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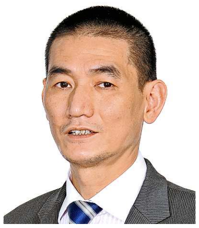
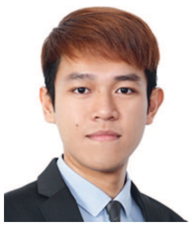
Comparability Analysis in Vietnamese Transfer Pricing





By Nguyen Dinh Du and Do Vu Bao Khanh

Transfer pricing has become a significant focal point in tax audits in Vietnam. Statistics indicate that among 90 Vietnamese taxpayers engaging in transfer pricing matters subject to tax audit and inspection in the first half of 2021, the tax authorities have collected a total of 596 billion Vietnamese dong ($25.9 million) in tax arrears and penalties, and adjustments of 1.21 trillion Vietnamese dong have also been imposed to reduce losses from taxpayers' financial records.

It can be observed that despite the increase in awareness of taxpayers regarding transfer pricing issues, and improvements in preparation of compliance requirements, taxpayers have been continuously subject to challenges from tax authorities regarding their transfer pricing positions, and especially the comparability analysis as a core principle in compliance. A failure to defend tax challenges will certainly lead to the imposition of adjustments by the tax authorities as described above, and it will further impact the risk profile of the taxpayer by creating a negative precedent in their tax records.

In light of this situation, this article will discuss some common issues in Vietnamese comparability analysis, with the aim of developing a basis for understanding and enabling improvement in compliance in transfer pricing matters.

Nguyen Dinh Du is Tax Partner and Do Vu Bao Khanh is Tax Senior Manager with Grant Thornton Vietnam.

From the General Theory...

It is first important to understand transfer pricing principles. Transfer pricing is commonly understood as the minimization of consolidated corporate tax expenses at group level, via influence on price or margin settings in transactions between ''controlled'' entities, thereby shifting taxable profit from one area with a higher tax rate to another with a lower tax rate.

In order to counter such conduct, the Organization for Economic Cooperation and Development (OECD) transfer pricing guidelines proposed a core ''arm's-length principle'' that would be applied in both transactional settings and examination.

At the most basic level, the arm's-length principle states that the price charged in a transaction between two related parties should be the same as the price charged in a comparable transaction between two unrelated parties. This principle, along with other transfer pricing guidance, was adopted by the Vietnamese tax authorities for the establishment of local regulations, as well as transfer pricing audit procedures.

As a result, taxpayers in Vietnam are required to examine their related party transactions, with the examination process being defined as a comparability analysis. In particular, comparability analysis comprises the process of identifying and establishing a comparison foundation using independent transactions and/or financial data.

There are two categories of regulatory methodology that Vietnamese taxpayers are commonly required to apply for transfer pricing analysis examination: (i) the comparable uncontrolled price (CUP) method, or (ii) the profit margin (PM) method. While the CUP method requires direct comparison between related party transactions and unrelated party transactions, the PM method creates an indirect connection, stating that if the profit margin of a taxpayer is similar to the profit margins of other independent and ''comparable'' industry players, then the transfer pricing position of the tested taxpayer could be sufficiently secured.

. . . To the Actual Application

Application of CUP Method The CUP method is legally required as a prioritized methodology in comparability analysis due to its integrity and reliability. In particular, illegal transfer pricing activities can easily be identified by examining the taxpayer's ledger and accounting records. The Vietnamese tax authorities have long applied the CUP method during tax audits, as any variance between pricing in related-party transactions and similar transactions with an unrelated party can easily be identified and would be subject to further tax challenges and possible adjustments.

However, application of the CUP method could sometimes be considered misleading, due to certain factors that might arise and result in different pricing between related and unrelated transactions. Pricing is not only the factor that requires investigation in comparability analysis; there are also many factors surrounding transactions which may influence the pricing mechanism and need further consideration, such as nature of the goods, physical specifications, categories, quality, trademarks, reliability, and volume. Such non-pricing factors should also receive deeper analysis in order to consider the feasibility and appropriateness of comparability.

An example commonly observed is that of a taxpayer who manufactures and sells the same products to both a group subsidiary and other independent customers under similar contractual terms and conditions, making the CUP method seem like the ideal methodology in transfer pricing examination, from both the taxpayer's and tax authority's perspective.

In this case, if the selling price associated with the related-party transaction is lower than that for the unrelated transactions, the taxpayer might expose itself to the risk of transfer pricing adjustments during a tax audit, as additional profit is believed to arise by raising the price in the related-party transaction to the unrelated price. However, the functions that the taxpayer assumes in each transaction is the key distinction, and may help the taxpayer in defending itself.

Another perspective on the above situation is that while the output of this taxpayer is secured by the group, the independent transactions would require significant sales and marketing effort and expenses, and consequently lead to the increase in the independent selling price in order to compensate for such costs. As a result, using the CUP method would require the taxpayer to identify any differences which arise in functions undertaken, risks assumed and assets utilized in each category of transaction, and document such influential factors accordingly in compliance documentation.

