

Key TP considerations during the recovery from COVID-19 in Vietnam

Dinh Mai Hanh, Tat Hong and Supratik Mukherjee of Deloitte Tax Vietnam discuss some of the transfer pricing challenges that could be faced by entities in Vietnam that are a part of a multinational enterprise group, in the wake of COVID-19.

The COVID-19 pandemic is currently in its third year and has had an unprecedented impact on human life and business all over the world. The impact of COVID-19 has been equally devastating on businesses in Vietnam. Many have been negatively affected and some have been forced to modify the way in which they conduct their business.

The value chain of MNE groups has been impacted considerably and so has transfer pricing (TP) outcomes. In the ensuing paragraphs, we will discuss some of the TP challenges that could be faced by an entity in Vietnam that is a part of a multinational enterprise (MNE) group, and the possible ways to navigate through these challenges.

The comparability analysis perspective

Many companies in Vietnam were severely impacted by the pandemic in 2020 and 2021 and hence they may have reported a low profitability or even losses as compared with earlier years.

From a TP perspective, related parties within a MNE group must transact in a manner that is similar to how third parties conduct their business in the same period.

However, when local companies prepare TP analyses, especially the comparability analysis using an external benchmarking study to benchmark their profitability at the net level, it is possible that the current year financial data of the comparable companies is not yet available. This would mean that the local entity is left with one option, which is to benchmark its profitability (which has been negatively impacted by COVID-19) with the profitability of comparable companies for earlier years (which were not impacted by COVID-19, hence likely to be more profitable than the tested party). This would be an unfavourable situation for the tested party.

Therefore, the tested party should incorporate adequate documentation of the business reality in the TP analyses of years affected by

COVID-19 and substantiate the fact that such lower profitability (or loss) arose due to the market conditions and not due to the pricing of related party transactions (RPTs). For instance, the impacts of the stringent lockdown measures implemented by the Vietnamese government due to the pandemic should be reasonably analysed, quantified and documented. Furthermore, if there is no particular reason otherwise – such as to serve a tax audit – the taxpayer may opt to wait until the contemporaneous financial data of comparable companies becomes available so that the financial outcomes could be benchmarked in a more chronologically comparable context, especially when the local comparable companies are selected.

On a separate note, one must be mindful of the fact that all industries have not been equally affected by the pandemic. For example, the airlines and the hospitality industries were severely impacted, but companies engaged in the business of sanitisers, masks and other personal protective equipment have experienced a positive impact on their operational results. Hence, if the tested party is in an industry that was severely impacted by the pandemic, the local file of the tested party, which has made a loss, should incorporate a detailed industry analysis, and adequately quote the source data that has been used to prepare such industry analysis. The detailed industry analysis should then be used effectively to explain the loss incurred by the company.

In normal circumstances, comparable companies that have incurred a loss are usually rejected while arriving at the arm's-length range. However, in an extraordinary time like that of the COVID-19 outbreak, if the tested party has incurred a loss owing to the pandemic, loss-making comparable companies should be considered. This finds support in the OECD Transfer Pricing Guidelines (Paragraph 3.64 of the OECD Guidelines).

It is possible that the tested party has incurred exceptional or non-recurring expenses that were incurred only because of the pandemic (e.g., the cost of providing testing kits to the workers, etc.). Such expenses must be identified and eliminated from the cost base while calculating the operating profit of the tested party. However, one must be mindful of eliminating similar expenses incurred by comparable companies, provided such information is available in their annual report. If such information is not available for comparable companies, and hence if such adjustments to the profit level indicator (PLI) of the comparable companies have not been made, and if such expenses are excluded while computing the PLI of the tested party, questions can be raised during a tax audit.

To evaluate the adherence of the related party transaction to the arm's length principle, it is possible to select transfer methods such as the resale price method and the cost plus method which use gross profit-based PLIs. This becomes critical when the tested party has incurred a loss



Dinh Mai Hanh

Partner

Deloitte

T: +84 24 7105 0050

E: handinh@deloitte.com

Hanh is a Deloitte Vietnam's Transfer Pricing National Leader and Tax Partner. Hanh has played a key role in the TP service line of Deloitte Vietnam. With her leadership, Deloitte Vietnam is honored to be awarded as Vietnam Transfer Pricing Firm of the Year by the International Tax Review (ITR) in 2020

Hanh is author of various articles being published in Vietnam as well as International tax, transfer pricing and investment journals. She is also a frequent speaker at national and regional seminars, webinars, several institutions on numerous transfer pricing topics. She has built a wide network among Deloitte Asia Pacific as well Global teams through various cross-border projects.

With more than 25 years of professional experience in practising audit and tax advisory in Deloitte Vietnam, Hanh has abundant knowledge and experience in serving world's leading MNEs and giant Vietnamese private groups in various industries.

Hanh holds a CPA Certification from Australia and also a CPA Certification from Vietnam. She has a bachelor's degree in Accounting and English and holds an Master Degree in International Accounting from Australia and Executive MBA Degree from USA.

at the net level owing to the pandemic. To elaborate, a distributor may have still been in a position to make a reasonable gross profit margin at a comparable level to that pre-COVID. However, owing to stringent lockdown policies, sales could not be generated sufficiently to cover costs such as space rental, employment, etc., which has resulted in a loss or low-profit situation.

