Socialist Republic of Vietnam

TA Support for Revision of Value Added Tax and Corporate Income Tax Laws

Restructuring Corporate Income Tax and Value Added Tax in Vietnam
An Analysis of Current Changes and Agenda for the Future

January 2014

EASPV

EAST ASIA AND PACIFIC
Restructuring Corporate Income Tax and Value Added Tax in Vietnam

An Analysis of Current Changes and Agenda for the Future

January 2014
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The Corporate Income Tax (CIT) and the Value Added Tax (VAT) constitute the workhorse of the Vietnam tax system and each generates about 7% of GDP in revenues. Together they account for almost two-thirds of the total tax revenues. Their revenue performance compares well with most of the neighboring ASEAN countries.

Prior to the introduction of a VAT, Vietnam had adopted a turnover tax in October 1990 which was replaced by a VAT in 1999. Several rounds of amendments have been carried out since then with some major changes adopted in 2003, 2006, and 2008. Further changes have been recently approved by the National Assembly (NA) in 2013 and are due for implementation. Similarly, a profits tax was first introduced in 1990 and was subsequently replaced by CIT in its present form in 1999. It has since been amended in 2003, 2008 and the NA has again legislated some changes in 2013 with a view to removing some anomalies and providing a more business-friendly tax environment.

The government of Vietnam has thus made great strides in putting into place a modern tax system. The tax structure however is still evolving to keep pace with continued changes in domestic economy as well as the global environment. The recent amendments approved in 2013 by the National Assembly in the two tax laws are meant to further rationalize the tax system, make it more transparent in order to enhance Vietnam’s investment friendly image while at the same time maintaining revenue adequacy and buoyancy of the revenue system.

This report was prepared as a collaborative product of the World Bank in Vietnam and the Tax Policy Department (TPD) of Ministry of Finance (MOF) in the context of preparation for amending the Corporate Income Tax Law and the Value Added Tax Law. The report focuses not only on evaluating the corporate income tax and the value added tax as they stand today, but also going a step further offering comments on addressing pending issues for the subsequent deliberations by the authorities in the future and in particular in view of the international experience to contribute to the implementation of the Government’s Financial Development Strategy and Tax Reform Strategy 2011-2020. The report is expected to deepen analysis, in particular in policy area of enabling business environment, to justify the World Bank’s support through series of Economic Management and Competitiveness Credit (EMCCs), as well as maximize synergy with the implementation of Tax Administration Modernization Project (TAMP) financially and technically assisted by the World Bank.

The main report was prepared by Gangadha Parasad Shukla and Sandeep Bhattacharya from the Sanford School of Public Policy at Duke University, under the World Bank’s Technical Assistance led by Duc Minh Pham. The TTL and the authors would like to express our gratitude to other contributors to the report, consisting of Habib Rab and Indira Iyer from the World Bank, Lan Van Nguyen and Viet Anh Nguyen from IFC, Nguyen Van Phung, Pham Dinh Thi, Huynh Vuong Nam, and Le Thuy Linh from Tax Policy Department (TPD) and Truong Ba Tuan from National Institute for Finance (NIF) of Ministry of Finance (MOF), Nguyen Thi Thanh Hoai and Ly Phuong Duyen from Academy of Finance, Nguyen Ngoc Anh and Nguyen Thi Phuong Mai from the DEPOCEN. We would like to thank Khanh Linh Thi Le for the editorial and administrative support. The team would like to record a special thanks to Victoria
Kwakwa, Sudhir Shetty, Sandeep Mahajan, and Deepak Mishra of the World Bank and Ms. Vu Thi Mai, Vice Minister of Finance for providing their leadership, guidance, and support during the report preparation and dissemination.
<table>
<thead>
<tr>
<th>Abbreviation</th>
<th>Full Form</th>
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<tbody>
<tr>
<td>AETR</td>
<td>Average Effective Tax Rate</td>
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<td>ALP</td>
<td>Arm's length principle</td>
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<td>AMT</td>
<td>Alternative Minimum Tax</td>
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<td>ASEAN</td>
<td>The Associate of Asian Nations</td>
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<td>BOT</td>
<td>Building, Operations, Transfer</td>
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<td>BRICS</td>
<td>Brazil, Russia, India, China and South Africa</td>
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<tr>
<td>BT</td>
<td>Business Tax</td>
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<tr>
<td>BT</td>
<td>Building, Transfer</td>
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<tr>
<td>BTO</td>
<td>Building, Transfer, Operations</td>
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<tr>
<td>CDM</td>
<td>Clean Development Mechanism</td>
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<td>CERs</td>
<td>Carbon Emission Reduction Certificate</td>
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<td>CFC</td>
<td>Controlled Foreign Company</td>
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<td>CIT</td>
<td>Corporate Income Tax</td>
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<td>CPI</td>
<td>Consumer Price Index</td>
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<tr>
<td>CPM</td>
<td>Cost Plus Method</td>
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<tr>
<td>CUP</td>
<td>Comparable Uncontrolled Price</td>
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<tr>
<td>DTAAs</td>
<td>Double Taxation Avoidance Agreement</td>
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<tr>
<td>EBIT</td>
<td>Earnings before Interest and Taxes</td>
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<tr>
<td>EBITDA</td>
<td>Earnings before Interest, Taxes, Depreciation and Amortization</td>
</tr>
<tr>
<td>EMCC</td>
<td>Economic Management and Competitiveness Credit</td>
</tr>
<tr>
<td>EU</td>
<td>The European Union</td>
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<tr>
<td>FCCT</td>
<td>Foreign Contractors Tax</td>
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<td>FDI</td>
<td>Foreign Direct Investment</td>
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<td>FEA</td>
<td>Free Port Areas</td>
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<td>FMV</td>
<td>Fair Market Value</td>
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<td>FTZ</td>
<td>Free Trade Zones</td>
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<td>GDP</td>
<td>Gross Domestic Product</td>
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<td>GNI</td>
<td>Gross National Income</td>
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<td>HQs</td>
<td>Headquarters</td>
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<tr>
<td>IEF</td>
<td>Institute of Economics and Finance</td>
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<tr>
<td>IMF</td>
<td>International Monetary Fund</td>
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<tr>
<td>IPCs</td>
<td>International Procurement Centers</td>
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<tr>
<td>IRS</td>
<td>Internal Revenue Services</td>
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<tr>
<td>LLC</td>
<td>Limited liability companies</td>
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<td>LLP</td>
<td>Limited liability partnership</td>
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<tr>
<td>M&amp;A</td>
<td>Mergers and Acquisitions</td>
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<td>MAT</td>
<td>Minimum Alternative Tax</td>
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<tr>
<td>MNCs</td>
<td>Multinational Companies</td>
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<td>MOF</td>
<td>Ministry of Finance</td>
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<td>NA</td>
<td>National Assembly</td>
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<tr>
<td>Acronym</td>
<td>Description</td>
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<tr>
<td>OECD</td>
<td>Organization for Economic Co-operation and Development</td>
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<td>OHC</td>
<td>Operational Headquarters Companies</td>
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<td>PE</td>
<td>Permanent Establishment</td>
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<td>PIT</td>
<td>Personal Income Tax</td>
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<td>PSM</td>
<td>Profit Split Method</td>
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<td>PT</td>
<td>Profit Tax</td>
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<tr>
<td>R&amp;D</td>
<td>Research and Development</td>
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<td>RDCs</td>
<td>Regional Distribution Centers</td>
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<td>RPM</td>
<td>Resale Price Method</td>
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<td>SA</td>
<td>South Africa</td>
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<td>SBV</td>
<td>The State Bank of Vietnam</td>
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<td>SCT</td>
<td>Special Consumption Tax</td>
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<td>SEZ</td>
<td>Special Economic Zones</td>
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<tr>
<td>SMEs</td>
<td>Small and Medium Enterprises</td>
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<td>SOEs</td>
<td>State Owned Enterprises</td>
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<td>ST</td>
<td>Science and Technology services</td>
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<td>TNMM</td>
<td>Transactional Net Margin Method</td>
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<tr>
<td>TPD</td>
<td>Tax Policy Department</td>
</tr>
<tr>
<td>TREs</td>
<td>Tax Resident Enterprises</td>
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<tr>
<td>UK</td>
<td>The United Kingdom</td>
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<td>UN</td>
<td>The United Nations</td>
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<td>US</td>
<td>The United States</td>
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<tr>
<td>VAT</td>
<td>Value Added Tax</td>
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<td>VSPB</td>
<td>The Vietnam Social Policy Bank</td>
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<td>WHT</td>
<td>Withholding Tax</td>
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EXECUTIVE SUMMARY

The study is in two parts, part one covering the various policy aspects of Corporate Income Tax (CIT) and includes issues such as expenses and deductions to determine the tax base, transfer pricing, thin capitalization, taxation of special entities, and tax incentives. All this is done in the backdrop of international experience of corporate income taxes applied globally. Finally, alternatives for rate rationalization and their impact on CIT revenues using a forecasting model are examined. The existing provisions of the law are referenced in this part of the study as well, and further scope for reform discussed as necessary.

Part two of the study presents a similar analysis of value added tax as well as forecasting of VAT revenues. This chapter examines the present rate structure including zero-rating, exemptions and exclusions from VAT, and VAT refunds. Taxation of some special sectors such as agriculture, real estate and exports is also analyzed. All this is again done in the milieu of international experience of value added taxes in OECD countries, BRICS countries and the countries of ASEAN so as to get a practical and realistic picture. Finally, a revenue forecasting model for VAT is presented with a guideline for estimating VAT threshold for exempting small traders. All the chapters make reference to the present provisions in law and also the way forward to further strengthen and streamline the VAT.

As mentioned earlier, tax reform is more of an evolutionary rather than a one-time exercise. This study should therefore be read as a reference document for the existing tax laws of CIT and VAT, their strong and weak points and what remains to be done. The international experience included in both parts helps validate the suggestions and proposals for future tax reform.

The executive summary presents the findings of the study along with the way forward for both the taxes, first CIT and then VAT.

