Features of the US Vietnam Double Tax Treaty and Tax Planning Case Studies

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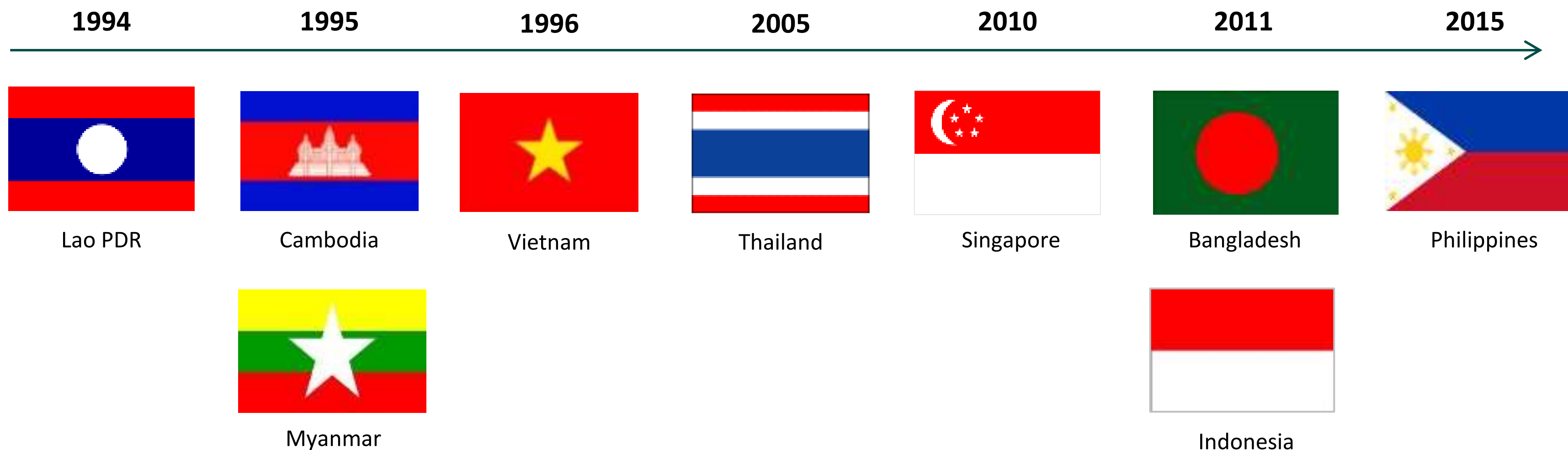

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Agenda

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- Introduction
- General Scope of tax treaties
- Business Profits and Permanent Establishments
- Distributive Articles (Dividends, Interest, Royalties)
- Capital Gains
- Employment Income
- Challenges in making cross-border payments
  - Deductibility of expenses
  - Transfer Pricing Concerns
  - Limitations on Benefits Clauses and General Anti Avoidance Rules (GAAR)

Warming relations

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The theme of the visit by the Vietnamese government officials to Washington in July 2015 was to agree on "a deepened, sustained, and substantive relationship on the basis of respect for each other's political systems, independence, sovereignty and territorial integrity."

- The US and Vietnam signed four agreements, including:
  - ✓ A double tax agreement
  - ✓ Assistance to UN peacekeeping missions
  - ✓ Cooperation in addressing emerging threats of health pandemics
  - ✓ Technical assistance on aviation safety
- Commitment to complete negotiations on the Trans-Pacific Partnership (TPP)
- Various political and defense related issues were discussed

Contents

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1. General Scope of the DTA
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3. Distributive Articles (Dividends, Interest, Royalties)
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6. Challenges in making cross-border payments
   - Deductibility of expenses
   - Transfer Pricing Concerns
   - Limitations on Benefits Clauses and GAAR rules

1 US-VN Tax Treaty - General Scope of the DTA

Prof. Van Den Temple, Netherlands Minister of Finance and first Chair of the OECD

"Such wonderful things can be done with tax treaties"

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“Tax treaties restrict the application of local country tax laws”

General scope of the treaty

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Who does the tax treaty apply to:

Article 1 (1) *"This agreement shall apply to persons who are residents of one or both of the Contracting States, except as otherwise provided for in the Agreement"*

Article 4(1) for the purposes of the agreement, the term *"resident of a Contracting State" means any person who, under the laws of that Contracting State, is liable to tax therein by way of his domicile, residence, citzenship, place of incorporation, place of registration, place of management, or any other criterion of a similar nature and also includes that Contracting State and any political subdivision or local authority thereof."*

How does a treaty work?

