To determine the tax payable by companies, tax authorities usually apply the following anti-transfer pricing measures when discovering unusual details in expenditures and profits of integrated companies:

- Comparison of market prices,
- Determination of buying prices based on selling prices, and
- Determination of taxable income based on the full- cost price.

The concept of "anti-transfer pricing measures" has just made its appearance in some documents of tax authorities and was mentioned by Circular 74 TC/TCT issued on Oct. 20, 1997 and Circular 89/1999/TT-BTC issued on July 16, 1999 by the Ministry of Finance to give guidelines on taxation of foreign-invested companies.

Example: A foreign oil company sells 1,200 liters of lubricant to the Company A in Vietnam (A is a joint venture between the oil company and a local partner) for US$1,500 payable in six months. At the same time, it sells 1,000 liters of the same lubricant to a Company B (a nonintegrated one) for US$1,000 in cash. Suppose that the interest rate on 6-month loan is 5%. Vietnamese tax authorities can compare those two prices to determine profit of the Company A by making the following calculations:

- Unit price of a liter of lubricant payable in six months: (US$1,000 + US$1,000 x 5%): 1,000 liters ≐ US$1.05 per liter.
- Transaction value of lubricant sold to the Company A: 1,200 liters x US$1.05 = US$1,260.

Suppose that the average gross profit of the whisky business is 10%,

Buying price = US$11 – (US$11 x 10%) = US$9.9 per liter.

3. Determination of taxable income based on the full- cost price.

When a local company sells out of its output of a certain product to an integrated company, and not a single item is sold on the market with the result that the tax agency has no value to make comparison, it has to use books of account of the company to work out the income.

Example: Company A is a joint venture between a local garment company and the foreign Company B. A specializes in doing subcontracts for B. In 1999, A tranferred to B 10,000 suits at a fixed price of US$10 each. The following data are

ON DETERMINATION OF MARKET PRICES OF FOREIGN-INVESTED COMPANIES

by MEcon. PHAN HIỂN MINH

In Circular 13/2001/TT-BTC issued by the Ministry of Finance on March 3, 2001, the phrase "anti-transfer pricing measures" was replaced with the phrase "measure to determine market prices". In fact, this measure aims at dealing with transfer pricing practices used by multinationals for avoiding taxes.

I. METHODS OF DETERMINING MARKET PRICES SET FORTH BY CIRCULAR 13/2001/TT-BTC

Besides issuing the List of Minimum Prices used for assessing duties on imports, the Ministry of Finance also introduced methods of determining the market prices in its Circular 13/2001/ TT-BTC.

1. Comparison of market prices

Tax authorities could compare different prices prevailing in arms-length market for inputs and products or services to set the transfer price used by integrated companies.

2. Determination of buying prices based on selling prices

When failing to determine the real market prices of goods imported from a foreign supplier, tax authorities can use the selling price offered by the importer to work out the buying price.

Example: Company A is a subsidiary of the Company B from a foreign country and acts as the sole selling agent for B in Vietnam. In 1999, A bought 10,000 liters of whisky from B, paid US$75,000 in import duty and excise tax and sold this amount of whisky for US$185,000. At the year's end, tax assessor's calculation of the buying price of whisky was as follows:

Net sales = Gross sales – import duties = 185,000 – 75,000 = US$110,000

Selling price (after import duties) = US$110,000: 10,000 liters = US$11 per liter.

from A's account books:

- Cost of goods made and sold: US$80,000
- Cost of delivery: US$6,000
- Overheads: US$12,000
- Total: US$98,000

Because A and B are integrated companies, and suppose that the average net profit of the garment business is 10%, the tax assessor calculated that the profit for A was US$98,000 x 10%.

At present, measures to determine the market prices used in transaction between integrated companies are a matter of urgency. These measures could help ensure fair competition between local and foreign- invested companies and tax revenues for the state.

II. SHORTCOMINGS OF APPLICATION OF METHODS OF DETERMINING THE MARKET PRICES

- Information needed for determining the market prices is usually from foreign sources or relating to trade secret, therefore it isn't available or accessible to tax authorities.

- In many cases, tax assessors have no basis for making comparison between prices used by integrated companies (because the transaction is unique or the product is a monopoly of a foreign company).

- Tax agencies are limited to their provinces while multinationals do business in many provinces and many countries.

