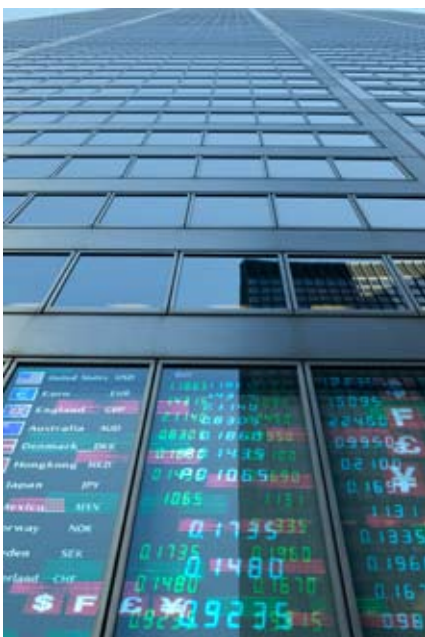


# Tax Alert

Transfer Pricing challenged in recent tax audits

VIETNAM

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## Transfer Pricing challenged in recent tax audits

The most recent tax audits at several companies indicate that the provincial tax authorities have been much more aggressive and sophisticated in challenging multinationals' transfer pricing practices. Some of the major queries raised by the tax authorities are:

- Details and reasonableness of the transfer pricing method(s) used by the companies as disclosed in their Form 01.
- The companies' transfer pricing documentation.
- Whether the companies' loss-making position was due to transfer pricing, given the companies' simple function and low risk profile. Companies challenged here were performing contract manufacturing (export processing). The tax authorities' expectation in those cases was that the companies should make a profit.
- Rejection of corporate income tax deduction for service fees paid to the parent company, where the expenditures were not adequately substantiated in terms of price setting and benefits rendered.

## KPMG's observations

### Regulatory background of the issues

The current Tax Administration Law requires that the arm's length principle (commonly called 'market price') be applied in companies' determining prices for business transactions with related parties. Circular 117/2005/TT-BC dated 19 December 2005 of the Ministry of Finance, effective 27 January 2006, contains transfer pricing regulations providing guidance for the application of the arm's length principle. The regulations particularly require that companies create and maintain contemporaneous transfer pricing documentation as supporting evidence of their compliance with the arm's length principle.

Transfer pricing documentation must be submitted to the tax authorities within 30 working days of the authorities' written request. Failing to provide transfer pricing documentation may result in the tax authorities making transfer pricing adjustments, which may lead to adverse tax consequences in terms of higher tax liabilities, penalties and, in some cases, altered tax profile.

The current local regulations set out five (5) transfer pricing methods: Comparable Uncontrolled Prices, Resale Price, Cost Plus, Comparable Profits Method, and Profit Split.

### The context for the tax authorities' potential challenges on transfer pricing matters

Vietnam is no exception to the regional trend where the revenue authorities are taking action to protect their tax revenue in the current downturn by enforcing the transfer pricing regulations. The tax authorities in various Asia Pacific countries explicitly indicate their view on profit level expectation of companies which perform low risk toll or contract manufacturing, even in the economic downturn.

KPMG's recent survey reveals a consensus on the following transfer pricing 'red flags' or high-risk transactions:

- persistent losses or low operating profits
- different prices/markups charged between:
  - (i) related and unrelated parties for similar transactions
  - (ii) various related parties for similar transactions
- absence of or non-adherence to inter-company agreements
- sharp changes in profitability from prior year(s)
- lack of (sufficient) documentation
- royalties charged for soft intangibles, i.e. intangibles that are not legally protected, such as business process/systems/methods
- high royalties with licensee exhibiting low profits or operating losses
- transactions with group company in tax haven
- significant year-end adjustment to inter-company prices
- sudden drop of profit after tax holidays
- significant inter-company management fees
- profit margin lower than the industry average
- actual behavior not consistent with documented transfer pricing policy
- separation of functions and risks that does not make sense from a business perspective.

As a sensible response, companies should have contemporaneous transfer pricing documentation as a line of defense. Obviously, 30 working days can be too short for companies to create transfer pricing documentation strictly in accordance with the local requirements (and the documentation created in response to the tax authorities' request may be after the fact then, i.e. not contemporaneous.) Responding properly to the tax authorities' queries during a transfer pricing audit is equally important to protect the companies' position.

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