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Basic rules of tax treaties:

1. **Taxes are applied based on local country tax laws (e.g. Vietnam, US tax law)**

2. **Tax treaties restrict the application of local country tax laws**

US-VN DTA: What it is and what it isn't

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- Residents of Vietnam
  - A DTA may reduce the US taxes of residents of VN
  - A DTA does not reduce VN taxes of residents of VN

- Residents of the US
  - A DTA may reduce VN taxes of residents of the US
  - A DTA does not reduce the US taxes of residents of the US

- A DTA simply prevents payment of tax on the same income to two countries

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2 Business Profits and Permanent Establishments

Business Profits - Article 7 and 5

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Article 7 (1) “The profits of an enterprise of a Contracting State shall be taxable only in that State, unless the enterprise carries on business in the other Contracting State through a permanent establishment situated therein”

Article 5 (1) “the term permanent establishment means *a fixed place of business through which the business of an enterprise is wholly or partly carried on*”

Article 5(2) PE includes especially: a place of management, a branch, an office, a factory, a workshop, a mine, oil or gas or gas well, a quarry or any other place of extraction of natural resources.

Permanent Establishment - Article 5 (con't.)

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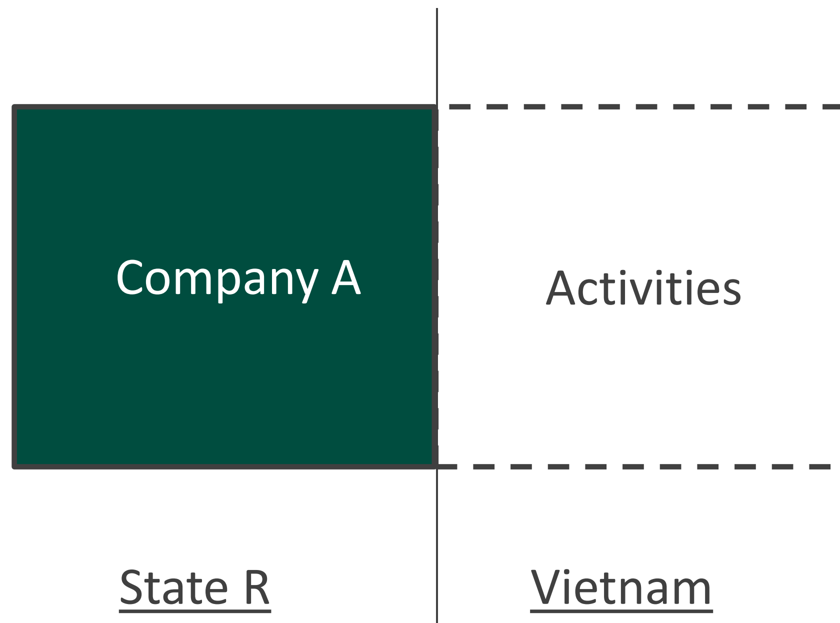
Article 5(3) (b) "the furnishing of services, including consultancy services, in a Contracting State

…. through employees or other personnel, ….

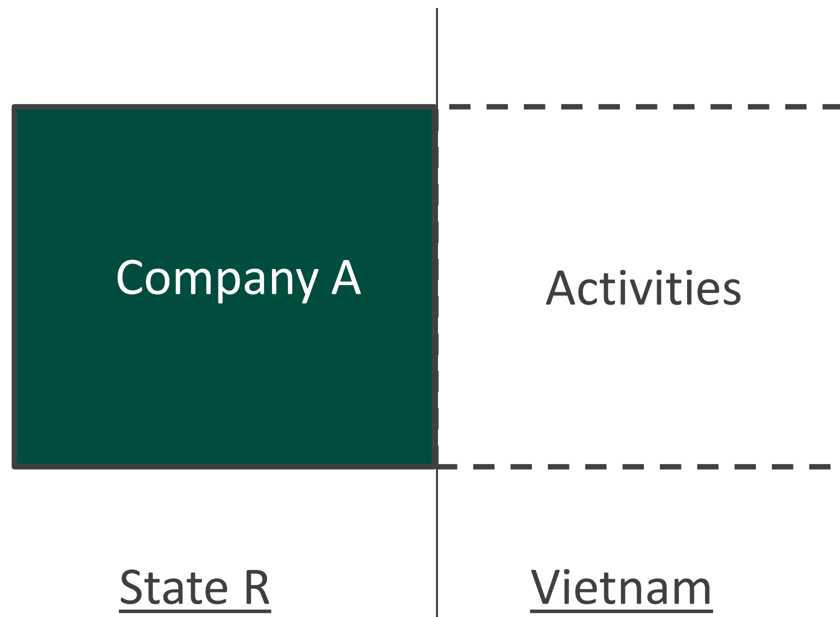
But only if the activities for a period of periods aggregating more than six (6) months within a twelve (12) month period