- The methods of determining the market prices requires skills and expertise from tax assessors and not all assessors meet this requirement.

- When having no condition to apply those methods, tax authorities are forced to be content with a written statement by the company about the veracity of information supplied. This solution is nearly meaningless because the company is ready to issue such a statement when it has no right to set prices for goods or services supplied by its parent company.

Many foreign auditors have considered these measures as an effort to protect the tax revenues by the Vietnamese authorities, instead of a legal action against transfer pricing practices.

III. SOLUTIONS

First of all, we should admit that transfer pricing practices and measures to determine the market prices are general concepts that couldn't be measured exactly. When applying these measures flexibility to a certain extent is needed. Tax authorities should aim at determining the reasonable transaction value of goods and services for the tax purposes, not at determining how and how much the company, as a taxpayer, has to pay for or earn from goods and services traded. In short, both the taxpayer and tax authorities should concentrate on determining if there is a difference between the transfer price and the market price. Thus, the appraisal of the worth of imported goods based on their transaction value should be stipulated clearly by tax laws with a view to creating a good environment for businesspersons. The following are our suggestions aboult this problem.

1. Determination of the market price according to the double taxation relief agreement

Many countries enter these agreements to avoid making taxpayers pay income tax in two countries on the same income. These agreements usually include articles describing what two integrated companies are. In fact, it isn't difficult to determine if there is any relation between the two companies, especially when the two countries enter a tax information exchange agreement.

In addition, the agreement usually stipulates that the tax authorities of one contracting country have rights to calculate and set prices and values in all contracts between two integrated companies when the prices and values aren't appropriate to the market prices in order to determine the taxable income of one of those two companies operating in the contracting country.

To transfer income from a subsidiary, the parent company usually applies one of the following practices to avoid taxes or transfer the money to the home country where tax rates are lower than Vietnam's.

- The parent company overprices goods or services supplied to the subsidiary in Vietnam.

- The subsidiary pays the parent company above-normal payments for license, copyright and other intangible assets and underprice products supplied to the parent company.

- The parent company charges its subsidiaries higher interest rates on loan as compared with commercial lending rates.

2. Regulations for integrated companies

The tax law should define what integrated companies are and how a transaction value is considered as different from normal market price.

As for companies considered as integrated ones, the tax law should require reports on the following transactions, besides annual income tax declaration as demanded by the Company Income Tax Law:

- House and office rental, sale and purchase of vehicles; equipment; machines; tools and other consumer goods with other integrated companies.

- Payments for, or transfer of, rights to use intangible assets (copyright, trademark or service mark, patent, special techniques and designs, etc.) to integrated companies.

- Financing operations: lending, guaranteeing short- and long-term loans, sale and purchase of securities, down payment and instalment inclusive interest made to integrated companies.

- Supply of service by subsidiary in Vietnam to integrated companies (market researches, marketing, management, accounting, legal and financial services, etc.).

Within a month after receiving reports from integrated companies, tax authorities should examine financial data supplied (sales, unit price, cost, profit ratio, etc.), compare them with their annual financial statements, analyze their payments to and receipts from subsidiaries, and gather basic information about the companies and their operation over years.

Tax authorities should inspect integrated companies that show the following signs:

+ Having their business decisions directed by other affiliated companies.

+ Making big transactions with other affiliated companies.

+ Reporting losses for two successive years.

+ Reporting marginal profits or losses that aren't suitable to their operation and development.

+ Experiencing unusual changes in profit and loss over years.

+ Having exchanges with other affiliated companies to reach agreements about tax payments.

+ Suffering losses lower than the average of the industry.

+ Gaining lower profit than other affiliated companies.

+ Avoiding taxes in the period when they enjoy tax reduction or exemption thereby reducing their profit considerably, or use other ways to avoid taxes.

3. Advance pricing agreement

This is a bilateral agreement for the benefit of companies:

- Companies are allowed to make declaration of prices they used when trading with other affiliated companies and reach an agreement with tax authorities about the method of determining the market prices.

- Possibility of double taxation is reduced considerably or totally removed.

- It saves a lot of time and troubles for both tax authorities and companies.

Determining the transfer pricing practices requires exact judgement from both tax authorities and taxpayers. Vietnam had better enter advance pricing agreements and use them as a basis for the supervision of foreign-invested companies when the number of these companies tends to increase in the coming years.■