The Corporate Income Tax (CIT)

The latest amendments in the CIT law were made recently in June 2013. Following the World Bank’s policy dialogue with the Government of Vietnam, the CIT Law of 2008 was revised in June, 2013. The revised law includes the following significant changes.

Expansion in Tax Base and Exemptions

- All resident establishments of a foreign enterprise are liable to pay CIT tax in Vietnam irrespective of source of income.
- “Other income” in category of taxable income now includes income from the transfer of investment projects, transfer of the right to participate in investment projects, to do exploration, mining and processing and right to utilize assets including intellectual property.
- There are now four new tax exempt categories including incomes from the transfers of the Certificates of Emission Reduction (CERs). Incomes of the State Development Bank of Vietnam (VDB) and the Vietnam Social Policy Bank (VSPB) are also tax-exempt.
**Deductible Expenses**

- Bank transfer vouchers are required for deductibility of expenses over of VND 20 million, while the cap for advertisement/promotional expenses has been increased from 10% to 15% for all enterprises.
- Funding for only certain categories of donations are allowed, all others are denied.
- A new category of non-deductible expenses has been added: voluntary contributions to the pension fund or social security to employees of the businesses are non-deductible in excess of certain norms.

**Tax Rates**

- A significant change has been made in tax rates: the standard CIT rate has been reduced from 25% to 22% and further reduced to 20% from January 1, 2016.
- Enterprises with total revenue of less than VND 20 billion (US$1 million) are liable to pay CIT at a lower rate of 20%, rate for minerals income remains in the range 32%-50%.

**Tax Incentives**

- The scope of investments entitled to tax incentives has been broadened and now includes preferential tax of 10% for software production, renewable energy, clean energy, waste energy, development of biological technology, and environment protection etc.
- A new amendment now offers preferential CIT rate at 10% to large manufacturing projects in excess of VND 6,000 billion (US$300 million) and projects in selected industrial zones, social housing, incomes from planting, protecting of forests etc.
- The law now provides preferential rate of 20% for a larger list of industries including investments in energy-saving projects, manufacturing of irrigation equipment; production and processing of cattle, poultry and fishery feed etc. Starting January 2016 the rate will be 17%.
- The new law extends the duration of concessional rates to enterprises that expand the productive scope, increase their capacity or renovate their productive technology.

These are significant changes in the law but some improvement still need to be undertaken by the government. Many of these changes are far reaching in their implication in terms of tax base, tax rate and particularly tax incentives. Below are discussed some avenues where there is still scope for improvement. These may form the future agenda for tax reform in Corporate Income Taxation.

Presently the top rate has been reduced from 25% to 22%, with a lower rate of 20% for smaller firms. This amendment in law was to follow the Tax Reform Plan 2011-2015 of Ministry of Finance. The Government expects that this will improve the country’s attractiveness to investment. However, this should also be accompanied by the following steps:

- There should be one single tax rate for all non-exempt and non-natural resource companies.
- Rate reduction should be followed by rationalization of the tax incentive schemes where some investments presently enjoy tax exemptions or 50 percent reduction in tax rates.
Preferably a single rate for companies involved in mining and exhaustible minerals extraction and processing at 50%, including oil and gas should be adopted.

The present list of exempt incomes can continue for the time being with minor modifications.

Measures to secure tax revenue and fiscal sustainability, including implementation of tax administration reform, broadening of the tax base, and rationalization of tax exemptions

Presently the criteria for receiving tax incentives are complex and these should be simplified. The overlapping incentives to industries established within the economic zones are not necessary as they already receive several advantages by virtue of their location in the zones. Also, research findings indicate that outright tax exemption or tax holidays are not cost-effective. Government is not able to evaluate the amount of revenues lost and many companies disappear at the end of the incentive period and reappear as new enterprise to claim tax holiday/exemption afresh. Thus it becomes a drain on the government revenues. Also, it is not even clear from the existing research whether tax incentives promote enough additional investment to justify the revenues lost.

Vietnam is already adopting a generous tax regime, so additional incentives may not be called for. A single rate of taxation for CIT for non-mineral companies (22%) has been legislated and this will be further reduced to 20% from January 1, 2016. In addition, preferential rate of 10% has been adopted for many sectors and some special types of businesses. It is more advisable to choose a single non-mineral rate that can be low enough to be investment friendly as well as generate adequate revenues and simplify tax compliance and tax administration. The best may be to do away with tax holidays, reduced rates and special deductions and multiple rates and to have one single non-mineral rate at 22%, and a single mineral rate of 50%. If this is done, the tax system would be still very attractive and business friendly and the government is not likely to lose revenue in the long run. Revenue forecasting models show that with this type of changes, there may not be any significant change in the levels of revenue.

The government may contemplate introducing a comprehensive category of “not for profit organizations” that are given tax exempt status. This category should include organizations after being examined on a case by case basis by the tax authorities, and periodic review as is the practice in USA. This will help simplify tax administration and compliance in the long run. Not only will these “not for profit organizations” themselves be tax exempt, donations to these organizations can be made PIT or CIT deductible at the discretion of the government in line with social objectives, subject to reasonable limits. Government owned agencies or organizations may also be given this status if they are indeed completely owned by the government, or if they genuinely do not seek to earn profits. Incomes from certain socially desirable operations of the State Development Bank Vietnam and beneficiaries of the Social Policy Bank have now been exempted in the revised CIT law of 2013. If the principle of allowing organizations to register as tax – exempt organizations under the CIT law is followed such organizations in the future, both government and private, may be easily accommodated. For instance, undistributed profits of private higher education may be placed in this category.

There is a cap on expenditures for advertising and other forms of sales promotion even after the 2013 tax law revision, but this is not necessary. The cap on such expenditures has been raised from 10% to 15% but this category of expenditures is usually essential for conducting business and placing a limit seems unjustified. However, these expenditures should be allowed only if backed by proper invoices/vouchers. Also, there has to be clear rules about when entertainment expenses are
business promotion and when they become employee benefit. Deductible expenses must be certified in case of non-cash payment:

Additional regulations to govern funding under the State program for geographical areas with particularly difficult social and economic conditions as deductible expenses are not called for. Since abolition of all tax incentives and tax holidays is being recommended here as a preferred policy option, this category (local geographical areas with particularly difficult social and economic conditions) may no longer relevant. If the government introduces provisions for non-profits and simultaneously abolishes tax incentives this provision may be redundant.

Additional provisions on thin capital may be considered. It is desirable to have regulations on deductible expenses of borrowing costs in the case that the ratio of business loans to total equity is too high. This regulation will ensure financial security for businesses and for the economy. The absence of provisions to control expenses in the case of “thin capital” is of particular concern in the context of transfer pricing by foreign owned or invested enterprises. In doing this, many definitions and issues will still need to be clarified. It is important to have clear and comprehensive definitions of "debt", "equity" and "interest" in the CIT Law. A clear definition of "credit institutions and banks" would also be necessary to ensure appropriate scope and application of the proposed rule

Regulations on nondeductible expenses for expenses in excess of the approved consumption of raw materials, fuel, energy, goods should be removed. Allow enterprises to deduct expenses for raw materials, fuel, energy, according to the actual invoices if valid. Normally, tax laws incorporate provisions on how to deal with goods lost or damaged due to fire; obsolescence etc. and these can cover inputs used in production as well as wasted inputs. Issues of excessive input deductions can be dealt with through audit.

An important issue is how many sets of accounts a business enterprise is required to maintain under the revised CIT law. It is not desirable that losses from a lower rate be applied to income from a higher rate and so three sets of accounts should be maintained under three heads (0%, 22% and 50%) to simplify the tax structure. The tax laws do not prescribe any method of maintaining accounts but this may be necessary. Large businesses with a turnover over a particular amount and companies should be obliged to maintain accounts and get them audited by an Accountant. A company should not be allowed to move from one system to another from year to year. The maintenance of accounts in the manner prescribed by statute can also counter tax evasion attempts by showing incorrect debts and expenditures

The issue of Tax integration should be on the future agenda of tax reform. One of the issues that the Government of Vietnam still has to address is tax integration. If however, the government feels that dividends and capital gains accrue mostly to the rich and they are not likely to correctly pay PIT on dividends (or capital gains), then the government should apply as much of the tax as it can at the corporate stage. Also, to encourage long-term investments, the government can consider introducing provisions for the indexation of the purchase price to compute capital gains tax in line with international practices.
The Value Added Tax (VAT)

The last amendments to the VAT Law 2008 were made in June 2013. The law applied to value added taxes had been primarily the VAT Law of 2008 and it was recently revised in June 2013. The main revisions to the VAT Law include providing clearer criteria for tax exemptions and providing a VAT threshold. These revisions simplify tax assessment, create more favorable conditions for small taxpayers, and will enhance efficiency in tax administration. A summary of these amendments is given below.

Exemption

✓ The Act now clearly specifies that salt products would be exempted only if the main ingredient has the chemical formula NaCl.
✓ Some new financial services are now tax exempt, e.g. health insurance, fisherman insurance, lending services of the taxpayers, debt selling, foreign exchange trading, collateral assets of debts sold by state owned enterprise handling the non-performing loans of credit institutions.
✓ Tax exempt status of public services of sanitation and water drainage in streets and residential areas has been removed.
✓ A new category of “money” (notes and coins) is made tax exempt to remove the obstacles in the importing and exporting processes.
✓ The criterion for tax-exempt business has been changed from income basis to turnover basis.

Taxable Price

✓ The taxable price for goods and services now includes the environmental protection tax (similar to import duties in the taxable value for imported goods).
✓ The taxable price for asset leasing now includes the lease prices for imported machinery (this removes the incentive to lease rather than purchase such machinery).

VAT Rates and Zero-Rating Exports

✓ Exports of goods and services would be zero rated only if they were consumed “outside Vietnam, in the non-tariff zones, and in some cases provided to foreign customers in accordance with the Government’s regulations”.
✓ Preferential rate of 5% for mineral ores used for fertilizer production has been removed and would be now 10%.
✓ A preferential VAT rate of 5% applies to selling/renting/leasing of social residential houses.