Foreign Contractor in Vietnam

- Company A is a resident of State R
- It wins a contract to provide services in Vietnam for a fee of 1M USD
- The services will be for a period of five months



- Company will be subject to Foreign Contractor Tax ("FCT") (CIT: 5% and VAT: 5%)
- The PE question is relevant only in the choice by Company A of FCT method (Deduction method and Hybrid Method will be available to a PE)



PE under Article 5?

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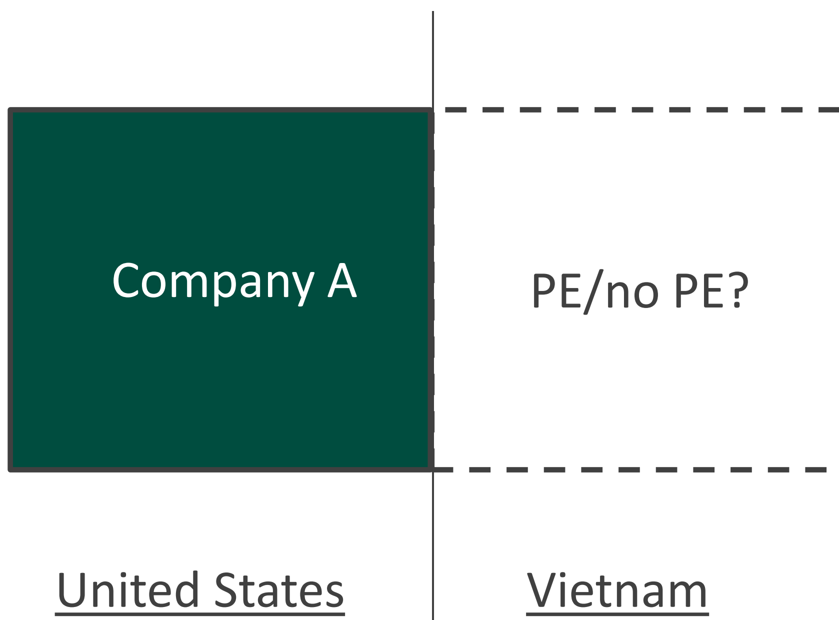
- If State R is the US or jurisdiction with a DTA with Vietnam, exemption from FCT- CIT may be available, if Company A does not have a PE in Vietnam
- The DTA provides if services less than 6 months in 12 month period



- **Use of Representative Office**

If the representative office is involved in the negotiations on behalf of the non-resident, the RO may be considered a Permanent Establishment in Vietnam. *(Official Letter 3316/TCT-HTQT dated 13 August 2009)*

VN Official Letters

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- **Third Party as a Permanent Establishment**

A VN entity must prove it operates within the framework of normal business and must not be subject to the control and guidance on how to conduct the business by the non-resident company. Otherwise, it will be treated as a PE of the non-resident. *(Official Letter No. 2067/TCT-HTQT 16 June 2011)*

