax (EBIT) to revenue ratio of (5%) for a distribution business, (10%) for manufacturing, or (15%) for a processing business.
- The taxpayer has only domestic related party transactions, and both the taxpayer and their related parties have the same corporate income tax rate, and do not benefit from granted tax incentives.

[2] Decree No. 132/2020/ND-CP ("Decree 132") issued by the Government of Vietnam on 20 December 2020.

[3] Article 19 of Decree 132.

[4] Decree 132 requires the TP documentation to be prepared before the time of filing the annual Corporate Income Tax returns and must be maintained and presented upon request from the tax authority. However, the Annual Disclosure Forms must be filed along with the annual return disclosing the arm's length value, related party transactions, the method adopted, and other details as prescribed.

The Vietnamese TP Guidelines align mainly with the provisions of the OECD Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations, 2022 ("OCED Transfer Pricing Guidelines") and adopt the arm's length principle [5] for determining transfer prices. Thus, in addition to generic documentation such as intercompany agreements and invoices, Vietnam taxpayers may also need to prepare contemporaneous transfer pricing documentation to support intercompany charges.

Key challenges

Enterprises that are attracting the attention of the tax authority are generally multinational companies that have several inter-company transactions, have reported operating losses, or are expanding businesses.

There has been a marked increase in the number of transfer pricing audits performed in recent years. Common challenges by the tax authorities include questions on the validity of comparables selected in transfer pricing documentation and deductibility of intra-group service charges. Companies in loss-making positions also draw attention from the tax authorities and are expected to be in a position to explain their business circumstances. Most general tax audits now include a review of the taxpayer's transfer pricing position.

In case of a cost-plus transfer pricing arrangement for payment of management fees, the GDT will carefully review both the cost incurred by the overseas service provider and the mark-up applied on the cost base. Historically, MNEs have been more focused on supporting the mark-up. However, as the GDT has become more familiar with intragroup services arrangements, they have started focusing on the cost base allocated to the Vietnam taxpayer.

In many cases, a Vietnamese taxpayer will be charged fees by the head office, and these fees are generally calculated based on labor costs incurred in these high-cost jurisdictions. Given that the labor costs in these jurisdictions are much higher than in Vietnam, the GDT often takes the position that the fees charged are too high.

Under Decree 132, an acceptable arm's-length range is from the 35th percentile to the 75th percentile, which is narrower than the previously acceptable range of the 25th to the 75th percentile under Decree 20. Accordingly, where taxpayers used the previously acceptable range, they will need to reassess their transfer pricing measures to ensure that the margins used fall within this tighter range. Specifically, it would be worthwhile to give further consideration as to whether any current group-level transfer pricing policy applied to Vietnamese entities aligns with the arm's length range stipulated under Decree 132.

[5] Article 9 of the OECD Model Tax Convention states "where conditions are made or imposed between the two enterprises in their commercial or financial relations which differ from those which would be made between independent enterprises, then any profits which would, but for those conditions, have accrued to one of the enterprises, but, by reason of those conditions, have not so accrued, may be included in the profits of that enterprise and taxed accordingly."

Tax Aspects of Intra-Group Management Services in Vietnam

In addition to the TP aspects intragroup management services, the Vietnamese tax considerations related to providing intra-group management services to Vietnamese entities depends on various factors, such as the nature and duration of the services, the existence of a Permanent Establishment (PE), the applicability of a double tax treaty, and the withholding tax obligations on payments made by the onshore recipient of the services.

Vietnamese Withholding Tax

Vietnamese rules will generally impose withholding tax on any income derived from Vietnam by a foreign service provider regardless of whether the activities of the foreign service provider resulted in a PE in Vietnam.

The Vietnamese source income of a foreign (i.e., non-Vietnamese) service provider having no legal presence in Vietnam from the supply of services to a Vietnamese company is taxed under the foreign contractor tax (FCT) regime.

Vietnamese FCT consists of two taxes:

1. Valued Added Tax
2. Corporate Income Tax

The most common method of reporting and paying taxes on Vietnam source income of non-residents is the deemed or withholding tax declaration method. Under this declaration method, the management service recipient in Vietnam will act as a withholding agent for the foreign contractor and will withhold, file, and pay taxes on behalf of the foreign service provider.

The tax rates applied to the gross income of the foreign service provider will be based on the nature of the services provided. The applicable tax rates for the provision of management services are a value added tax rate of 5% and the corporate income tax rate of 5%.