Vat Threshold and Computing methods

✓ A threshold of VND 1 billion based on the annual turnover has been now introduced.
✓ Enterprises above this threshold are now required to apply the invoice credit method to calculate VAT liability.
✓ For businesses below threshold, a presumptive turnover tax at rate varying from 1 to 5% depending on the nature of business activity has been mandated.
Subtraction method has to be used for enterprises and cooperatives below the VAT threshold. Subtraction method will also apply to household businesses, gold, silver and precious stones.

Foreign contractors in the areas of oil and gas must pay VAT by the invoice credit method.

Credit of Input Value Added Tax

The revised Law allows deduction of the input value added tax for goods lost or destroyed due to natural disasters, fires, accidents, and spoilage.

The new Law allows for non-cash payment through credit cards too.

VAT Refunds

The minimum refund limit of of 200 million dongs has been raised to 300 million dongs.

New tax refund clauses have been added to encourage tourism and mechanise exports.

Foreigners are now entitled to VAT refund when leaving the country.

VAT refund is also allowed for programs/projects using official development assistance (ODA), or non-refundable grant and humaitarian aid and for those having diplomatic immunity.

These are substantial changes in the law but some areas of improvements have still to be taken up by the government and the National Assembly. Vietnam has come a long way in Tax Reform in VAT. Below are however some areas where there is still scope for improvement. This should form the future agenda for going forward.

Presently, Vietnam has two tax rates in addition to a zero rate; it may consider moving to a rate structure with zero and one positive VAT rate of 10%. Multiple rates generally increase the administrative and compliance costs without any corresponding benefits in terms of revenues or improved equity. The rate of 5% may therefore be eliminated and the goods subject to this rate may either be moved to the 10% category or made VAT exempt or zero-rated if these are considered essential goods predominantly consumed by the low income group people. This will also be in line with the prevailing rates in the neighboring ASEAN countries.

The tax rate of zero percent is applied to export of goods and services, including those goods and services which are otherwise exempt from VAT, and international transportation. There are however a few select services that are not zero-rated. The definition of exports subject to zero-rating needs to be made more specific. Some services and unprocessed mineral resources are excluded from the application of zero rating on export (article 8 on exemptions), but their exempt status on export is also not explicit. The status of such services should be made more explicit. Also, the draft law presented to the NA left it to the government to decide what items may be provided to “foreign customers” at zero rate. The list of such items should be clearly specified as should the list of beneficiaries.

Zero-rating may be further rationalized by applying a zero rate on all exports and listing only the exceptions. To apply the destination principle fully, there is no need to list the specific goods and services granted zero rating, it is better to zero rate all goods and services exported and explicitly deny zero-rating to the chosen few. For instance, if the government wants to discourage export of low
value added natural resources, it can continue to deny zero rating to these items. Rather than excluding specific services from zero rating, and taxing them as exempt services on export, it may be a better idea to zero rate all services that are exported in accordance with a set of rules and regulations defining the place of supply of service or point of sale. Countries in the region have already issued such rules (Singapore and India) and the OECD is in the process of preparing a set of guidelines that the government may like to consider.

The current list of exempt items needs to be scrutinized and only a few of the 25 items should remain exempt. The list of exempt goods and services is too large and most of them may be moved to the taxed category. Generally VAT exemptions are justified only on distributional/equity grounds or when they are hard to tax. Therefore, only financial services, primary education, basic healthcare (not higher education provided on commercial basis and specialized health services), some cultural and merit goods and services, aid financed activities, resale and rentals of real estate and clean drinking water provided on non-commercial basis are good candidates for tax exemption.

Other goods and services included in the exempt category should be moved to taxed category. The rest of the items may be moved to the taxed category, for instance, agricultural and livestock products, dredging, irrigation and harvesting performed by the private sector on commercial basis, all sales of new real estate inclusive of land value, for profit medical services, and most other services if provided on a commercial basis for profit should be under VAT. With the introduction of the new VAT threshold at 1 billion VND, many of the exemptions presently being given for equity reasons may be removed, most of them would be covered under the threshold in any case. Only services provided by public agencies on a non-commercial basis deserve to remain VAT exempt. Gold imports should be taxed just like other imports. Imports of certain machinery and equipment may be taxed on a deferred basis until operations start and input credit is available to prevent large refund claims.

When moving an item from the exempt list to the taxed list, care should be taken to ensure that the sales price of good/service is not below market or that the price is not subsidized. In the absence of such caution, the VAT refund on inputs may exceed the VAT on the output and the government may end up losing revenues. In such cases, it is better to leave the good/service in the exempt category. Also, any provision that makes it more attractive to lease rather than sell assets solely due to VAT charged should be removed.

The current practice of having a zero threshold of exempting small traders leads to high administrative and compliance costs without any commensurate revenue yields. This practice was recently changed in 2013 and a ceiling of 1000 million dongs for registration under VAT has been approved by the NA. The final choice of threshold in the long run should be based however, on the tradeoff between the cost of administration and revenue implications. For the 11 million households who would have to declare and pay VAT on their agricultural products, the newly imposed threshold will exclude most small farmers and have them liable to a simplified presumptive tax on turnover. Direct sellers of domestic produce (farmers etc.) will continue to be exempt. Another lower threshold below which there should be no taxation or registration is also necessary because in such cases the revenues may not be even adequate to cover the costs of administration and/or compliance. Currently the government is considering 100 million dongs of turnover as the lower threshold.
For the small traders below the exemption threshold of 1,000 million dongs, some sort of taxation should be envisaged. Applying a turnover tax of 2-3 per cent which is then tax deductible by the next registered buyer would be in accordance with the international best practice. This should be a flat rate for all sectors and not different rates by sector as has been incorporated in the law. This will again give rise to classification disputes and raise administrative costs. This “presumptive” tax should not be linked to PIT or CIT since all enterprises are required to pay CIT regardless of size while household enterprises are not required to pay CIT. This has been incorporated in the latest revision.

The provision of voluntary registration for small traders should be kept in the law. Some small traders may find it beneficial to register under VAT voluntarily and there should be a provision in the law to accommodate such traders. With the implementation of the threshold, taxpayers whose turnover for a year or 12 consecutive months is higher than the upper threshold will file and pay tax by the credit method, and taxpayers whose turnover is below the upper threshold (1000 million dongs) but above the lower threshold (100 million dongs) will pay VAT according to the percentage of sales.

In case a business has both taxable and excluded or exempt goods and services then only the turnover from the sales of taxable goods and services would be used to determine the business turnover for the threshold purpose. For the newly established businesses, taxpayers could choose one of the two options on taxation or can voluntarily register for the tax credit method except for household enterprises which would be subject to the presumptive tax. If, at any time during the year, any business exceeds any of the two thresholds, they must register immediately in the appropriate category, maintain prescribed records and start collecting and paying the appropriate VAT. To ensure stability in case that business turnover is volatile, businesses will be required to apply a stable tax calculation method (the tax credit method or the presumptive method for VAT) in the next fiscal year or 12 months.

With the adoption of the threshold for small traders, credit method would be applied across board. This would imply that the subtraction method of VAT calculation for small traders stands abolished. Thus only the credit invoice method for large firms and presumptive tax for small ones are sufficient. However, the government is planning to retain this method for gems and gold, which is not necessary.

The existing provisions for refunding are complicated and vary with the nature and activity of a particular business. The present VAT rules in Vietnam are complicated and vary with the nature and activity of a particular business: a different set of rules is applicable for businesses operating under the subtraction system, exporting businesses, and businesses undertaking investment activities. Also, there is no justification for distinguishing between the VAT refunds on capital goods versus VAT refund on other inputs. To prevent fraud based on input claims by disappearing companies, such new companies that claim large refunds from new investment should be audited to make sure they are genuine. The solution lies in increasing audit and enforcement capacity, not in delaying refunds by a year by default which imposes a real cost of capital on businesses and is not likely to encourage exporters or investors. Also, all new businesses must be audited for a couple of years before getting refund to make sure it is a genuine unit and not a scam.

The raising of threshold for refund to 300 million VND from 200 million VND except for exporters and large investors takes care of inflation to some extent. This threshold is still on the
lower side and should be increased to 500 million dongs. Also, a carry forward period of three months may be applied to every business and a threshold for obtaining the current period refunds may also be fixed but it should not be excessive and should remain uniform across different businesses. Allow all exporters who export more than a certain percentage of their output to claim refunds monthly based on their return filing frequency even if below the threshold of 500 million, and extend a similar benefit to large investors based on a transparent ratio criterion. Excess input tax should be preferably refunded fully after each tax period which happens to be quarterly in case of Vietnam. Also, shorter time periods to claim refunds should be allowed to exporters and investment projects. A waiting period of 1 year is too long. The standard default period for refund claims should be at most 3 months if the refund amount is below 500 million VND.

**Deduction of input VAT on goods lost or destroyed would now be allowed as recently legislated.** If the input VAT of lost goods and services is not deductible, businesses will be unable to recover the VAT paid on lost or destroyed goods. These provisions existed in decrees and they were simply regularized. On the other hand, the provision allowing investment input credit for all capital goods even in cases where some goods produced are taxable and some are not is proposed to be deleted. Similarly, the proposal to apportion input credit based on separate accounting where some goods produced are taxable and some are not, failing which the input credit is to be apportioned by percentage of turnover of taxable and non-taxable output should be approved. Thus, it would a good idea to introduce a clear and simple rule to apportion credit in cases of taxable and non-taxable goods.