3 Distributive Articles (Dividends, Interest, Royalties)

US – VN DTA: Dividends, Interest, Royalties

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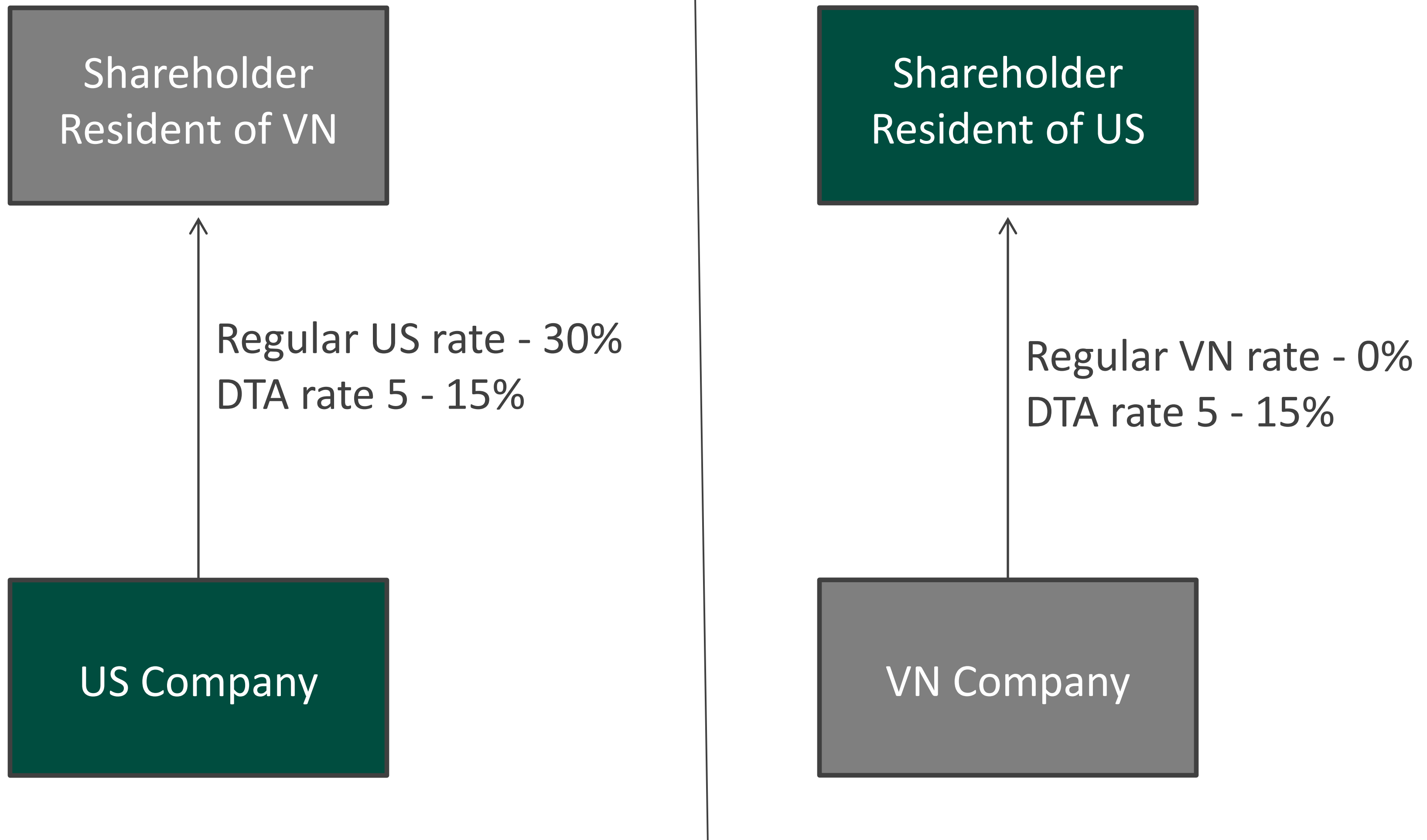
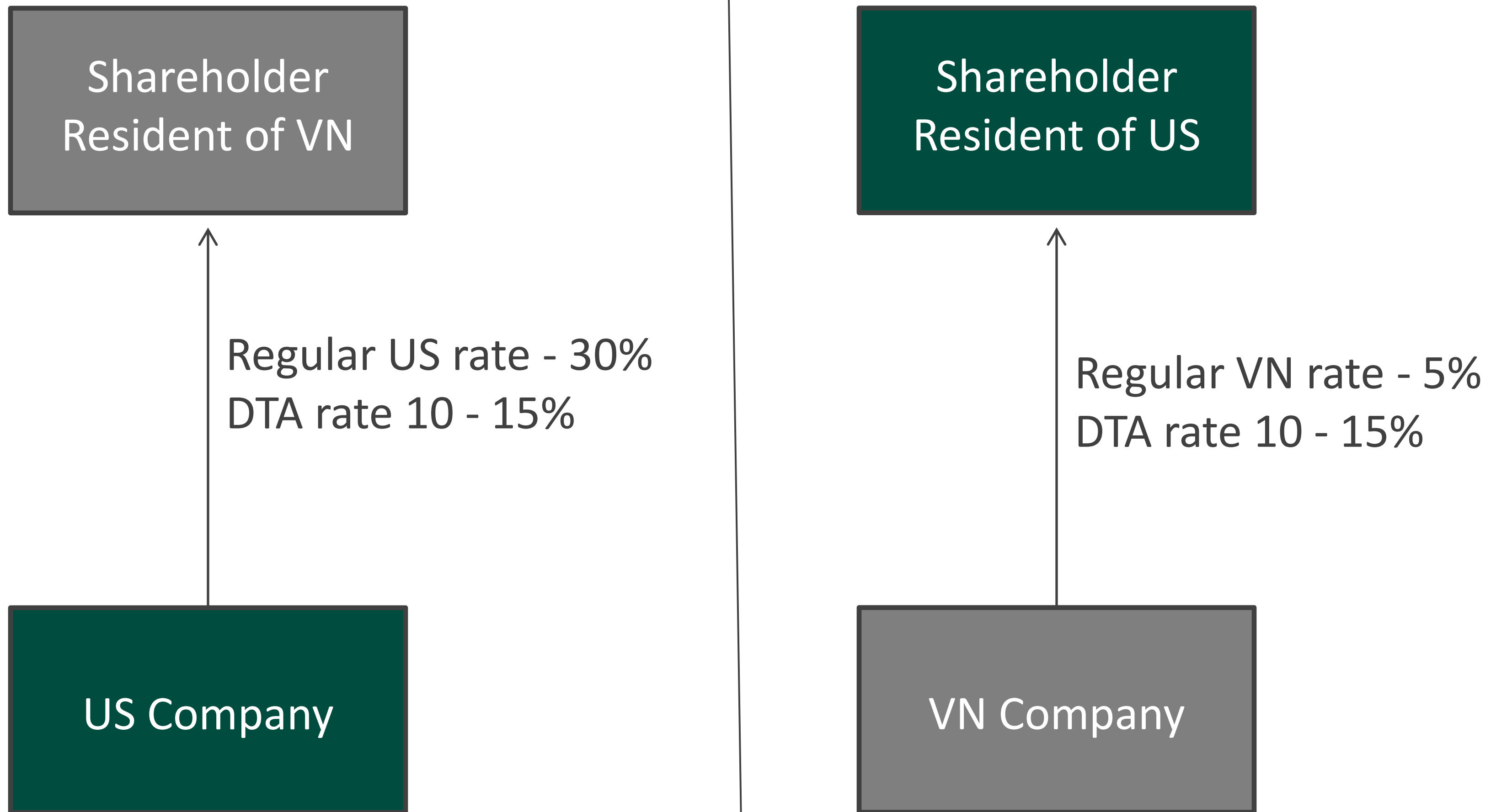
Payment	Tax Treaty Rate	VN Tax Rate	US Tax Rate
Dividends	▪ 5% if the recipient owns at least 25% of the company paying dividends ▪ 15% in all other cases	Not subject	30%
Interest	▪ Exempt if recipient is the central bank/government. ▪ 10% in all other cases ▪ 15% if the interest payment is made in reference to cash flow of the debtor	5%	30%
Royalties	▪ 5% on right to use commercial, scientific industrial equipment ▪ 10% on other royalties	10%	30%

