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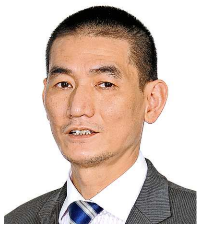
Covid-19 Transfer Pricing Impact in Vietnam—Preparing for Audit



BY VISHWA SHARAN AND NGUYEN DINH DU

The Covid-19 pandemic is still having far-reaching economic and social consequences. Business activities were halted and faced an existential threat. Many businesses changed the way they were conducted, and as a result, elements of the value chain have also changed. This has transfer pricing ramifications for organizations with cross-border transactions.

Transfer Pricing Challenges

The principle of comparability governs transfer pricing. For an arm's-length analysis, the margin of the tested company is compared to the prevailing industry average. Therefore, selection of the right comparables is crucial for healthy analysis.

The application of the profit method is difficult in that it relies on historical information for testing the price. There is a time lag between when the financial results are declared and the data is uploaded to the commercial database, and thus the margin of the tested party is always compared with the previous year's data.

This means that in the current year the tested party's Covid-19 impacted profitability would be compared with a previous normal year's profitability of comparables. On the contrary, will the tax authority accept a normal year's data of the tested parties to be compared with the pandemic-affected loss making comparables in the next year, as the situation returns to normalcy?

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Any stakeholders would consider such situations non-comparable, and thus the changed business reality needs to be taken into consideration.

In an open market, there is a range of price points at which the various parties may agree to contract based on bargaining power. As a result, the arm's length is a range of points rather than a price point. Given that this is an unusual year, the arm's-length range could be enlarged from the inter-percentile range (i.e., 35th to 75th) that is quite steep at the lower end to the interquartile range (i.e., 25th to 75th) (Decree No. 20/2017/ND-CP and Circular 41/2017/TT-BTC).

Considerations for Comparability

Over the past two years, Vietnam has imposed stringent lockdown, social separation, and quarantine measures to cope with virus outbreaks. This restricted local mobility and hampered productivity while skilled migrant employees from other provinces returned to their hometowns, causing a labor shortage for a brief period.

The impact on various business types as well as within the same business category was different. On the one hand, there was a negative effect on discretionary products such as fast-moving consumer goods (FMCG) or textile products, but on the other hand, there might have been a favorable impact on the related businesses for sanitizers, soap, masks, personal protective equipment (PPE), and other similar items. Therefore, comparing a discretionary item to medically related products will not give a correct picture.

There was also a paradigm shift toward working from home, and demand for IT infrastructure and videoconferencing saw positive impact for these businesses; in contrast, there may be other IT companies that were negatively impacted.

Further, the situation in Vietnam may not be equivalent to other Asian countries: Comparables in Vietnam would be more reliable. There are instances where tax authorities are reluctant to accept data of companies in the private domain even though in the same geographic market—in the current situation, such data would be more representative of arm's-length prices.

The pandemic has shown that an arm's-length margin that is reflective of an industry's performance can also be negative in an economic downturn. Therefore, loss-making comparables satisfying comparability criteria should not be rejected just based on financial outcome. The changed business scenario may reduce the reliance that can be placed on historical data when performing a comparability analysis.

In transfer pricing, only the expenses incurred during the normal course of business and those incidental to the business operations should be considered. Exceptional and non-recurring expenses leading to loss or low profitability should be identified and eliminated when computing operating expenses. The party that incurs the cost may not be the party that should assume the risk. Such costs should be allocated based on how an independent third party would have acted.

Gross margin methods are not accepted locally—while under the current scenario gross margin would be more reflective of arm's-length, eliminating any inefficiencies due to supply chain constraints, lockdown, etc. Further, the usage of CUP (comparable uncontrolled price) data, that is, price level comparison, would be more accommodating than the profit methods.

What Should a Taxpayer Expect From a Transfer Pricing Audit?

Businesses are seeking ways to protect themselves from the possibility of being exposed to transfer pricing risk. The best strategy is to identify any changes in facts or circumstances, or changes in any contractual terms, that may have material impact on transfer pricing and prepare defense documents accordingly.

The focus of a transfer pricing audit this year is expected to be more on arm's-length conditions than previously, which was mostly on comparability. Intragroup transactions such as royalty, management fee, and interest also could be a focus area. The substance, cost benefit, and evidence could be contested in the absence of robust documentation.

Given the economic pressures that tax authorities are under, they might turn to stringent audits to make up for lost revenue.

As a first step, companies should prepare and file statutory requirements to safeguard against defaulting. Tax administrations should provide flexibility to allow amendments to tax returns such that transfer prices are set on an arm's-length basis using the latest available information.

Strategies to Mitigate Potential Transfer Pricing Risk

Tax authorities frequently regard intra-group services such as management fees and royalty payments to be a cash repatriation mechanism. In a period of reduced profitability or loss, such payments would be viewed with greater skepticism. Management functions are primarily support functions rather than fundamental tasks, that do not have a substantial impact on the bottom line. Using management support does not imply that a profit will be made.

With work from home and more online jobs, an organization may not require certain services or it may require additional support, such IT, legal. The operation needs to be re-examined in a fresh context and ensure that the benefit outweighs the cost incurred. Whether or not such services are provided, they should be compensated in the case of retainer arrangements. The need to keep such a retainer, on the other hand, is a business decision.