**Real estate should be taxed at the point of first sale of the new residential or business construction at market price.** Subsequent resale of real estate should ideally not be taxed. Following the international best practice, in order to avoid distorting choice between house ownership and renting, commercial leasing of residential property is also generally exempt.
PART 1 - Corporate Income Tax
Chapter I: Introduction

A profits tax was first introduced in Vietnam in 1990 and was levied on the income of all business enterprises whether private sector, state sector or established through foreign investment. The tax had a broad coverage with few exemptions. The corporate income tax in its present form was introduced in 1999. It was later amended in 2003 with a view to abolishing discrimination among different sectors of the economy, attracting more investment and enhancing tax revenues. It was amended again in 2008 effective January 1, 2009 to remove certain anomalies and provide a more business-friendly tax environment. Presently, this tax is one of the major sources of revenue in Vietnam and has been generating between 3.5 and 5 per cent of GDP in tax revenues in recent years.

The legal documents examined for assessing Corporate Income Tax in Vietnam include:

(a) CIT Law No.14/2008/QH12 of June 3, 2008 promulgating the Law on Enterprise Income Tax;
(b) Decree No. 124/2008/ND-CP of December 12, 2008 detailing the implementation of the Law on Enterprise Income Tax;
(c) Decree No. 122/2011/ND-CP of December 27, 2011 detailing the implementation of the Law on Enterprise Income Tax;
(e) Decision No. 53/2004/QD-TTg of the Prime Minister dated April 4th, 2004 on policies to encourage investment in the Hi-tech Park;
(f) Decision No. 206-2003-QD-BTC, 12 December 2003 on management procedure for use and depreciation of fixed assets;
(g) Circular No. 05/2005/TT-BTC, November 1st, 2005, Guiding the regime of tax applicable to foreign institutions without Vietnamese legal status and foreign individuals engaged in business or with income incurred in Viet Nam; and

Features of the Corporate Income Tax

Taxpayers

Organizations engaged in goods production and trading or service provision are subject to enterprise or corporate income tax. These include state enterprises, limited liability companies, joint-stock companies, partnerships, private enterprises, cooperatives and foreign-invested enterprises.

Similarly, foreign companies doing business and earning incomes generated in Vietnam are subject to this tax. Taxable entities include resident establishments of foreign companies comprising
manufacturing and business facilities through which the foreign companies conduct a part or all of their production and business activities in Vietnam such as:

(a) Branches, executive offices, factories, workshops, means of transportation, mining, oil and gas fields or other sites of extraction of natural resources in Vietnam;
(b) Construction sites, works of construction, installation or assembly;
(c) Establishments providing services, including consultancy services through employees or an organization or individual;
(d) Agents for foreign enterprises;
(e) Representatives in Vietnam of authorized representatives empowered to sign contracts in the name of foreign enterprises or representatives not authorized to sign contracts in the name of foreign enterprises but regularly delivering goods or providing services in Vietnam.

**Tax Exempt Income**

(a) Income earned from agricultural production activities of Co-Operatives;
(b) Income earned from performance of technical services directly serving agricultural production;
(c) Income earned from performance of contracts for scientific research and technological development; from products during their period of test production, and from products made from new technology applied for the first time in Vietnam¹;
(d) Incomes from the production and business of enterprises that employ disabled persons, detoxified people (former drug addicts now rehabilitated) and HIV sufferers. This excludes other incomes or income from activities outside the main business activities of the enterprise concerned. The number of these special category employees must be at least 30% of the average number of workers in a year employed by the enterprise. Enterprises engaged in financial activities or real estate are not entitled to this exemption and neither are enterprises that employ less than an average of 20 persons during a year;
(e) Income earned from occupational training activities specially reserved for ethnic minority people, disabled people, children living in particularly difficult conditions and reformed offenders;
(f) Income distributed to an investing company that are in the nature of return for capital contribution, joint venture and/or association with a domestic enterprise after payment of corporate income tax in accordance with CIT Law by the investee;
(g) Aid funds received for use in educational, scientific research, cultural, artistic, charitable, and humanitarian and other social activities in Vietnam.

¹ This last category of income from products made from new technology applied for the first time should be removed. In the case of multi-nationals especially, it is difficult to distinguish a “new” product from an upgrade. Such labeling of “new” is fairly common for most consumer goods, as is continuous improvement in technology. Unless there is a stringent justification or selection criteria for this category that makes claiming this exemption truly justified, this is likely to be misuse.
**Taxable Income**

Taxable income from goods production and trading or service provision activities is the total turnover minus deductible expenses related to earning the income plus “other” income.

“Other” taxable incomes include income from capital transfers and from real property transfers; income from the ownership or right to use assets; income from transfer, leasing out or liquidation of assets; interest on deposits, loans or sales of foreign currency; recoveries from contingency reserves; income earned from bad debts which were written-off and are now recoverable; debts payable to unidentifiable creditors; income from business omitted in previous years, and other income including income receivable from activities of production and/or business outside Vietnam.

The proposed new CIT law sought to introduce some forms of “other income” for inclusion in taxable income. This includes income from transfer of contributed capital; transfer of investment projects, transfer of the right to participate in investment projects, transfer of the right to do exploration, mining and mineral processing. At the same time, it is proposed to allow offset of losses from the transfer of property, transfer of investment projects, transfer of the right to participate in investment projects, transfer of the right to do exploration, mining, mineral processing which must be (1) determined separately, (2) to be declared. and (3) to be set off against the profits/losses of these activities first; the remaining loss can be set off against an assessable income of business activity during the tax period.

These incomes are incomes of enterprises and should be considered a part of assessable income. To ensure transparency, simplicity, and ease of administration, these incomes are explicitly included in the category “other income” in Clause 2 of Article 3 of Enterprise Income Tax Law as follows:

"2. Other income includes income from the transfer of capital, transfer of capital contribution; income from transfer of property, transfer of investment projects, transfer of the right to participate in investment projects, transfer of exploration, mining and mineral processing rights; income from the ownership or use of property; income from the transfer, lease or disposal; interest income from deposits, loans, sale exchange; reversal of reserves; collecting bad debts that were written off but now recovered; revenue liabilities that cannot be determined; business income from the previous year and missed earnings; Other, including income received from production activities, trading outside of Vietnam."

It is advisable to transition to one positive non-mineral rate for all corporate income and one positive rate for all mineral income in Vietnam. The Haig – Simon definition of comprehensive income is the international standard which all tax regimes aspire to achieve. This definition of comprehensive income includes all forms of income that add to net worth. All legitimate income of businesses should be included in taxable income to avoid shifting to tax preferred activities.

Two sets of issues arise: (1) is the income in the form of capital gains (including derivatives), (2) or royalty/lease income? The answer is generally yes. But in the case of capital gains, there will be demand for offset of losses since that is allowed in other cases. This does not arise in the case of (2) which is straightforward addition to taxable income, but issues of expenses would arise.
Since it is advisable to have one uniform rate of CIT and a 5 year loss carry forward provision already exists, a preferred approach may be that all non-mineral net taxable income (that is not otherwise exempted) be clubbed in one pool and taxed at the single positive non-mineral rate of 22%, and all mineral incomes be similarly clubbed and taxed at 50%. This means that there will be a maximum of three separate sets of accounts that an enterprise can possibly maintain - exempt income; taxable turnover and other income, deductions and losses for the single non-mineral rate; and taxable turnover and other income, deductions and losses for the single mineral rate of 50%. Losses from one rate should not be applied to another rate. Therefore, there is no need for separation of accounts by type of income (transfers, real estate, financial etc.). Only 3 sets of accounts arise in this new system (0%, 22% & 50%). Once this is done, and all forms of non-mineral incomes that are not exempt are taxed at one uniform rate, the only case where we need to separate expenses and losses is when the same enterprise may have more than one type of income. In either case, the above approach should solve the problem. There is still no need for more than 3 sets of accounts and no further distinction needs to be made.

In the case of capital gains income from the above, especially in the form of options, there may also be a case made for inflation indexation of the purchase price to avoid overstating the capital gain or loss.

Gross income earned from activities of production and business of goods and services abroad are taxed under the provisions of the current Law on Enterprise Income Tax of Vietnam. The tax rate is presently 25%. The tax payable is reduced by the amount of CIT which has been paid abroad, but the tax deducted cannot exceed the income tax calculated under the provisions of the Law on Enterprise Income tax of Vietnam. Taxed income from securities transfer is the securities selling price minus (-) the purchase price of the transferred securities, minus (-) expenses related to the transfer, without indexation of the purchase price.

There is also a move to remove the “income being recoveries from contingency reserves” from taxable income. This is not recommended due to the following reason: If payment into contingency reserves are deductible from income while computing CIT payable in the year they were paid into the reserve fund (or to a limited extent like in the case of the science and technology fund) then they should be taxable when they are withdrawn from the fund, otherwise this income escapes taxation entirely. In any case, if they are used to offset a loss or to affect deductible expenditure, the loss or expenditure is deductible from taxable income.

**Permissible Expenses**

As mentioned above, taxable income is calculated from the gross income after deducting permissible expenses. The 2009 CIT law deems all expenses that meet two conditions as deductible (except for certain specified non-deductible expenses). Expenses must meet the following 2 conditions for being considered deductible.

