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Thuan will be in an excellent position to review the tax compliance of the target company.

DEDUCTIBILITY OF INTEREST LOAN FOR COMPANY WITH RELATED PARTY TRANSACTIONS – WHAT SHOULD BE AWARE?

In recent tax audits performed by tax authorities national wide, especially in big cities and provinces where the tax contribution accounting for large part of the state budget like Ho Chi Minh City, Hanoi, Hai Phong or Binh Duong, Ba ria-Vung Tau…, one of a typical issue of tax challenge is the deductibility of interest loan when a company falls in the position triggering related party transactions with a lender.

Vietnam does not have a thin capital rules in place except for certain business sectors and as normal practice, a lot of Vietnam companies operate with thin capital. They tend to use bank loans or shareholder loan or even non-bank third party loan for business, especially with real estate companies. For the past tax audit, interest paid for a bank loans are generally not scrutinized by tax authorities given the interest rate offered by a commercial bank are most considered as on market price but now those could be a material issue for a company as transacted with a commercial bank can be subject to related party limitations and cap deduction of interest loan for corporate income tax purpose.

The Vietnam tax system requires taxpayers to conduct a self-tax assessment/declaration/settlement; then tax exposure will be identified by the tax authorities upon the commencement of a tax audit. As such, a company should be aware of transfer pricing limitation for interest loan deduction, especially transaction with a commercial bank which might really not have related relationship with the company.

Tax exposure can be significant due to non - compliance with TP regulations, typically with issues:

- Incorrect determination of exemption from disclosure of TP transaction, exemption from preparation of TP documentation report or insufficient declaration in TP form;
- Lack of TP documentation to provide to the tax authorities upon the tax audit event;
- Unadjusted TP charges/allocation under Covid-19 pandemic creating a different business situation; and
- Challenge of TP documentation not being prepared by the deadline and timeline for submission to the tax authority.

In case of a tax exposure, a penalty can include:

- Tax obligations on such under-declared income;
- 20% administrative penalties or 1–3 times the evaded tax obligations for tax fraud/evasion; and
- Late payment interest at a rate of 0.03%/day on outstanding tax obligations.

It is noted the rules on interest loan deduction in related party transactions have been in place for quite long, not a new regulation.

The latest updated transfer pricing rule is Decree 132/2020/ND-CP (Decree 132) which was issued on 5 November 2020 on tax administration for transactions with related parties and be effective from 20 December 2020 and is applicable for the corporate income tax (CIT) period 2020 and future years.

Following the enactment of the Law on Tax Administration No. 38/2019/QH14 effective from 1 July 2020 (Law on Tax Administration), the Government issued Decree 126/2020/ND-CP dated 19 October 2020 (Decree 126) to provide guidance on the implementation of a number of articles of the Law on Tax Administration, including guidance on transfer pricing (TP).

Under the rules, related parties are parties having relationships where, among others:

"d) An enterprise guarantees or offers another enterprise a loan under any form (even including third-party loans guaranteed by financing sources of related parties and financial transactions of same or similar nature) to the extent that the loan amount equals at least 25% of equity of the borrowing enterprise and makes up for more than 50% of total medium and long term debts of the borrowing enterprise;"

In such a case, Decree 132 sets forth regulations on the deductibility of loan interest expense, providing:

"Total loan interest cost is deducted in case of determining the income subject to corporate income tax of the enterprise engaged in related-party transactions:

> *a) Total loan interest cost arising after deducting deposit interests and lending interests within a specific taxable period which is deducted during the process of determination of income subject to the corporate income tax is not 30% more than the net profit generated from business activities within the taxable period plus loan interest costs arising after deducting deposit interests and lending interests arising within the taxable period plus depreciation/ amortization expenses arising within that period of a taxpayer;"*

Compare with the early regulations (Decree 20), there is an increase in the deductible loan interest expense cap to 30% (earlier rule set at 20%) of the total net profit from business activities within the period plus (+) net loan interest expenses (after offsetting deposit interest income and loan interest income) plus (+) depreciation expenses incurred in the period.

In addition, a company can carry forward net loan interest expenses that were not deductible due to the above-mentioned interest expense cap, for a subsequent five years.

Also according to Decree 132, taxpayers who are exempted from TP declaration or TP documentation obligations are still required to comply with the above cap.

As of now, there are no further guidance on how to calculate and when to determine the "*loan amount*" or "*total medium and long term debts*" to verify a company engaged in related party transactions. Will the tax authorities base on the financial statements at a specific point of time or use weighted average loan balance to determine? And on equity side, will this be a paid

up capital or registered charter capital shown on the company business registration certificate? In a year, if a company register to increase its charter capital (so for not subject to the related party transactions that year) and it does have 90- days for making capital contribution, will this be acceptable? The issues are thus controversial and it is expected the Ministry of Finance to have a detailed guidance on those matters. In the meant time, it is understood as at any specific point of time in a financial year, if a company receives a loan that satisfy the criteria of related party transaction, then it will be subject to the deductibility cap for loan interest for the whole year.

In order to minimize the cash payout amount with relation to tax penalties/ tax re-collection, where occurring, and whether or not the tax audit project has performed under the initial plan, it is necessary to pay attention and be aware of the restrictions mentioned above.

In order for a well preparation of a future potential tax audit, company should consider:

- Developing a clear strategy, preliminary timeline/schedule, and a strong supporting/ dedicated team to work with the tax authority during the tax audit;
- Periodically self-reviewing to identify and assess key potential risk areas/issues, estimate in advance the tax exposures and determine the proper action plan to minimize any tax risks;
- To the extent the non-compliance is found, make additional tax declaration and settle the tax payable as soon as before a decision for a tax audit is issued;
- For unclear tax matters/uncertain tax policies, researching the relevant official letters which are similar to the company's case is recommended, or seeking the specific ruling which provides direct guidelines to the case for reference and protection if challenged by the tax authority; and

If the company does not agree with the tax audit decision, then consider a proper appeal plan to obtain the most appropriate decision/judgment.

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