The corporate income tax portion may be reduced or exempted under a double tax

treaty, subject to certain conditions and procedures.[6]

The parties to the service contract are free to negotiate which of them will bear the withholding tax under the contract. For example, the foreign service provider may bear the tax on a gross payment basis, or the service recipient may bear the tax on a net basis, depending on the contractual parties' commercial arrangements.

Double Tax Treaties

Vietnam's tax treaties tend to be a mix of the OECD and UN Model Conventions. Vietnam has double tax treaties in effect with almost 80 countries and territories. These treaties often provide tax relief on the income of foreign service providers in Vietnam, subject to certain conditions. The tax relief may depend on the type of services provided, the existence of a PE or lack thereof, and whether the service provider qualifies for and is able to obtain a certificate of residence from their country of residence.

It is important for taxpayers to note that tax treaty relief is not automatic in Vietnam and requires advanced approval from the Vietnamese tax authority. This approval requires a formal application for tax treaty relief be submitted to the tax authorities. This application takes the form of a standardized template and requires the submission of supporting documentation such as a copy of the service agreement and the tax residency certificate of the applicant, etc. The tax authorities will review the application and issue an approval granting the tax treaty relief requested.

If taxes are withheld that are subject to reduction or exemption under a tax treaty, the taxpayer can apply for a tax refund subject to a three-year limitation.

Permanent Establishment

Under the tax treaties discussed above, business profits earned in Vietnam are normally exempt from Vietnamese taxation unless they can be attributed to a Permanent Establishment (PE) in Vietnam,

[6] In most effective double tax treaties between Vietnam and other countries, the corporate income tax portion for management service fee may be exempt under Article 7 – Business Profits if there is no Vietnamese permanent establishment through which the income is derived.

as specifically defined in the treaties. Under Vietnam's tax treaties, a PE is defined as a fixed place of business through which the business of the enterprise is wholly or partially carried on.

A PE may be deemed to exist in Vietnam if a foreign entity provides services in Vietnam through its employees or other personnel physically located in Vietnam for more than 183 days in a 12-month period.

While local guiding regulations on the implementation of double tax treaties in Vietnam do not provide specific guidance on how the number of days is calculated, examples provided in the regulations indicate that the determination of the number of days threshold is based on a 'Physical Presence Test' (i.e. personnel of the foreign company need to be physically present in Vietnam for more than 183 days within a 12-month period).[7] However, one area of contention typically during tax disputes or tax audits, is tax officials may look at the duration of a service agreement rather than the days employees are physically present in Vietnam.

If the foreign company does not have a PE in Vietnam, then the income earned by providing services from offshore to a Vietnamese company, should be exempt from corporate taxation in Vietnam.

Deductibility of intra-group management service fees

In Vietnam, the deduction of intra-group management service fees is a topic that often sparks controversy. During tax audits, local tax departments regularly dispute the deduction of these fees based on the argument that a subsidiary in Vietnam is a separate legal operating entity and, thus, should not require management services from an overseas head office or related party to conduct its business.

As mentioned previously, for management fees to be deductible, a Vietnamese company must demonstrate that the management fees provide a specific and direct benefit to the company. However, this is usually challenging in practice. den of

To support the deductibility for management service fees, it is essential to keep relevant documentation. Such documentation may include management services agreements, evidence of meetings, conference calls, emails, timesheets, or other documentation that demonstrates the services were indeed provided.