- They are actually paid for and used in production and business activities;
- They are backed by adequate legally acceptable invoices and documents as prescribed by law.
Deductible and Non-Deductible Expenditures

Depreciation of fixed assets used for goods production and trading or service provision activities, costs of raw materials, supplies, fuel, energy and goods actually used in conduct of business, other expenses for promoting goods sale or service provision including expenses for packaging, transportation, advertisement, marketing, sales promotion and payment of brokerage commission, wages, remuneration and allowances actually paid to laborers and costs incurred thereof, employer’s contributions to social and health and unemployment insurance, expenses for services such as electricity, water, telephone, repair of fixed assets, rentals of fixed assets, legal services, property insurance, and technical services, expenses on research and development, innovations and modifications, payment of interests on loan for doing business, deductions for reserves, taxes, charges, fees and land rents, business management expenses allocated by foreign companies to their resident establishments in Vietnam, and certain donations are some examples of deductible expenses. The law defines certain limitations on deductible expenses:

✓ Establishments with “high economic efficiency” may apply quicker depreciation rate that is limited to two times of the prescribed depreciation rate;

✓ Depreciation corresponding to the original cost in excess of VND 1.6 billion/car, for passenger cars of 9 seats or less brought in use on or after January 1, 2009 (except cars exclusively used for the commercial passenger transportation or for tourism and hotel business) and depreciation of civil aircraft and yachts not used for commercial cargo, passenger or tourist transportation are not allowed;

✓ Enterprises are required to set reasonable consumption limits for raw materials, materials, fuel, energy or goods used for production and business activities from the beginning of a year or a period of product manufacture and notify these limits to their managing tax agencies within 3 months after commencement of production using these consumption limits;

✓ Expenses for advertisement, marketing, sales promotion and some other categories of marketing expenses that exceed 10% of the total amount of deductible expenses are not allowed except to newly established enterprises, who may deduct 15% in the first 3 years from the date they are established;

✓ The restricted level of 15% of total deductible expenses for the first 3 years is applicable to new enterprises that are granted business registration certificates on or after January 1, 2009, but not to new enterprises established as a result of consolidation, separation, split, merger, and type or ownership transformation;

✓ Payment of salaries, wages and other amounts payable to employees that the enterprises have accounted in business expenses in the taxable period but have not made payment for or incurred without maintaining payment vouchers as prescribed by law are not deductible;

✓ Enterprises are entitled to deduct a maximum of ten (10) per cent of their annual taxable income in order to establish the Science and Technology Development Fund of the enterprise. In case enterprises incur such expenses without setting up this fund, they may deduct valid expenses on scientific and technological development and research from taxable income, as they may deduct the expenses in excess of the amount contributed to the fund that were not
paid for from the fund. In the proposed new CIT law, an amendment was mooted that would
prescribe a minimum contribution to this fund for state-owned enterprises. This provision
would make it mandatory for state owned enterprises to set aside a minimum share of their
income into the fund to develop science and technology. This is a matter of policy. While it
is laudable to develop science and technology, the government owns these enterprises and
could very well set up the fund directly by setting aside a portion of the dividends paid by
these companies to the government;

✓ Payment of interest on loan for doing business from credit institutions, financial
organizations and other economic organizations; and payment of interest on loans borrowed
from other entities computed at the actual interest rate which must not exceed 1.5 times the
basic interest rate as published by the State Bank of Vietnam at the time the loans are allowed
to be deducted, amounts in excess are disallowed;

✓ Taxes, charges, fees and land rents to be deducted have to be related to business;

✓ Business management expenses allocated by foreign companies to their resident
establishments in Vietnam are allowed according to the proportion of such resident
establishments’ turnover to the total turnover of the foreign companies;

✓ Financial aid or donation for education, health care, to overcome the consequences of a
natural disaster or to build a charitable home for poor people as stipulated by law is
considered deductible.

Taxes can be assessed either financial year wise or calendar year wise. Tax period is determined
by calendar year. Where enterprises choose to apply the fiscal year different from the calendar year, the
tax period is determined by the applicable fiscal year.

There is no requirement for fixing the tax period. Enterprises choose the tax period themselves
based on their situation and inform the tax authority.

\textit{Depreciation Rules}

All fixed assets of an enterprise which are involved in business activities are subject to
depreciation. The duration of use of an asset which is a key factor in determining the amount of annual
depreciation is indicated through a decision of the Ministry of Finance (MoF). Fixed assets are placed in 8
categories: (i) dynamic machinery and equipment, (ii) working machinery and equipment, (iii)
measurement equipment and laboratory instruments, (iv) transport equipment, (v) instruments for
management, (vi) building and architectural works, (vii) livestock and perennial plantation, (viii) fixed
assets of other kinds.

These are further subdivided into 48 sub-categories. For new assets in each of these 48 sub-
categories, the minimum and maximum duration of use are prescribed in the MoF decision. If the asset is
already in use, the duration is calculated based on the ratio of the reasonable value of the asset and the
selling price of the new asset of that type multiplied by the notified duration of use for the new asset. Land
use right being a special type of fixed asset is not subject to depreciation.

An enterprise can itself determine the duration of use under these guidelines.
An enterprise may select the method of depreciation calculation appropriate to each of its fixed assets from one of the following three methods depending upon its ability to meet the conditions applicable to each method:

(a) The straight line method: The annual rate of depreciation is the value of asset divided by the duration of use. Enterprises with “high business effectiveness” may conduct fast depreciation in order to renovate technology but limited to twice the rate of the straight line depreciation.

(b) The reducing balance method: The reducing balance method of calculating depreciation can only be used for machinery and equipment, or instruments for measurement and testing which are newly invested fixed assets (not second hand). This method applies to enterprises in sectors where technology needs to be changed and the sector needs to be quickly developed.

(c) The method of quantity or volume of products: This method may be used for fixed assets involved in business activities as machinery/equipment directly relates to manufacturing of products and the total quantity or volume of products manufactured can be calculated according to designed output of the asset.

Every enterprise has to register its selected methods of depreciation calculation with the tax authorities. If an enterprise has selected an inappropriate method of calculating depreciation, then it is notified by the tax authorities.

The selected and registered method of depreciation calculation for a fixed asset will be used consistently and continuously throughout its use.

**Turnover, Taxable Income and Tax Payable**

Turnover means total sales revenue, processing fees and fees for provision of services including price subsidies and additional charges and fees to which the enterprise is entitled, calculated in Vietnamese dongs.

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<th>Equation</th>
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<tr>
<td>Assessable Income = Turnover - deductible expenses + other incomes</td>
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<tr>
<td>Taxable Income = Assessable Income - Exempt Income - Loss Carry Forward as permitted</td>
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<tr>
<td>CIT Payable = {(Taxable Income - Deduction for payments into Science and Technology fund) } * applicable tax rate</td>
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**Tax Rates**

The enterprise income tax rate applicable to business establishments is 25 per cent.

The tax rate applicable to business establishments conducting activities of prospecting, exploration and exploitation of oil and gas and other precious and rare natural resources are between 32 per cent and 50 per cent, depending on each project and business establishment.
Public service units that are involved in the activities of goods and services business subject to enterprise income tax that can account for their revenue but cannot account and determine the cost and profits of the business operation declare and pay enterprise income tax on the revenue from sales of goods and services as follows:

- For services: 5%.
- For goods business: 1%.
- For other activities (including activities of education, health, art performance): 2%.

**Tax Incentives**

Investment projects or cooperatives enjoy reduced tax rates of 20 per cent or 10 per cent on setting up new production establishments in branches, trades, fields or geographical areas in which investment is encouraged.

The preferential tax rate of **10% for fifteen (15) years** is applicable to:

(a) Newly established enterprises for investment projects in areas with extreme socio-economic difficulties.

(b) Newly established enterprises for investment projects in economic zones and Hi-tech zones established by the Prime Minister.

(c) Newly established enterprises for investment projects in the following industries:
   - Hi-tech as prescribed by law; scientific research and technology development;
   - Investment in water plants, power plants, water supply and drainage system; bridges, roads, railroads; airports, seaports, river ports, train station, and particularly important infrastructure as decided by the Prime Minister;
   - Software production.

The preferential tax rate of **10% during the entire operation of the enterprise** is applicable to:

(a) Part of the income from educational, vocational training, health, cultural, sports and environmental activities (hereinafter referred to as socialization).
   
   The specific list of socialization activities is made by the Prime Minister.

(b) Part of the income from publishing activities as prescribed by the Law on Publishing; that includes publishing, printing and issuing the publications as prescribed by the Law on Publishing.

The preferential tax rate of **20% for ten (10) years** is applicable to newly established enterprises for investment projects in localities with socio-economic difficulties.
The preferential tax rate of **20% during the entire operation** is applicable to Agricultural services cooperatives, People’s credit funds, and Micro financial institutions. Micro financial institutions prescribed in this clause are organizations established and operated under the Law on credit institutions.

Investment projects are entitled to tax exemption for at most 4 years after their taxable incomes are generated, and a 50 per cent reduction of payable tax amounts for 9 subsequent years on setting up **new or relocated** production establishments in branches, trades, fields or geographical areas in which the investment is encouraged, namely:

(a) Newly established enterprises for investment projects in localities with extreme socio-economic difficulties.

(b) Newly established enterprises for investment projects in economic zones and Hi-tech zones established under the Prime Minister’s Decisions.

(c) Newly established enterprises for investment projects in the following industries:

   - Hi-tech as prescribed by law; scientific research and technology development;
   - Investment in water plants, power plants, water supply and drainage system; bridges, roads, railroads; airports, seaports, river ports, train station, and particularly important infrastructure decided by the Prime Minister;

   For newly established enterprises for investment in water plants, power plants, water supply and drainage system; bridges, roads, railroads; airports, seaports, river ports, train station, and particularly important infrastructures decided by the Prime Minister: the enterprise must earn incomes and revenues from the **operations** of such projects to enjoy enterprise income tax incentives.

   - Software Production

(d) Newly-established enterprises engaged in educational, vocational training, health, cultural, sports and environmental activities in areas facing socio-economic difficulties or extreme socio-economic difficulties.

Four years of tax exemption, 50% reduction in the tax amount payable for 5 subsequent years for newly established enterprises engaged in educational, vocational training, health, cultural, sports and environmental activities in localities not in the list of localities with socio-economic difficulties or with extreme socio-economic difficulties.

Two years of tax exemption, 50% reduction in the tax amount payable for 4 subsequent years for newly established enterprises for investment projects other than in educational, training, cultural, sport and environmental sector **not in the list of areas** with socio-economic difficulties.

The list of areas with socio-economic difficulties or with extreme socio-economic difficulties is regulated in the Annex promulgated together with the Government's Decree No. 124/2008/ND-CP on December 12, 2008.