Many Vietnamese firms that are part of large multinationals (MNEs) operate under licensee agreements, in which they use the IP for manufacturing and pay a royalty based on sales or profit. In the event of a business slump, reduced revenue would have a commensurate impact on sales-based royalty payouts: A royalty payout based on profit results in no royalty payout in the event of a loss.

It is more important to identify factors that led to low profitability than to outright disallow such expenses. The arrangements are entirely a prerogative of the business, and the tax authority should not meddle in the need for such arrangements.

The DEMPE (development, enhancement, maintenance, protection, and exploitation) framework for intangibles is designed to allocate revenues from intangible exploitation based on a functional profile, risk, and asset. The entity that performs essential value-creating functions connected to DEMPE, such as exercise of control, may expect to receive comparable returns. Revisiting of DEMPE would be required to check for any changes in functional and risk analysis.

Permanent changes in the supply chain will have typical transfer pricing issues such as business restructuring, exit charges, location saving, and shifting of client contracts. The documentation should record such supply chain disruptions, cross-border movements of employees and assignments, and relocation of business functions. Temporary impact can be taken care of by appropriate economic adjustments. The taxpayer should identify the exact reasons that are affecting the business to carry out the economic adjustment to nullify any material impact.

Economic adjustments other than working capital are not known to be widely accepted in Vietnam; entities that consistently report losses are more likely to raise the eyebrows of the tax authorities. Accordingly, the precise cause of the loss could aid in evaluating the pandemic's influence on the profit level indicator and in carrying out economic adjustments.

An appropriate adjustment is required to be made for the period when the production capacity was lying idle. However, capacity utilization data of comparables are not generally available. Another way could be by considering pre-pandemic revenue as a normal year and extrapolating the current year's financials to the normal year. A comparison of budgeted financial results against actual financial results could be showcased as to how Covid-19 affected them.

Depending on the specific case, other economic factors, such as market risk and foreign exchange risk, can also be quantified for their impact on profitability and can then be adjusted.

Cash Flow Constraints

During the pandemic, we have seen many lost orders, supply disruptions, and the spurt in exceptional costs has not only resulted in operational challenges but also significant liquidity issues. Companies are looking to access alternative cash sources to manage liquidity pressures to ride out the existing financial disaster. MNE group entities often rely on intra-group financing to meet their working capital needs.

In this context, it is important to note that Vietnamese Decree 132/ 2020/ ND-CP, which mandates interest deductibility rules in Vietnam, stipulates that the deduction cap for net loan interest expenses is up to 30% of the taxpayer's earnings before interest, tax, depreciation, and amortization (EBITDA) in a particular tax period. This is regardless of whether the loan was granted by a related party or an independent party. As a result, a company seeking a loan from a third party that is guaranteed by a related party is automatically covered within its ambit.

If the group decides to financially support a cash-strapped subsidiary, then such loan interest exceeding the threshold would be disallowed for tax purposes, subject to carry-forward value.

Revisit Operating and Remuneration Models

The economic substance in a transaction is more important than the contracting terms. Post pandemic, the functional and risk profile of the company may have undergone complete change. Accurate delineation would aid in identifying economically relevant factors, contractual terms, and other economic circumstances that may have material impact on the profitability of the company.

It is common for MNEs operating in Vietnam to set up limited risk entities. Limited risk entities generally operate under a ring-fenced environment that is entitled to a guaranteed return. Thus, the loss in such entities would be contested. However, it is pertinent to note that even in a third-party scenario, the contracting parties would be expected to share losses to ensure the contract's long-term viability.

Notably, the transfer pricing models that were made at the time of certainty are no longer valid during times of uncertainty. Besides, the entity is a limited risk entity and not a no-risk entity. Considering options realistically available, an independent party may agree to certain types of arrangements that may appear commercially untenable in normal times. What was not arm's length at that time may be arm's length now.

For entities working under a cost-plus model, the revenue authority should either allow reduced markup or cost-to-cost reimbursement for the lockdown period. An ultimate contracting entity that failed to generate revenue because of a limited risk entity that failed to perform its contractual obligation should not be expected to compensate that limited entity fully. However, the limited risk entity making persistent losses needs to revisit its functional profile and the appropriateness of characterization of the entity.

The options realistically available would aid in evaluating whether an independent party would alter the existing contract in light of changing business realities. Independent parties would strive to safeguard their economic interest and modify a contract only when there is no better attractive alternative. What may seem not at arm's length under normal times may be the best choice under pandemic conditions, considering profit potential in the long-term contract. It is possible that an entity would agree to bear losses in the short term rather than going out of business altogether.

Conclusions and Recommendations

The company should document each incident as it occurs, so that facts are in place when an audit occurs several years down the road. The influence of Covid-19 on the industry should be discussed in detail in the industry reports. It must be proven that low profits or losses are due to third-party events that go beyond the company's control, rather than non-arm's-length reasons. The major defenses would be economic adjustment, cost-benefit analysis, and evidence.

The local file should have a dedicated section to explain the impact of the pandemic. Loss-making companies, even if they are not chosen as final comparables, could be submitted as an annex to buttress the claim that numerous players incurred losses but were not included in the final list of comparables.

Accurate delineation of transactions, including contractual terms, the functions of the parties, commercial substance, and risks, is important. Events and factors having a material impact should be recorded. For any change in functional and risk profile, the remuneration model should be aligned to value creation in the supply chain.

This article is of general nature only and readers should obtain advice specific to their circumstances from professional advisers.

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