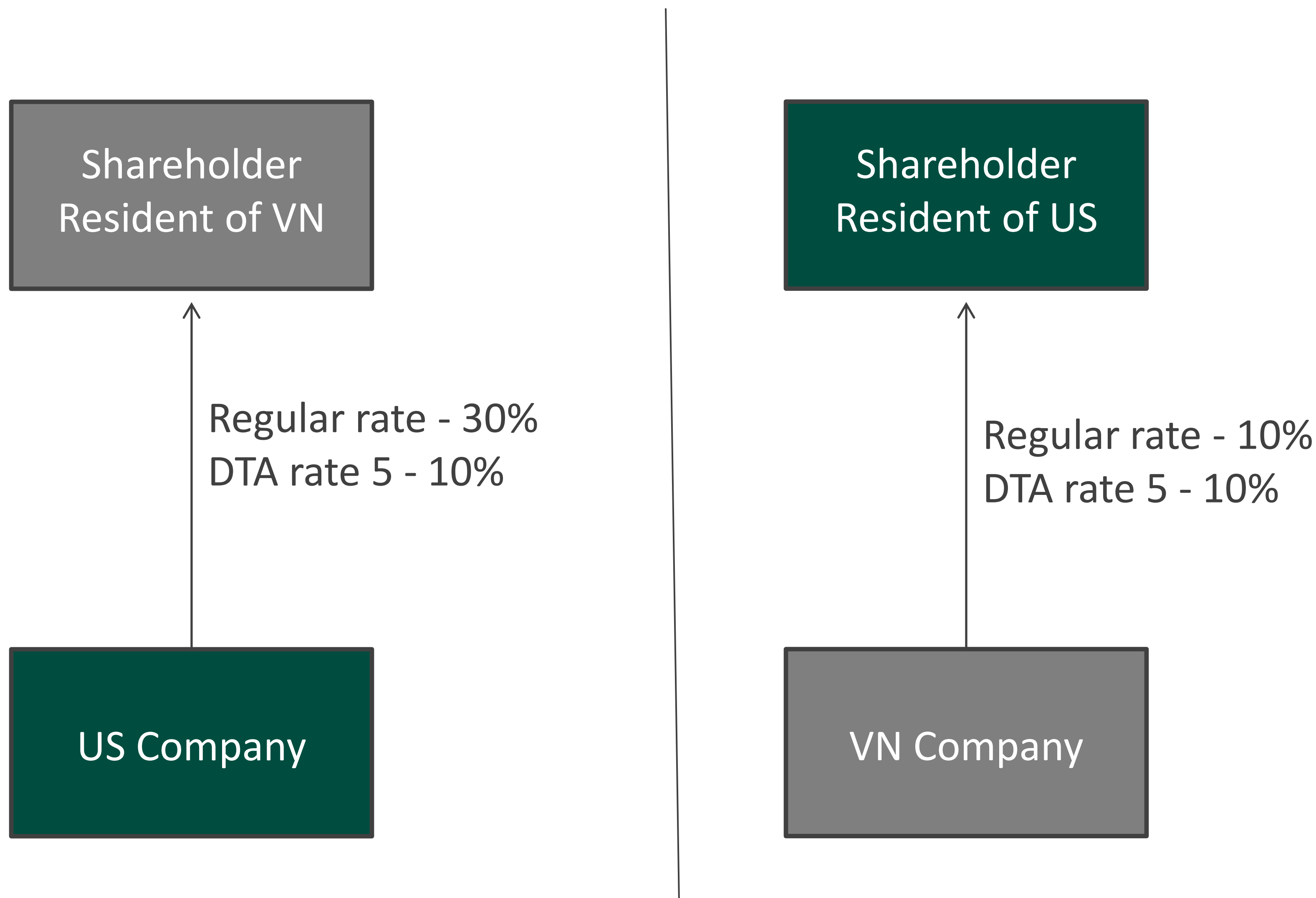
US – VN DTA: Dividends



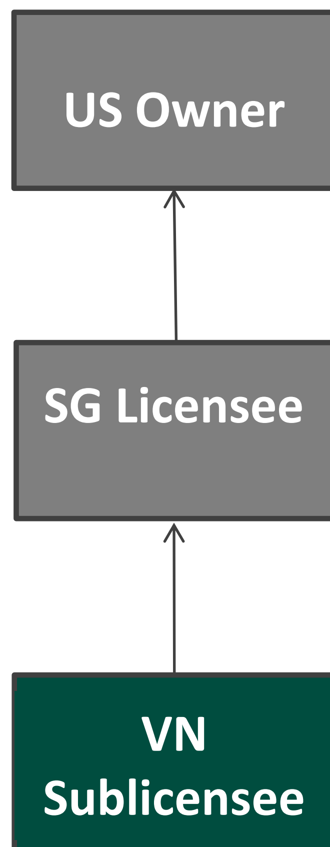
US – VN DTA: Interest



US – VN DTA: Royalties



Payments of Royalties



- The owner of the brand is a US company
- The US Company licensed its brand to a Singapore company who manages the use of the brand in Asia
- A Vietnamese company pays royalties to Singapore

	Under VN Law	Under VN-SG DTA	Under VN-US DTA
Royalties	10%	5%	10%

- What is the applicable DTA?