*Loss Carry Forward*
If businesses suffer losses, they are entitled to transfer such losses to the following year, which shall be offset against their taxable incomes. The duration eligible for the loss carry forward should not exceed 5 years.
Chapter II: Rate Rationalization and Revenue Implications

The present CIT rate in Vietnam is 25%, to be applied to all taxable corporate income. This rate applies to income not otherwise exempted or taxed at lower rates of 10%, 20% or at 50% or 0% of the tax otherwise payable (the case of tax holidays). The Tax Reform Plan 2011-2015 of Ministry of Finance provides a guidance to reduce gradually CIT rate in accordance with a rational roadmap in order to facilitate corporate sector in strengthening its financial capacity and improve the country’s attractiveness to investment. The CIT rate cut scheme should be coupled with rationalizing tax incentives, broadening the tax base, and strengthening tax administration to secure much needed fiscal resources. The existence of multiple effective rates and incentives and preferences (chapter one) reduces the transparency of the system as well as creates opportunities for companies to reduce their tax liability through aggressive tax planning.

One of the recommendations made in the current set of proposals to reform the CIT law has been to further lower the tax rate of 25 per cent to 22% for large firms and 20% for firms that have less than 200 employees and a total turnover of no more than 20 billion VND. This has been accepted by the National Assembly and will be implemented shortly.

The specific proposed changes suggested in the draft law and approved by the national Assembly are:

(a) The tax rate will be 22% on non-mineral income of enterprises.

(b) The enterprises which have less than 200 employees and a total turnover of no more than 20 billion VND will be taxed at 20%.

(c) Microfinance institutions are subject to the tax rate of 20%.

(d) The income from project investment and construction of social housing for sale, for lease, lease purchase for objects defined in the Housing Law is taxed at the tax rate of 10%, without exemption or reduction.

(e) Additional regulations: income from newspaper activities (including newspaper ads) of the press under the provisions of the Press Law and income from publishing activities under the provisions of the Publishing Law to be taxed at 10%.

(f) The tax rate in the field of education and training, vocational training, health care, culture, sports and the environment (the field of socialization) is 10% for income from these activities.

(g) Additional regulations have been proposed for tax incentives including incentives for investment expansion. Incentives proposed are:

- Tax rate of 10% for 15 years, maximum tax holiday 4 years and reduction of 50% tax payable for 9 years for new investment projects; for the application of, venture
investment in and incubation of advanced technologies, production of composite materials, energy from waste, biotechnology, hi-tech etc. This is also available to new production of goods industries that invest 6 trillion VND and have turnover at least VND 10 trillion a year within 3 years or new production of goods industries that invest 6 trillion VND and have more than 3000 employees, except goods subject to Special Consumption Tax (SCT) and in mining;

- Additions to the category of 20% rate for 10 years, with tax holiday for 2 years and reduction of 50% of CIT in next 4 years: new investment projects producing high quality steel, energy efficient products, machinery and equipment for agriculture, forestry fishery, salt, water irrigation etc (20% will be reduced to 17% from 1/1/2016);

- Additions to the category of tax exemption for 2 years and reduction of 50% of CIT payable for next 4 years enterprises making investment (new investment is not specified) in industrial zones with difficult socio-economic conditions;

- Enterprises engaging in technology transfers to anyone located in areas with socio-economic difficulties get 50% reduction of CIT on incomes from the transfers.

**Revenue Effects**

It is expected by the proponents of the changes that these rate reductions will increase the net of tax return to equity capital and make some investments profitable at the margin that otherwise may not have been. It is also expected that such a move will attract new investment into Vietnam as well as divert some investment currently heading to lower tax jurisdictions towards Vietnam and provide more incentives to existing domestic investors. Generally the thinking behind a move such as this is that (a) Some of the tax revenue lost will be recouped in the long run when the increased investment leads to increased output and income, (b) even if there is a small loss in revenue, it may be acceptable when weighed against the benefits of increased investment such as jobs, technology transfer and reduction in negative externalities or the provision of positive externalities.

However, if we discount such dynamic effects and still want to preserve revenue in the short run, reducing the corporate rate to 22% from 25% should be accompanied by elimination of concessionary tax rates of 10 or 20 percent for preferred economic investments. If this is not done, it will obviously lead to some revenue losses in the short run and perhaps even in the medium to long run. The rate reduction should be accompanied by a rationalization of the incentive scheme where some investments presently enjoy tax exemption or 50 percent reduction in tax rates. Such incentives or tax expenditures should be carefully examined for their impact and effectiveness and compared to outcomes achievable by using other policy measures outside the tax regime such as provision of improved infrastructure.

The important issue that arises from the point of view of the tax authorities when such rationalizations are considered is the revenue implication of the reduction of the top marginal CIT rate. While the change may be revenue neutral due to elimination of tax expenditures and concessions, revenue authorities may believe that withdrawing incentives and preferential rates may have other long-term effects on economic activities that may result in lower revenues in the future. Therefore, the two issues are connected in several complicated ways and the answer to what the long-term revenue impact will be is not straightforward. We need to look into the short-term (static) effect of a reduction in the top marginal
CIT rate and the short-term impact of a reduction in tax preferences vis-à-vis the long-term (dynamic) effects of the two groups of changes.

The effects of a reduction of the CIT rate on revenues can be summarized with the following quote from Mankiw (2006) “To what extent does a tax cut pay for itself? This question arises regularly for economists working at government agencies in charge of estimating tax revenues. Traditional revenue estimation, called static scoring, assumes no feedback from taxes to national income. The other extreme, illustrated by the renowned Laffer curve, suggests that tax cuts can generate so much economic growth that they completely (or even more than completely) pay for themselves. Most economists are skeptical of both polar cases. They believe that taxes influence national income but doubt that the growth effects are large enough to make tax cuts self-financing. In other words, tax cuts pay for themselves in part, and the open question is the magnitude of the effect”.

Revenue-Neutral, Static and Dynamic Changes

This, however, does not consider the case of a combination of tax rate changes and other measures to widen the tax base, to remove tax expenditures and preferences including preferential rates of taxation and tax holidays. Even with a completely static base, we can always think of a combination of such measures that can be revenue-neutral.

To analyze the effect of a change in tax rates on revenues we can use either a static or dynamic model. A static analysis model uses firm data on the existing tax base to estimate the tax impact of different tax structures while a dynamic model uses aggregate data to estimate through regression possible effects on the revenue over time. The two models can also be used in combination to simulate possible alternative paths for revenue in the future with different economic scenarios. Which models of the static and dynamic type can actually be used depends solely on available data. Several models are available. An example of a detailed static model is the Corporate Income Tax micro-simulation model described below. This is the most reliable model since it uses individual tax returns for the static part of the analysis.

A. STATIC ANALYSIS

I. Introduction

1. Description of Corporate Income Tax Micro-Simulation Model

A micro-simulation model has four major components: (i) Table of Parameters; (ii) Corporate Tax Calculator Model; (iii) Tax Returns Database; and (iv) Macro Modules.

(i) Table of Parameters

The Table of Parameters contains information about the current statutory corporate tax rates and the proposed changes to those rates. According to the database available, different types of corporations can be considered (only if we wish to consider the effect of different tax rates on different corporations – otherwise we simply consider the corporations facing existing tax rate of 25%, against alternative rates of 23%, 22% and 20%). Right next to the current CIT rates, the proposed changes are shown. In any event,
this table provides flexibility to the model as changes to the current and proposed tax rates can be easily done without modifying the macro codes.

(ii) Corporate Tax Calculator Model

Using the data (i.e. tax rates) stored in the Table of Parameters, the Tax Calculator Model calculates the tax liability of an individual corporation. The formulae contained in the Tax Calculator Model simulate the tax calculation procedures as presented in the provided tax returns samples. The Model will assign appropriate tax rates applicable to the corporation (assumed to be 25% only in the general case, but many preferential regimes and tax holidays also exist and they can be simulated as well).

The Calculator Model presents the calculation of individual corporation tax liability under the current and proposed law, as well as the changes or impacts on the corporation’s tax liability due to the discretionary changes.

(iii) Tax Returns Database

Tax Return Database stores the tax returns data from national samples of selected corporations. Again, for the sake of model presentation, only returns of taxpayers that are provided are considered. This part of the model could be completed with a large and representative stratified sample of CIT tax returns.

(iv) Macro Module

The Macro Module automates the process of simulating the calculation of tax liability for the corporations in the database. The Module reads each individual corporation record in the database; stores it in the Tax Calculator Model and saves the calculated tax liability in the designated location in the Tax Returns Database. This process continues until the last record in the database is covered.

2. Steps to Construct The Model

(i) Sampling of Tax Returns. Stratified sampling is suggested. First, different strata are established on the basis of some critical categories such as size of assets, income, industry, or region. Firms in each stratum resemble by the category used to select the strata. Second, sample of firms will be selected from these strata. Different weights are assigned to each stratum, and will be used to determine the proportion of firms in each stratum to be randomly drawn for the ultimate sample. For example, if strata are selected on the basis of gross income, higher income strata will be given higher weights; the proportion of firms drawn from those strata will be higher. Also, note that samples from different filing periods may also be selected to account for non-calendar filing and filing extensions. The “tax return” sheet usually has embedded a weight column that could be adjusted with the proportion of firms represented by each stratum.

(ii) Data Cleaning. This step is to ensure consistency and reliability of data selected for the simulations.
(iii) **Data Completion Process.** Filling in missing data relies on either data from corporate financial statements, and/or imputation data.

(iv) **Construct a Tax Calculator to Simulate Corporate Income Tax.** Corporate income tax base is derived from gross income from different sources minus itemized deductions including costs of goods sold, depreciation allowance, interest payments, overheads expenses, and any net operating loss from prior years. Tax payable is estimated as the product of tax base and corporate income tax rate. Tax liability should also be adjusted for any tax credits that are allowed. From this base tax calculator, impact of any proposed changes in the corporate income tax code on a representative firm and on government tax revenue will then be simulated.

The crucial element is availability of a stratified sample of CIT returns. Since such a sample is currently not available in Vietnam a simpler solution is to obtain the total taxable profits and other aggregate values of all corporations subject to the 25% rate and other preferential rates in consolidated form for the last available year. With a completely static base, the new proposed rates can simply be applied to these taxable profits to get an estimate of the tax estimated at the different rates. The simplified model used in this case is described below using data available from the 2010 Enterprise survey.