Transaction-by-Transaction Comparison Comparing transactions on a one-by-one basis appears to be ideal; it is recommended, however, that taxpayers undertaking related-party transactions and unrelated party transactions in similar categories should carefully look back and review their transfer pricing position and amend or supplement necessary evidence, in case there is any difference and/or unfavorable influential factor that might impact the transfer pricing position in a future tax audit.

Application of Profit Margin Method As stated above, the PM method creates indirect evidence by comparing the profit margin of the taxpayer with other players in the industry called ''comparable companies.'' Since indirect comparison is the assumed basis, the reliability of the PM method is considerably lower than the CUP method, making the PM method the runner-up in order of priority for use. However, the PM method is still considered a common testing methodology, in Vietnam and other jurisdictions, due to its ease of application and lower comparability standards compared to the CUP method.

In the context of Vietnamese transfer pricing regulations, the PM method shall only be applied if the CUP method cannot be applied due to a lack of internal data, or the impact of influential pricing factors, as described above. For example, a taxpayer that manufactures and sells all its products to related parties would be likely to have no other option than applying the PM method.
The PM method, however, seems to be the most arguable method to apply, which would lead to further explanation between taxpayers (or their tax advisers) and the tax authorities regarding the selection of ''comparable company.'' The definition of ''comparable company'' does indeed seem subjective from one point of view to another, and the tax authorities reserve the right to challenge the comparability nature of analysis and election.

It is common to see comparable companies be argued against and rejected by the tax authority due to the difference from the taxpayer in terms of economic scale, operating environment, and other operational factors. It is therefore advisable that the selection of comparable entities in the PM method analysis should be carefully reviewed by both taxpayers and possibly their professional advisers in order to ensure that the selection and rejection process is performed properly, using both the industry insight of the taxpayer's personnel and the tax expertise of their advisers.

Another significant point is the attention on geographic location in performing a comparability analysis. A Vietnamese taxpayer is required in searching to prioritize local comparable companies, as a further extended search outside Vietnam can be performed only if sufficient Vietnamese comparable companies are not identified.

Except for highly specialized functions and products, common industries for which there are usually an adequate number of comparable entities in Vietnam could include, but are not limited to, texture and garments, food and beverages, agriculture, plastics, real estate, banking, and logistics.

That said, there have been numerous cases when a shortage of Vietnamese comparable companies was the main factor leading to the rejection of compliance documents. As a result, taxpayers belonging to the above industry sectors, or who have any concerns regarding the local prevalenceof their operations, are advised to consult with their tax advisers throughout the comparability analysis process.

Last but not least, the localization of the Vietnamese transfer pricing regulations from the OECD transfer pricing guidelines also creates variance, and thus hardship, in local compliance in general, as well as in comparability analysis specifically.

One significant difference in Vietnamese comparability analysis is that the local transfer pricing regulations mandate, both in law and in actual practice, the year-to-year comparison when applying the PM method. However, as generally accepted by the OECD and other jurisdictions, a taxpayer's financial profitability in one single year could be benchmarked against the weighted average data of comparable companies for a certain period. As a consequence, this difference has become the primary reason for local compliance documents being rejected during audit.

Preparation of transfer pricing documentation is not considered a low-cost activity, and it is common to see efforts from a group financial department to reduce the costs of preparing such documents by adapting the existing materials from one jurisdiction to another. For example, comparable companies that were elected to compare for group level and following home jurisdiction might be leveraged for a Vietnamese subsidiary without proper adaptation to local regulations, i.e., performing an additional search for Vietnamese comparable companies.

Another significant mistake is the mechanical leverage of comparability analysis without proper consideration of the difference in operations between one subsidiary and another. For example, wholesale companies that were elected for the PM method analysis for the ultimate parent are utilized to analyze the transfer pricing position of the Vietnamese manufacturer, which would obviously lead to the rejection of the compliance documents as a whole and consequently create a negative precedent for the Vietnamese taxpayer.

To Sum Up

This article has highlighted both the theory and factual application of comparability analysis in Vietnamese transfer pricing. In light of the above, it is recommended that a taxpayer engaging in transfer pricing matters in Vietnam should carefully take into consideration guidance from local regulations that applies to a comparability analysis.

It is also advised that proactive planning should be considered for related-party transactions to make sure that transfer pricing risks are mitigated and compliance documents are prepared correctly.

This column does not necessarily reflect the opinion of The Bureau of National Affairs, Inc. or its owners.

Author Information Nguyen Dinh Du is Tax Partner and Do Vu Bao Khanh is Tax Senior Manager with Grant Thornton Vietnam.

The authors may be contacted at: du.nguyen@vn.gt.com; khanh.do@vn.gt.com