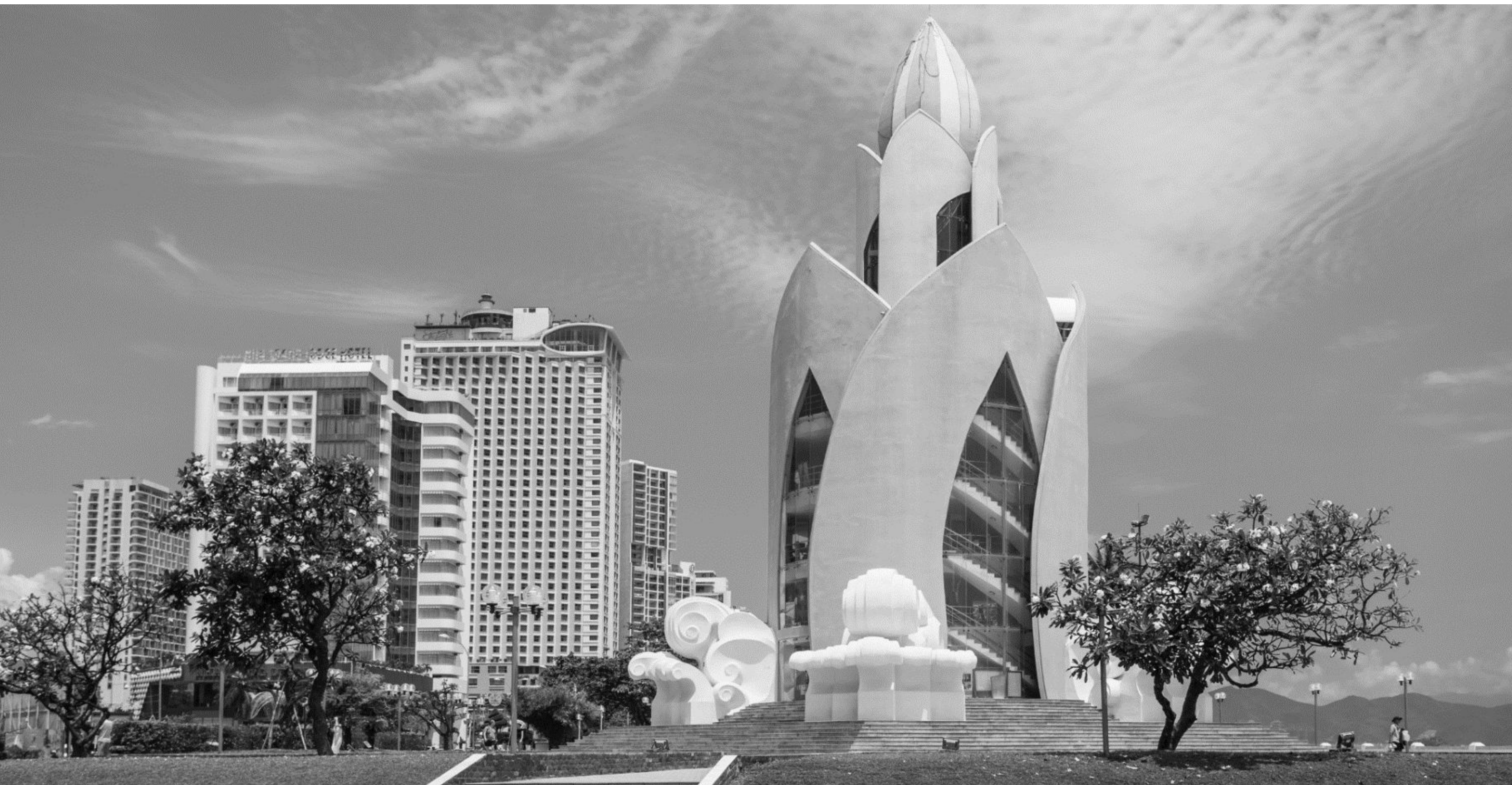
[7] Article 11(1.2.2)(c) of Circular 205/2013/TT-BTC dated 24 December 2013 of the Ministry of Finance guiding the implementation of the double tax treaties between Vietnam and other countries and in force in Vietnam

Concluding remarks

When providing intra-group management services to Vietnam, it is important to consider the various tax and transfer pricing implications. These implications are dependent on several factors, including the nature and duration of the services, the existence of an applicable double tax treaty, whether the service provider has a Permanent Establishment in Vietnam, and any withholding tax obligations placed on the service recipient. Taxpayers seeking tax relief from withholding tax under a tax treaty will need to make an application to the Vietnam tax authorities for approval.

Vietnam has a Benefits Test that requires Vietnam taxpayers to prove they have received direct and specific benefits from receiving intragroup management services. In practice, it can be challenging to prove that a Vietnamese entity has received such benefits from an overseas company. This often leads to an assertion by the Vietnamese tax authorities, that the management service fees should be considered non-deductible expenses, leading to an upward adjustment in taxable income.

As management fees are being charged by related entities within a group, transfer pricing rules will apply. The transfer pricing rules in Vietnam are in line with the OECD Transfer Pricing Guidelines. It is essential to maintain transfer pricing documentation and supporting documents that demonstrate the arm's length nature of the management fees. This will help to prove to the tax authority that the Vietnamese entity has received direct and specific economic benefits from the intragroup services and support the deductibility of the service fees for corporate income tax purposes.



Contacts

Jack Sheehan
Partner and Tax Leader
jack.sheehan@dfdl.com

Lan Hua
Tax Director
lan.hua@dfdl.com

Sowmya Varadharajan
Head of Transfer Pricing
sowmya.varadharajan@dfdl.com

Vandana Vijayakumar
Regional Transfer Pricing Director
vandana.vijayakumar@dfdl.com

Sneha Chhaya
Transfer Pricing Manager
sneha.chhaya@dfdl.com