**II. Model, Data & Results (as applied to Vietnam)**

Now that the proposal to reduce the top rate for large non-mineral firms to 22% and for smaller firms to 20%, to retain and expand tax holidays and the special rates of 10% have been approved; the ideal analysis would have been to separate incomes from the Enterprise survey 2010 into the following categories: (1) Income taxed at 25% - further subdivided into large and small firms’ income;(2) Mineral income paying rates between 32-50%; (3) Income taxed at either concessional rate of 20% or 10%; (4) incomes enjoying tax holidays by rate actually charged. However, such a division is not available to this study from either tax returns or the enterprise survey 2010. The Average Effective Tax Rate (AETR) has actually been calculated by dividing tax paid by net taxable profit reported in the survey. What we expected to find is the following set of rates for firms paying non-negative amounts of taxes:

- Firms paying zero taxes who have positive profits: this could be due to exemption, tax holiday that allows 0%, or losses carried over that are deducted;
- Firms paying at 5%, 10%, 12.5%, or even 16% - 25% that avail the 50% reduction in taxes payable from the base rates of 10%, 20%, 25% or 32%-50% if all rates are covered in the 50% of taxes payable scheme;
- Firms paying at statutory rates of 10%, 20%, 25%, 32%-50%.

**1. Multiplicity of Rates**

The enterprise survey 2010 was examined to ascertain what the range of AETRs reported by firms actually was in relation to the multiplicity of possible rates firms could potentially face. The variable “rate” was created expressing CIT paid as a percentage of pretax profit. To create this, we had to drop all cases of missing and zero pretax profit (since we cannot divide by zero). Cases of negative profit
were also dropped as were cases of negative CIT. The results are revealing and show that out of 170537 observations that remain, the percentage CIT rate varies from a minimum of 0% to 8263%.

A look at the possible list of rates above should reveal that the tax system is made very complex and opaque by the multiplicity of potential rates that a firm could pay in theory and the effects on horizontal and vertical equity are indeterminate. Thus a rationalization of this rate structure itself is an objective that the government may consider pursuing in the future.

| rate | 170537 | 34.27431 | 53.3949 | 0 | 8263 |

The next stage was to drop all those cases where the rate is greater than 50% since they cannot be explained easily and then try to see if the remaining rates fall in the categories we expect. The results obtained are presented in the next table:
About 17000 observations are dropped when we eliminate those firms reporting rates above 50%. For the remaining 155000+ firms the range reported varies continuously from 0 to 50. The variation would have been even more if we had not rounded the rates to the nearest integer since it is derived from
data that may suffer from rounding issues. There is some bunching of rates at 0%, 14-16%, 20%, 24-25%, 29-31%, 33%, 40% and 50% but the range is fairly continuous with almost every value between 0 and 42% showing at least 1000 firms.

2. **Urgent Need for Cleaning Data and Conducting a Fresh Enterprise Survey**

   Whether this is an error of data in the survey or a reality is not known. The message is two-fold (1) if the table above represents reality then the prevailing system is unbelievably complex and should be streamlined; (2) better data should be gathered through the survey if meaningful policy analysis is to be attempted. This is elaborated next.

   The survey data does not allow us to segregate firms and their income by tax rate applied to different streams of income, or to ascertain the rates or holidays or exemptions. Since this information is not available, we are unable to conduct simulations on what would happen if rates are lowered from 25% to 22% and 20% while retaining special rates and tax holidays since we cannot separate firm’s income by tax rate applied. Therefore, the simulations have to be conducted with a number of assumptions to clean data and the effect of retaining holidays and special rates cannot be estimated. The simulations actually conducted keeping this data deficiency in mind are presented instead.

   For the future, it is advisable to start collecting data for enterprises that separate incomes according to the applicable tax rates. Under the new regime, tax rates for mineral incomes are still in the range of 32%-50%. The CIT rate for large companies will be 22% and for small companies will be 20%. The tax rate of 10% will continue. Some companies will pay at 0% or at 50% of each of the above rates during their tax holiday period, and some others will earn income that is exempt. In addition to reporting total pretax profit and tax paid, firms should be asked to report income in each category, separated by tax rate. As a simple check, the individual pretax profits reported by each firm should add up to the total, and the tax paid reported should be equal to the applicable rate multiplied by the income reported in each category. Even if firms earn incomes taxed at different rates, it would then be possible to add up incomes earned at a particular rate. This will facilitate analysis of revenue impacts when rates change, adjusted for possible dynamic effects. With the present availability of data, this exercise was simply not feasible. From the Enterprise survey 2010, the following summary of the data was provided by the local sources and it is presented in the next table:
### Categories of Firms by Tax Rate

<table>
<thead>
<tr>
<th>Categories of Firms by Tax Rate</th>
<th>NUMBER</th>
<th>Explanation</th>
<th>TOTAL TAXABLE PROFIT</th>
<th>TAX PAID</th>
<th>TAX RATE IMPLIED</th>
</tr>
</thead>
<tbody>
<tr>
<td>TOTAL FIRMS</td>
<td>290290</td>
<td>All enterprises having information</td>
<td>351329139</td>
<td>93267741</td>
<td>26.55%</td>
</tr>
<tr>
<td></td>
<td></td>
<td>All enterprises having both CIT paid and taxable profit information</td>
<td>364192812</td>
<td>93259966</td>
<td>25.61%</td>
</tr>
<tr>
<td>BOTH TAX RATE AVAILABLE &amp; IMPLIED TAX RATE IS (&gt;=0)</td>
<td>169758</td>
<td>CIT rate Available (=1+2) and CIT paid &gt;=0 and PreTaxProfit &gt;=0</td>
<td>404354532</td>
<td>92625031</td>
<td>22.91%</td>
</tr>
<tr>
<td>FIRMS WITH IMPLIED LOSSES BASED ON PRE TAX PROFIT</td>
<td>71365</td>
<td></td>
<td>-83056748</td>
<td>670592</td>
<td></td>
</tr>
<tr>
<td>FIRMS WITH DATA AVAILABLE &amp; NEGATIVE TAXES</td>
<td>192</td>
<td></td>
<td>-561992</td>
<td>-449414</td>
<td></td>
</tr>
<tr>
<td>FIRMS WITH IMPLIED TAX RATE &gt;= 27%</td>
<td>70521</td>
<td></td>
<td>115429543</td>
<td>45199247</td>
<td>39.16%</td>
</tr>
<tr>
<td>FIRMS WITH NON NEGATIVE TAX PAID, NON ZERO OR NEGATIVE PROFIT AND IMPLIED TAX RATE AVAILABLE AND BELOW 27%</td>
<td>99237</td>
<td></td>
<td>288924989</td>
<td>47425784</td>
<td>16.41%</td>
</tr>
</tbody>
</table>

### 3. Firms with Negative Profits but Positive Taxes

A cursory look at the data above raises some issues about its reliability and gives anomalous results. Of the 300,000 or so active firms surveyed, data on CIT was available for around 290,290 firms. However a look at the row that lists firms with negative taxable profit (71365 in number) shows that they paid taxes worth 670,592 million VND. It is not clear how this is possible. This could be possible due to mis-reporting of book profit as taxable profit, or the inclusion of VAT or other taxes paid as CIT or even
cases of reporting taxable profits not accepted by the GDT or even perhaps that these firms were taxed on turnover. In any case there cannot be any reasonable explanation as to why firms with negative taxable profit (net taxable losses) should pay so much in CIT. This is all the more confusing since the next row lists 192 firms with negative profits that paid negative taxes (which should be the equivalent of refunds).

4. Firms with Effective Tax Rate of greater than 27%

There are several firms (70,521 in number) that paid an effective tax rate of above 27% during the year. With a top marginal tax rate of 25% for non-mineral firms there can only be 2 explanations for this: that the firms paid CIT on mineral income at rates between 32-50% or the firms paid CIT based on turnover. Since no reduction of CIT is proposed for firms with mineral income or any changes proposed for firms paying CIT on turnover, these firms were also dropped from the analysis along with the firms above who reported negative profits but positive taxes.

Excluding these firms leaves a potential total of 99,237 firms to conduct simulations which can further be broken down as follows:

<table>
<thead>
<tr>
<th>IN VND MILLIONS</th>
<th>NUMBER</th>
<th>TOTAL TAXABLE PROFIT</th>
<th>TAX PAID</th>
<th>TAX RATE IMPLIED</th>
</tr>
</thead>
<tbody>
<tr>
<td>FIRMS POTENTIALLY USED TO CONDUCT SIMULATIONS</td>
<td>99237</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>of which: firms with indeterminate turnover</td>
<td>13</td>
<td></td>
<td></td>
<td>16.42%</td>
</tr>
<tr>
<td>REMAINING FIRMS</td>
<td>99224</td>
<td>288800092</td>
<td>47421600</td>
<td>16.43%</td>
</tr>
<tr>
<td>of which</td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>LARGE FIRMS</td>
<td>72211</td>
<td>277425155</td>
<td>45576887</td>
<td>16.43%</td>
</tr>
<tr>
<td>SMALL FIRMS TURNOVER LESS THAN 20 BILLION VND AND EMPLOY LESS THAN 200</td>
<td>18081</td>
<td>11374938</td>
<td>1844713</td>
<td>16.22%</td>
</tr>
</tbody>
</table>

The sample of 99,224 is not bad in terms of coverage since it is free from dubious data. In terms of taxable profit, the sample is now rid of a lot of profitable firms that paid more than 27% in taxes, but is also rid of losses so the effect on total taxable profit is not so pronounced. The remaining sample accounts for 82% of declared (positive) profits. However, proportionally more of the tax paid (some of it by loss making firms as discussed above, and most of it by firms paying more than 27%) is lost. The tax paid by the sample is now lower at 51% of the total. We are also unable to explain why 70,521 firms paid
at an effective rate over 27%. It is unlikely that so many enterprises had mineral income, unless firms paying on turnover basis are a large proportion of this category. The government may also consider for the future the burden on these firms – lowering the top rate of 25% is unlikely to benefit them.