4 Capital Gains

US – VN DTA: Capital Gains Tax

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- In VN, capital gains in Vietnam are taxable at 22% of the gain Sale of securities by a non-resident 0.1% of the consideration
- In the US, general income tax rules apply
- Under the DTA, alienation of any (movable) property shall be taxable only in the State where seller is a resident

- <u>Except</u>
  - Immovable property
  - Shares of the capital stock of a company the property of which consist wholly or principally of immovable property situated in Vietnam may be taxed in Vietnam.
  - Alienation of a PE and business properties of a PE

US – VN DTA: Capital Gains Tax

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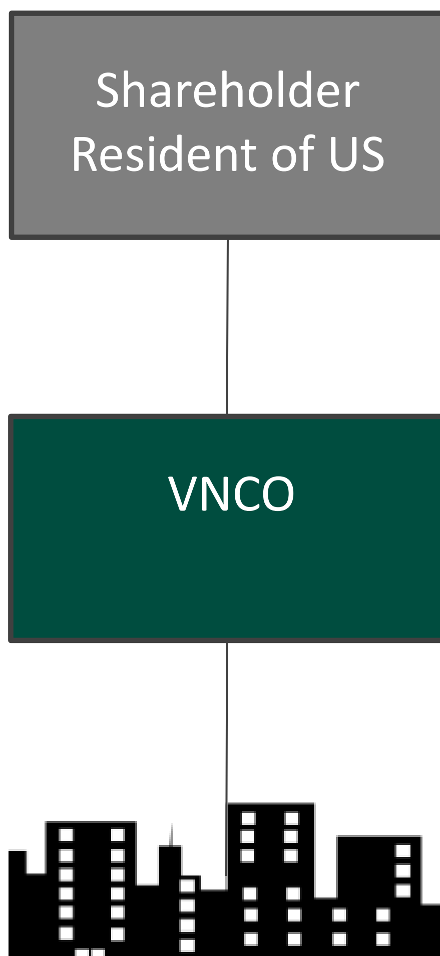

Possible exemption from income tax in Vietnam

NOTE: The VN-US DTA is less favorable compared to other DTAs because the test of determining whether the shares derive value from immovable property is only 30% or more. (Other DTAs use more than 50%)

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5 Dependent Personal Services

US – VN DTA: Dependent Services

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Income	Tax Treaty Rate	VN PIT Rate	US Tax Rate
From the exercise of employment	Possible exemption for non-residents	5% - 35% for residents 20% for non-residents	10% - 39.6%

Conditions for exemption:

- If the recipient is present in the other State for a period or periods not exceeding in the aggregate 183 days in a 12 month period;
- The remuneration is paid by, or on behalf of, an employer who is not a resident of the other State; and
- The remuneration is not borne by a resident of the other Contracting State or a permanent establishment or a fixed base which the employer has in the other State.

Case study

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Mr. Tony Stark, an American mechanic, has been sent by his US-based employer to work in Vietnam. He will continue to be paid by the US-based employer.

Mr. Stark flies in and out of Vietnam during the 12 month period. The US-based employer re-charges Mr. Stark's salary to its project office in Vietnam.

- Is Mr. Stark liable for PIT in Vietnam?
- If so, what part of his income needs to be reported in Vietnam?
- If he is subject to tax in Vietnam, can he claim exemption from taxation in the US?
- What would be required for him to obtain tax treaty relief?

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6 Challenges in making cross-border payments

Cross – border payments as tax planning tool

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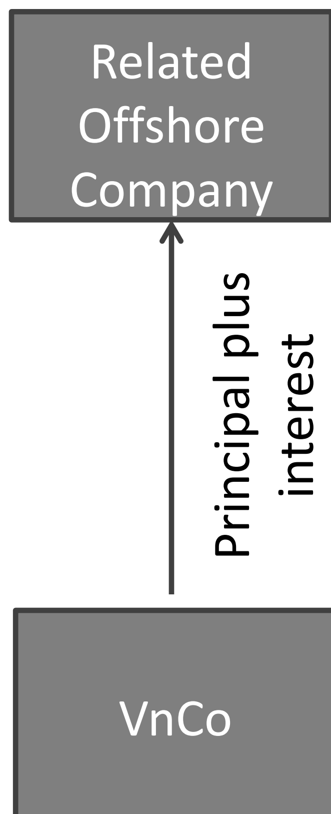

- Based solely on its business results, VnCo is a profitable company.
- But VnCo pays a loan to a related party which charges 20% interest. VnCo pays 5% FCT on the interest.
- As a result VnCo declares a loss.

Cross – border payments as tax planning tool

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- Tax rate
  - Dividends – Not subject to FCT
  - Interest – Subject to 5% FCT
- Is it more advantageous for VnCo to pay a loan and pay 5% FCT, rather than declare dividends?
- What are the issues or flaws in this tax planning scheme?

