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TRANSFER PRICING IN FOREIGN DIRECT INVESTMENT ENTERPRISES IN VIETNAM - SITUATION AND SOLUTIONS

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This article analyzes the situation of transfer pricing in FDI enterprises in Viet Nam. Based on the framework of transfer pricing of international organizations (OECD, 2017; UN 2017), collating with Decree 20/2017/ND-CP and circular 41/2017/TT-BTC, this article proposes recommendations to enhance the effectiveness and efficiency in implementing regulations on the management of transfer pricing in related-party transactions, aiming to create an equal playing field for FDI enterprises in their process of investing into Viet Nam.

Keywords: *FDI, transfer pricing in FDI, FDI enterprises*

Introduction

Since the opening of the economy, Viet Nam has attracted a large amount of foreign direct investment (FDI). Counting from the time when the Investment Law was introduced in 1987 through 2015, there were 21,392 FDI projects operating in Vietnam (not to mention expired or withdrawn projects) with the total number of registered capital of approximately 314,7 billion USD. With a clear directional policy to attract investment, FDI projects since 1996 has been focused on export industries, infrastructure, import-substitution industries, and labor-intensive industries. As of December 2015, there has been 10.764 projects with the total registered capital of 163 Billion USD in production and manufacture sector. The FDI inflow into Vietnam not only increases in quantity but also in the scale and quality of each project, with the appearance of many international corporations and multinational companies. The

receiving of FDI capital has created the opportunity for Vietnamese enterprises to access to modern technology, advanced management techniques, and created jobs for local labor. FDI has become one key source for economic development, the driving force for Vietnam's economy, improve its dynamics and competitiveness.

However, besides positive contributions, activities of FDI enterprises has also posed many challenges to public management for the governance bodies in Vietnam. Particularly, many FDI businesses has a practice of declaring losses in many year for tax avoidance, leading to loss of governance revenue. That practice also created unfair competition with local enterprises, negative impact to the financial management mechanisms in the FDI sector, having impact on the effectiveness of this funding source, and the adverse impacts on the goals of attracting and managing the FDI inflows into

Vietnam. The problem is that there has been a practice of "transfer pricing" in FDI enterprises in Vietnam. According to assessment of financial experts, the situation of transfer pricing is alarming in Vietnam at present. While developed countries may have had good ways to limiting transfer pricing in multinational companies, Vietnam still lack this kind of experience. Thus, an investigation into the situation of transfer pricing in Viet Nam, in the context of increasing FDI and growing operation of multinational companies, is essential. The research results will serve as the basis to find solution to manage transfer pricing, creating an fair and healthy business environment, harmonizing the benefits of the three FDI stakeholders: the enterprises (foreign investors) - the host country (Vietnam) - source country (investing countries) in the current context of globalization.

Related-party transactions and transfer pricing operations in multinational companies

Due to the dispersing activities in many countries, with a multi-dimensional link structure (horizontal, vertical and combined), the related-party transactions of multinational companies are very diverse, complicated, and increasing in volume. According to a recent global estimate by the World Bank (WB, 2011), approximately 2/3 of economic transactions in MNCs are related-party transactions, and this trend will continue to increase in the future. This trend is even more obvious in developing countries in the process of economic opening and integration, when the relevant domestic industry and service is either not available or do not have enough capacity to serve the operation of foreign-invested enterprises.

Based on the nature and characteristics, related-party transaction can be categorized into following groups:

- Related-party transaction involving highly peculiar materials, or materials produced at a sub-

sidary placed in a country with its own advantages that make the price of the raw material very low.

- Related-party transaction involving final products: subsidiaries in different countries can procure final products manufactured in a country and then resell without the need to invest on machinery or labor for production.

- Transactions that move large quantities of machinery and equipment for production and the destinations of these transactions are often the developing countries.

- Transactions involving invisible assets such as franchises, trademarks, brands, labels, expenses related to product research and development.

- Transaction involving the provision of management services, financial services, or expenses for experts working in the receiving countries.