As observed, this approach has been considered satisfactory in many TP audit cases since it has reasonably eliminated the impact of the pandemic at the operational level of both tested party and the comparable companies. Nevertheless, one should be mindful that RPTs at the operational level or



Tat Hong Quan

Director
Deloitte

T: +84 28 710 14341
E: quantat@deloitte.com

Tat Hong Quan is a director with Deloitte Vietnam and has more than 12 years of experience practising TP consulting in Vietnam as a technical specialist. With extensive experience in the Big Four, Quan has specialised in TP planning advisory, TP risks assessment, documentation compliance and controversy advisory services across various industries such as consumers, energy and resources, industrial products, telecommunication and technology, healthcare and life sciences.

In addition, Quan is Deloitte Vietnam's TP technology champion, responsible for adopting the Deloitte global automated tools and technologies.

Quan has a bachelor's degree in International Business from New Zealand and a diploma in Japanese Study from New Zealand.



Supratik Mukherjee

Senior manager
Deloitte

T: +84 28 710 14450
E: supmukherjee@deloitte.com

Supratik is a senior manager with Deloitte Vietnam and has more than 13 years of experience in TP documentation, planning and implementation, due diligence, advance pricing agreements and mutual agreement procedure in the Big Four across India and Vietnam. He also has extensive experience in representation before assessment and dispute resolution authorities at various levels.

Supratik has worked on these types of projects for clients across a variety of industries, including the information technology services, consumer durables, healthcare, life sciences and diversified industrial sectors.

Supratik is a qualified Chartered Accountant from the Institute of Chartered Accountants of India and also has a Bachelor of Commerce from St. Xavier's College, India.

in the financial items must also be tested separately to satisfy the local requirements.

For example, the comparable uncontrolled price could be supplemented for royalty expense and interest expense. For expenses arising from availing of intra-group services (IGS), one can select the overseas service provider as the tested party and compare the mark-up with the profitability of independent comparable service providers. For purchase of goods from the related party (the Vietnamese entity being the licensed manufacturer), the related party (which is a contract manufacturer) can be selected as the tested party and its margin can be tested.

Expectations from a TP audit

One must be mindful of the principle of substance over form, the demonstration of the benefit test for the use of an IGS, especially in a situation where the company has incurred a low profit or a loss. The tax authorities may look at such IGS payments as strategies for repatriation of cash by the Vietnamese entity to its related parties. Hence robust documentation of the necessity, the authenticity and

the arm's length rationality of the incurred IGS in the local file and providing adequate evidence is essential towards a successful defence during a tax/TP audit.

For instance, the availing of management services is intended to run the business smoothly as per the accepted standards of the MNE group. It should be delineated in the local file that the making (or not making) of profit should not be a yardstick in evaluating whether a company should pay for management services. Or, as a corollary, payment of management service cannot guarantee that the company will make a profit. The only yardstick to determine the appropriateness of the value of intra-group services is whether it has passed the benefit test. These points should be adequately documented in the local file and consequently should help the company in mitigating the risk of a TP adjustment.

In another example, in which the Vietnamese entity is paying a royalty that is calculated as a percentage of sales, a reduced turnover owing to the pandemic should have already resulted in a lower royalty payout. Therefore, one must closely look at the reasons for such losses and not reject expenses arising out of such licensed intellectual property

(IP). In summary, the company should be able to demonstrate in the local file that there was a reasonable necessity for it to avail of such support services or to receive such IPs from its related parties, and it would not have been able to operate without those supports.

Unlike other TP-developed jurisdictions, economic adjustments (such as working capital adjustment, capacity utilisation adjustment, etc.) are not very easily accepted by the tax authorities in Vietnam. Hence, if such adjustments are performed in the local file, there should first be an adequate and detailed explanation of the reasons for losses owing to of the pandemic and why consequently an economic adjustment was necessitated.

If one chooses to perform a capacity utilisation adjustment to its own profitability, since capacity utilisation data of comparable companies is not available, one may do an adjustment based on the capacity utilisation in the current year (affected by the pandemic) vis-à-vis its capacity utilisation in an earlier year in which it achieved normal production volumes.

Owing to the pandemic circumstances, the Vietnamese subsidiary may receive financial assistance from its parent in the form of a loan, especially to tide over its working capital needs. Accordingly, it will accrue an interest expense in its books. However, it should be noted that a maximum net interest expense of 30% of the company's earnings before interest tax depreciation and amortization (EBITDA) is allowed as deductible in its corporate income-tax return of the current year. Any interest expense above this

threshold is disallowed in the corporate income-tax return. Notwithstanding, such disallowed interest expense can be carried forward to future years subject to certain conditions. This must be kept in mind before the MNE group enters any financing decision.

Going forward

Accurate delineation of the transaction is of the utmost significance given the fact that the BEPS action plans have been emphasising the alignment of the TP outcomes with the value creation of the MNE group or among entities of an MNE group.

Such accurate delineation will help in identifying whether any of the critical assumptions that led to the structuring of a transaction in the pre-COVID time has been invalidated and therefore whether the transaction itself and the related transfer prices would still be valid, or whether substituted transactions should be considered. Subsequently, any potential changes or even explanation of the impacts of COVID-19 on TP outcomes must be sufficiently supported by rationale and concrete evidence because Vietnam is still predominantly a form-based tax environment, although the "substance over form" principle has always been emphasised in the local regulations.

One must be mindful of the fact that the above points should be considered as recommendatory only, as the Vietnamese authorities have not issued any guidance on the TP considerations due to the impact of COVID-19.