Challenges

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- US tax pick up of “deemed dividends”
- What if instead of a loan, VnCo pays royalties to the related offshore company? Service fees? Management fees?
- What are the challenges against the deductibility of these expenses in Vietnam?
- What are the challenges as to availing of tax treaty relief?

Challenge 1: Substance requirement

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1. The expenses actually arose and are related to the activities of production and business of the enterprise
2. The expenses are accompanied by complete invoices and source vouchers as required by law.
3. With respect to invoices for purchase of goods or services on each occasion for which the payment is 20 million VND or more, a receipt for payment without use of cash shall be required except

Challenge 2: Arm's length price requirement

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- All transactions between related parties are required to be conducted at market prices.
- Aggressive transfer pricing audit activities in different sectors/ transactions suspected of profit shifting.
- Application of Advance Pricing Agreements (APAs) and Mutual Agreement Procedures (MAPs) in transfer pricing planning and avoidance of double taxation.

Challenge 3: Availability of DTA relief

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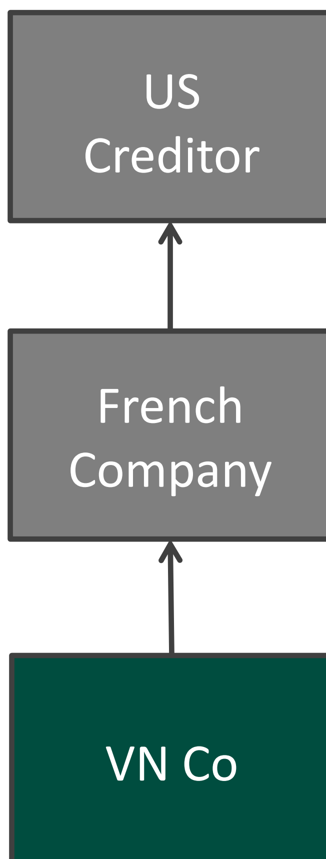

French Company borrows money from US Creditor. French Company then lends money to the VnCo. VnCo pays French Company which then pays US Creditor.

- Why would it do that?
- What do you think are the flaws in this tax planning scheme?

US-VN DTA: Limitation on Benefits Clause

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- LOB Clauses are drafted with the intention of avoiding treaty shopping
- Under the US-VN DTA, DTA relief is limited to "qualified persons." Otherwise, DTA relief will not be extended
- Examples: individuals, publicly traded corporations or those engaged in the active trade or business
- Active trade or business does not include the making or management of investments. The shell companies have no legitimate business purpose beyond minimizing tax exposure.

Vietnam's General Anti-Avoidance Circular

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- The GDT issued a circular introducing rules against abusive arrangements to obtain tax treaty relief or exemption
  - Agreements or contracts are deemed to be abusive if their main purpose is solely or mainly to obtain treaty benefits
  - Treaty relief or exemption will be denied if the recipient of the income is deemed **NOT** to be a resident of the treaty territory and the recipient is **NOT** the "beneficial owner" of the income

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Who is a beneficial owner?

- NOT a mere agent, nominee, conduit company acting as a fiduciary or administrator
- A B/O is someone with:
  - full right to use and enjoy (the income)
  - unconstrained by a contractual or legal obligation to pass the payment received to another person

Vietnam's GAAR circular

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- Vietnam's test on who is NOT a beneficial owner:
  - Use of "substance over form" test for the identification of abusive transactions
- Seven tests:
  - *As to substance of transaction*

1. The applicant is due to distribute its profit to a third country within 12 months of receipt of the income.
2. The applicant has a back to back loan, royalty or technical service agreement with a third party.

Vietnam’s GAAR circular

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- **Seven tests**
- *As to the recipient*

3. The applicant does not carry out any particular business operations except for right to income from assets.
4. The applicant’s assets, size of business and/or a number of employees do not correspond to an amount of income received, even though the applicant may have some business operations.
5. The applicant does not have any control, power or (has) a low risk over the assets, income and/or rights to future income
6. The applicant is a resident of a low or no tax jurisdiction.
7. The applicant is formed as a special purpose vehicle solely for treaty shopping purposes.

Issues that we will encounter

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- **QUESTION:** Will the seven tests be seen as mere badges of treaty abuse or will these be deemed direct evidence of abuse?
- **QUESTION:** Who bears the burden of proof? The taxpayer or the tax authority?
- **QUESTION:** Aside from denying treaty relief, will the tax authority also deny deductibility of the expense?

Thank you

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