- Transaction having funding and being funded on resources such as talents and human resources.

- Loans and related party loans among subsidiaries or between the holding company and its subsidiaries.

When performing those related-party transactions, a problem arises is that how will the price be determined. As reported by many organizations in the world (OECD, 2017; WB, 2011; UN 2017), related-party transactions within a group of companies are often based on a price that is set internally, not based on the market, and that is transfer pricing.

Transfer pricing is the practice of setting the price for goods, services and assets that are transferred between the members of the group across the border without the market with aim to transfer income and profits from high-tax countries to low-tax countries, minimizing tax for multinational companies worldwide (OECD, 2017).

Thus, transfer pricing is an act of business entities to change the value of goods and services exchanged with the affiliated parties. Price can be

redefined in related-party transactions from the following three reasons:

First, from the right to make business decisions, entities have the right to decide the price of a transaction. Therefore they have the right to buy or sell goods and services at the desired price.

Second, from the relationship with shared benefit, the difference in transaction prices made between business entities having the shared benefit does not change that total shared benefit.

Third, the decision on the transfer price between the members of a affiliated group does not change the sum of the general benefit but may alter the sum of their tax obligations. Through the pricing, tax obligations are transferred from high-tax locations to lower-tax locations.

Transfer pricing has negative impacts to FDI host countries, on following key points: (i) the host government lost a large amount of tax revenue, as reported in the International Tax Compact (2011), transfer pricing activity made developing countries, FDI host countries lost approximately 60% of the annual tax revenue. In addition to that, developing countries annually have to balance a large amount of foreign currencies to import raw materials and machine at higher price than the actual value; (ii) create an unhealthy business environment, unfair competition, in which domestic enterprises are at a disadvantage; (iii) Prolonged loss due to the transfer pricing is a way for foreign enterprises to acquire host country enterprises in international joint-ventures.

The situation of transfer pricing at FDI enterprises in Viet Nam

With fair assessment, for the last 30 years, the foreign-invested sector has developed rapidly in Viet Nam, and increasingly prove to be an integral part of the economy, contributing to the improvement of competitiveness and effectiveness Viet Nam economy. In recent years (2011-2016), the foreign-invested sector contributed 1/4 total investment capital of the economy, 55% industrial output, 70% export volume, 18% of total budget revenue and 20% of gross domestic product (GDP). The 2016 enterprise survey showed that in the 2011-2016 period, the FDI sector had a pre-tax profit higher than that of the private sector (more than 180%). Meanwhile tax and government revenue contribution and of the FDI sector is only 81% that of the private sector. The number on tax and government revenue contribution includes direct and indirect taxes. Indirect taxes, on the nature, is not a contribution of the non-FDI sector to the budget, rather it's the amount of Vietnamese people contributed to the budget through consuming products of the FDI sector. The government revenue contribution of the FDI, if excluded indirect tax, is only equivalent to 51% that of the private sector.

Table 1: Average growth of revenue, profit, tax payment, capital of different sectors in 2011-2016 (%)

	Revenue	Profit	Tax Payment	Corporate Income tax	Capital
SOEs	18.62	20.81	8.60	9.60	11.76
Private	11.89	17.44	20.73	20.86	17.07
FDI	18.62	25.47	8.60	7.50	16.28

(Source: Enterprise survey, General Tax Department, 2017)

Table 1 shows that the FDI sector has the highest average growth in profit in the period of 2011-2016 (25.47%), compared to the state-owned sector (20.81%) and the private sector (17.44%).

Meanwhile, the average growth in the total tax of the FDI sector is only 8.6% compared with 20.73% of the private sector. In particular, the average growth on corporate income tax is also lower, which is only 7.5% compared with 20.86% of the private sector.

Table 2: Tax contribution of different economic sectors in 2016 (%)

	Total Tax/tax revenues, fees	Direct tax /revenue from tax, fees	Total Tax/Total budget revenues	Direct tax/Budget Revenue
SOEs	27.96	24.36	25.18	21.94
Private	42.82	41.64	39.47	37.50
FDI	25.29	21.41	22.78	19.28

(Source: Enterprise survey, General Tax Department, 2017)

Table 2 shows that in 2016, the FDI sector has the lowest proportion of tax contribution in the state budget compared with two other domestic sectors. In particular, the contribution of the FDI sector is only about 19.28%, while the private sector contributed 37.5% of the total government revenue.

The question is why is there a big difference between tax contribution of the FDI sector with other two domestic sectors? There are many possible reason for this tax inequality but transfer pricing must be mentioned.

Desktop review of the secondary data from the media and reports by tax administration offices in 2011-2016 shows that the transfer pricing behavior of FDI enterprises in Viet Nam focuses on the following key forms:

- Raising the value of contributed capital by overpricing the equipment and technology contributed to partners Viet Nam.
- Selling goods, materials to related parties at prices higher than the selling price for non-related parties.

- Transfer pricing through the transfer of invisible assets usually takes place in case of foreign company transferring technology to related parties in Vietnam and collecting the copyright fee at a much higher cost than the extent of use.

- Transfer pricing through loan interest by funding affiliates in Vietnam loans with very high interest rate. In this way, the overseas related party transfers the pre-tax profit from the Vietnamese related party to a foreign country to enjoy a lower income tax than in Vietnam.

- Foreign corporations, holding company signed a production and service with companies in countries with very high processing price, then these companies transfer contracts for subsidiaries in Vietnam to carry out the production and service signed with the holding company but does not receive money directly. They will only collect money according to the price set by the parent company which is very low.

- Insurance broking companies sign the reinsurance contract abroad and collect the fee in Vietnam for transfer to the foreign reinsurance company but do not record the turnover for the calculation of corporate income tax.

- The enterprise signed 2 procurement contracts with foreign company, with low-value contract for payment, high-value contract for increasing input cost; the difference between the two contracts then is linked to a third company (domestic) to retrieve goods from the foreign company, using public debt clearing procedure.

Increase the cost of inputs provided by the affiliate company across the border such as: raw materials, fuels, assets, goods, interest rates, provision of services including the services that have not been determined and regulated by the Vietnam government agencies and regulation.

According to Vietnam Business Annual Report by the Chamber of Commerce and Industry of Vietnam (VCCI) announced recently, in 3 types of enterprises operating in Vietnam, FDI enterprises have the highest loss percentage, at some point reached to 51% (in 2008), in three years from 2012 to 2014 it's approximately 48%. Despite that continuous reported losses, FDI businesses still expand their production and business. Moreover, while the FDI enterprises reported losses, most of the domestic businesses in the same industries reported profits.

It can be observed that, despite intense operation and gaining significant market share in passenger transport, Grab and Uber always reported losses. Information from the General Department of Taxation shows that from 2/2014 to present, both the Grab and Uber taxis are at losses. Grab has a legal capital of 20 billion, but has losses of more than 938 billion. This raised many doubts whether or not the two enterprises are having transfer pricing and tax evasion.

Explaining the losses, Grab said that the losses was due to large advertising and promotion costs, leading to the situation that after more than 3 years of operation, the company has accumulated losses of more than 938 billion dong. However, this explanation is not persuasive. Many experts think that this may be another case of transfer pricing among FDI enterprises operating in Vietnam.

Not only Uber or Grab, many other FDI businesses such as Lottle, Metro, BigC... still reported huge losses despite having very high revenue. Therefore, according to the economic experts, trans-

fer pricing in FDI enterprises operating in Vietnam have created loss of government budget revenue. This situation require the government administration to better control FDI businesses' activities to limit of transfer pricing.

Policy to control transfer pricing in Viet Nam

Over the last decade, the number of countries adopted and executed regulation on transfer pricing increased quickly. In 1994, only two countries issued the anti-transfer-pricing tax law, the U.S. and Australia. Then by 2009, there are at least 49 countries, including the majority of countries in the OECD countries have passed a tax law on controlling transfer pricing.

In Vietnam, transfer pricing has been determined by financial policy makers as an issue that needs to be addressed as more and more signs of transfer pricing in the transactions related to foreign companies.

The first legal document referring to the transfer price is the Circular No. 74/1997/TC-BCT guiding on tax for foreign investors, then Circular No. 89/1999/TT-BTC and Circular 13/2001/TT-BTC. Then in Circular No. 05/2005/TT-BTC on guiding tax for contractors, this issue is removed from the content. Until 19/12/2005, transfer pricing was re-mentioned in Circular No. 117/2005/TT-BTC issued by the Ministry of Finance to instruct the implementation of the market price in the business dealings between the parties having the affiliate relationship. In 2010, Ministry of Finance issued Circular No. 66/2010/TT-BTC on 22 Apr 2010 guiding the implementation of the market price in trading transactions between related parties. The circular replaced Circular No. 117/2005/TT-BTC on Dec. 19, 2005. After nearly 10 years of implementation, on the 24th of February 2017, the government of Viet Nam has issued Decree No. 20/2017/ND-CP with regulations on tax administration for enterprises with related-party transactions, together with that Circular No. 41/2017/TT-BTC on 28/4/2017 guid-

ing on implementing a number of provisions of Decree No. 20/2017/ ND-CP. These regulations superseded Circular No. 66/TT-BTC. According to the Price Waterhouse and Cooper (PWC), Decree 20 and Circular 41 marked a significant milestone in the regulatory system on related-party transaction prices in Vietnam, showing Vietnam's commitment to establishing a tax policy that consistent with the global tax policy framework (BEPS) in terms of transparency and tax-avoidance controlling efforts.

Discussions

The issuing and implementing of Decree 20 and Circular 41 demonstrated drastic measures from the state management agencies in Viet Nam on the issue of transfer pricing in FDI enterprises. However, based on the study of the contents of the circular, collating with the frameworks of international organizations on transfer pricing (OECD, 2017 ; UN 2017) as well as surveys with consultation organizations on Circular 41, there is some disadvantages that affect the implementation of these regulations. Reasons come from two sources: (i) content of the provisions of the Circular 41; and (ii) the implementation of the circular by FDI enterprises.

Regarding the content of regulations in circular 41:

- Circular 41 requires companies to use data recognized by the state agencies as the basis for analysis and comparison. However, due to lack of data in Viet Nam, taxpayers will no basis for reference when determining prices in related-party transactions. This leads to the question of whether taxpayers can extend the limits of reference databases (such as data from same industries in Asia), and whether that is allowed by tax authorities.

- One of the other challenges is related to disclosure of annual information in related-party transactions. Clearly the purpose of this information disclosure is to help tax authorities monitor and audit for the transfer pricing. However, taxpayers may have

difficulty completing this declaration of information because those transactions are “business secrets” of the company group.

- The permit of the tax authority to use internal data for the purpose of adjusting the related-party transaction price in case of a taxpayer is considered non-compliance with regulations may cause more disagreement between the taxpayer and the tax authority.

On the side of FDI enterprises:

- The majority of multinational companies have made their investment projects in Viet Nam in hopes that demand will increase. However, due to continued under-capacity operation, a large portion of general costs cannot be offset through conventional selling prices.

- Although cheap labor is one of the attractive factors for multinational companies investing in Viet Nam, additional training and coaching costs increase the cost of personnel in the early stages of the investment process.

- The link between the industries within value chains in Viet Nam quite limited. Therefore, the majority of the inputs for the production of FDI enterprises must still be imported, leading to increased input costs.

- The macroeconomic factors, the depreciation of the local currency is also the reason that multinational companies suffered risks on exchange rates...

Recommendations on solution for transfer pricing Vietnam

From the above discussions, for Circular 41/2017 come to life, facilitating the operation of FDI Enterprises as well as the government agencies in Viet Nam, solutions should focus on following key issues:

1. For legislation agencies: consideration should be taken to including transfer pricing to the content of the corporate income tax and law on tax administration enhance coercion, and increase the

effectiveness of enforcement. On the other hand, policy makers should also consider to amend or extend requirements for comparison data source to suit the current situation in Viet Nam.

2. For tax and custom agencies: training to be held for all tax and custom officers on transfer pricing issues; at the same time, intensive training for the departments of tax inspection and inspection of compliance with transfer pricing regulations. Regular exchange of experiences between tax authorities, customs of local provinces, academic and business activities of the tax authorities/customs in the region and the world. Implementing appropriate propaganda measures for taxpayers to understand the regulations and requirements on transfer pricing in economic transactions.

3. For foreign enterprises: need to understand the regulations on anti-transfer-pricing in Viet Nam, to comply with and cooperate with the tax authorities in tax regulations.

4. For expert, consultation and training entities: need to build specialized data to provide reliable information to tax authorities during law enforcement. Vietnam's specialized agencies, such as the General Statistics Organization, the General Department of Taxation, can work with the accounting and auditing consulting organizations to build database on multinational companies operating in Vietnam and at the same times allocate annual budget to subscribe to database on multinational companies by independent international consulting organizations to serve as the basis for comparison, collation when determining the internal related-party transfer price. For tax training and consulting organizations, it is necessary to strengthen the exchange and training on business ethics, law compliance, enforcing transparent accounting policies and always aware that equality, mutual benefit is one of the core principles of sustainable business whether in domestic or overseas.

Conclusion

International economic integration has created tremendous opportunities for Viet Nam's economic development. Despite being influenced by the global crisis and recession, the efforts of the government has brought optimistic signals showing that the economy is recovering. Along with the restored momentum of the world economy, many foreign investors are returning to Viet Nam to continue unfinished projects or begin the process of investing in long-term projects. It can be seen that, along with the wave of foreign investment activities transfer pricing will happen. The problem is how to limit the negative effects of transfer pricing to the development of the economy, ensuring the national sovereignty, creating fair competition and not deviating from the orientation of socio-economic development nor affect the policy of attracting foreign investment.

Transfer pricing is a sensitive and unavoidable issue in the process of investing that countries will experience and gradually seek to address. An effective transfer pricing control requires a close coordination between the state management agencies, especially the tax authorities, the cooperation of enterprises, coordination of professional, consulting and training organizations. Viet Nam is following other countries, so it is necessary to study the experience of other countries, regularly monitor, up date the transfer situation that occurs in countries in the region and in the world. The investigation, completion and addition of the legal system on economic, the participating in tariff agreements of Viet Nam have provided a more comprehensive view on tax, including the transfer pricing issue, in order to put related-party transactions back to their true nature as equal, voluntary transactions, not for the own benefit of any single party. However, with a multidimensional and complex relationship in the context of the current economy, the core issue of solving the main price problem is the conflict between the interest

groups and the nation, hence the research on transfer pricing and the management of transfer pricing should be continue to by scientists at various angles and aspects. ♦

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Summary

Bài viết phân tích thực trạng chuyển giá tại các doanh nghiệp có vốn đầu tư trực tiếp nước ngoài ở Việt nam thời gian qua. Trên cơ sở tham khảo khuôn mẫu về chuyển giá của các tổ chức quốc tế (OECD, 2017 ; UN, 2017), đối chiếu với Nghị định 20/2017/NĐ-CP và Thông tư 41/2017/TT-BTC, bài viết đề xuất các khuyến nghị nhằm tăng cường tính hiệu lực và hiệu quả trong việc triển khai áp dụng các quy định về quản lý chuyển giá trong các giao dịch liên kết, nhằm tạo ra một sân chơi bình đẳng cho các doanh nghiệp FDI trong quá trình đầu tư vào Việt Nam.

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- Economic Studies Journal
- Finance - Accounting Studies Journal