<table>
<thead>
<tr>
<th>NUMBER</th>
<th>Explanation</th>
<th>TOTAL TAXABLE PROFIT</th>
<th>TAX PAID</th>
<th>TAX RATE IMPLIED</th>
</tr>
</thead>
<tbody>
<tr>
<td>290290</td>
<td>All enterprises having information</td>
<td>351329139</td>
<td>93267741</td>
<td>27%</td>
</tr>
<tr>
<td>99224</td>
<td>REMAINING FIRMS</td>
<td>288800092</td>
<td>47421600</td>
<td>16%</td>
</tr>
</tbody>
</table>

RATIO 82% 51%

5. Effective Tax Rates in the sample

The striking feature of the data is the effective tax rate implied for the firms in the sample which is around 16.4% for all firms and large firms and only slightly lower at 16.2% for small firms. This implies that if the base is completely static, the policy recommended that eliminates the special rate of 10% (and special rate of 20% if the normal rate is above 20%) and all tax holidays would increase revenue even if the general rate is brought down for all non-mineral firms. Even a normal top rate of 20% for all non-mineral firms if combined with elimination of tax holidays and the elimination of the 10% rate would increase revenue in this scenario. We can see the magnitude of the potential increases in a static model below:

<table>
<thead>
<tr>
<th>Total tax if CIT rate=23% (VND million)</th>
<th>Total tax if CIT rate=22% (VND million)</th>
<th>Total tax if CIT rate=20% (VND million)</th>
<th>%age increase</th>
<th>REMAINING FIRMS of which LARGE FIRMS SMALL FIRMS</th>
</tr>
</thead>
<tbody>
<tr>
<td>66424021</td>
<td>63536020</td>
<td>57760018</td>
<td>40%</td>
<td>34%</td>
</tr>
<tr>
<td>63807786</td>
<td>61033534</td>
<td>55485031</td>
<td>40%</td>
<td>34%</td>
</tr>
<tr>
<td>2616236</td>
<td>2502486</td>
<td>2274988</td>
<td>42%</td>
<td>36%</td>
</tr>
</tbody>
</table>

6. Significant Loss of Revenues through Tax Holidays

The clearest message that we can state from the completely static model is that Vietnam is losing so much revenue currently from its tax holidays and special rates that it could contemplate further lowering its rate to 20% for all firms and still gain CIT revenue if it simultaneously eliminates tax holidays and special rates. However, an increase in the effective tax rate may lead to a reduction in the
tax base in the long run, which may cause revenues to fall if the effects are strong enough. To confirm that a reduction in the tax rate combined with elimination of tax incentives will not cause a significant drop in revenues we have to examine the potential dynamic impact of this change.

7. Moving Forward with Rate Reform

Vietnam is already moving forward with a rational single rate of taxation for CIT for non-mineral companies. It is also going to implement a second slightly lower rate for small companies. This may encourage income shifting to tax preferred activities. The choice of company size should be based on business considerations and economies of scale and not influenced by the tax rate. Going forward, it is worth considering a single non-mineral rate that can be low enough to be investment friendly as well as generate adequate revenues and simplify tax compliance and tax administration. Therefore, it is proposed that the agenda for reform in the future would do away with tax holidays, reduced rates and special deductions and multiple rates and have one single non-mineral rate at 22% and a single mineral rate of 50%. As discussed elsewhere, some industries/enterprises may be given tax exempt status based on proper procedure and a formal procedure for determination of tax-exempt status. In all other cases of socio-economic objectives, the government can use refundable or non-refundable tax credits since these are certain, equitable and explicitly accountable tax expenditures. There is already a fairly long list of exempt income for socially desirable activities and no major modification is proposed to that list.

B. DYNAMIC ANALYSIS

I. Introduction

To estimate the effect of changing the tax rate on revenues we can relax the assumption of a fixed base and allow it to change in response to the rate. This obviously means that revenues could increase if the tax base increases in response to a decrease in rates. The overall impact on revenues depends on the size of the response in the base and the actual effect on the Average Effective Tax rate (AETR). These models are more dynamic in nature since they try to estimate the size of this response as well. The two major types of models are (1) effect of rate on revenue or taxable income directly, and (2) effect of rate on investment/FDI. The latter is more widely studied in the literature, but is less useful as highlighted in the following quote: “Note that the link between the effect of the tax rate on investment and its effect on revenue is not straightforward. For example, if lower tax rates reduce the effective tax rate on new investment, this may stimulate investment. But, in the short run an increase in investment may reduce, rather than increase, taxable income because at first (accelerated) tax depreciation allowances often exceed any increased profits due to the capital investment and because increased profits may not arise for several years. This is important in part because it suggests that the response lag to tax system changes will vary depending on the kind of behavioral response. For example, the change in taxable income due to income shifting is likely to be relatively fast, but the change in taxable income due to a response in real investment is likely to be slower, and in the short run may be perverse (i.e., more investment may reduce taxable income).” (Kawano and Slemrod, 2012, pg 6).

If the base is completely static, then a reduction in the AETR can only reduce revenue. As we have seen in the static analysis above, an increase in the AETR would increase revenue substantially. However, a combination of reduction in statutory rates with removal of preferential rates even in static
model can have a revenue-neutral or revenue-enhancing effect as well depending on the overall AETR. To estimate what might happen when we allow for dynamic changes in taxable income over a longer period, we need a combination of both models. The first (preferred) model that tries to relate tax rates to revenues directly is the econometric model for CIT revenues as applied to South Africa (SA) as an illustration (Glenday 2008). The model uses regression of tax revenues on the CIT rate as well as several other “control” variables and the coefficient on this variable (the AETR/CIT rate) is the elasticity of the tax revenues with respect to the tax rate. It gives an indication of how much revenue will change due to a change in rates alone, and is related to the change in the base of the CIT as well. The formal model is presented below. While this model adequately demonstrates the approach used, it is not the only possible specification of the variables. In the ideal scenario, we would like to have the following series for at least 12-15 years annually to be able to estimate any of the model specifications:

- GDP at basic prices
- Corporate profits/Net or Gross Operating Surplus
- Business Investment
- Loss carry overs
- Corporate income before tax and CIT paid
- Corporate tax rate structure
- Corporate tax incentives structure
- Consumer Price Deflator, Producer and Wholesale Price indices
- Information on shocks to economy
- Discretionary changes to CIT structure and quantified annual fiscal impact for all years
- Share of corporate profits subject to each tax rate each year
- Share of CIT collections from each tax rate each year

The SA model results are presented below to illustrate the model attempted for Vietnam. All the elements present in the table of results for SA were available for a shorter series of 11 years from 2001 to 2011 except for an AETR for all years calculated directly from statutory rates and estimated bases and net losses for 2011. The SA model also used available data for 30+ years due to which econometrically robust time series error correction techniques were feasible which are not feasible in our case due to the small number of observations.

II. Model, Data & Results for SA Type Model Developed for Vietnam

Data for the model used for Vietnam was provided for the period 2000-2012 for the variables listed below. Data for the AETR was not available from direct calculation so CIT/GDP was used as a proxy for the AETR. This is not a satisfactory measure since CIT revenue is the dependent variable and GDP is an explanatory variable. Since net loss was not available for 2011-12, lagged losses were used instead (based on the enterprise survey) to preserve degrees of freedom. This means that we can effectively use data for 2001-11 for regression, a total of 11 years annual data. The data series used are:

- Nominal GDP
- Business Investment of firms in the enterprise survey
- Net Operating Losses lagged 1 year of firms in the enterprise survey
- Consumer, Deflator, Industrial, Export and Import Price indices
✓ CIT revenue in nominal terms

In all the models, log of real CIT revenue is the dependent variable. The AETR is taken as a percentage leading to a ready interpretation of the coefficient that a 1 unit (in this case 1 percentage point) increase in the AETR leads to a β % increase in CIT revenues. Several model specifications were tried. In models 3 and 4 as opposed to models 1 and 2, a lagged dependent variable (the lagged log of real CIT revenues) was used in addition to the time variable. Models 2 and 4 use log of real business investment in the current year as an explanatory variable as opposed to models 1 and 3 that use log real losses lagged by one year. The dependent variable is common to all models, and all other explanatory variables are unchanged. A table of results is presented below after the table on SA models and results.

**Table B.3 Estimates of Company Income Tax, South Africa, 1983/84-2006/07**

<table>
<thead>
<tr>
<th>Dependent variable: Natural log of constant value company income tax</th>
<th>Company income tax values (including secondary company tax) adjusted by 2000 consumer price index (KBP7032J)</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Explanatory Variables</strong></td>
<td><strong>Variable</strong></td>
</tr>
<tr>
<td>Ln(real GDP)</td>
<td>Log of real GDP in constant 2000 prices</td>
</tr>
<tr>
<td>Ln(real all industry prices)</td>
<td>Log of prices of all products for domestic use (KBP7048J) adjusted to 2000 prices by CPI (KBP7032J)</td>
</tr>
<tr>
<td>Ln(real export prices)</td>
<td>Log of prices of export goods and services (KBP5033J) adjusted to 2000 prices by CPI (KBP7032J)</td>
</tr>
<tr>
<td>Company tax rate</td>
<td>Company tax rate assuming 30% dividend distributions</td>
</tr>
<tr>
<td>D_UDPT</td>
<td>Dummy =1 for years (1981-1990) with Undistributed Profits Tax (UDPT), otherwise = 0</td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th></th>
<th>Coefficient</th>
<th>t-statistic</th>
<th>Probability</th>
<th>Coefficient</th>
<th>t-statistic</th>
<th>Probability</th>
</tr>
</thead>
<tbody>
<tr>
<td>Constant</td>
<td>-49.15</td>
<td>-14.42</td>
<td>0%</td>
<td>-47.25</td>
<td>-15.00</td>
<td>0%</td>
</tr>
<tr>
<td>Ln(real GDP)</td>
<td>2.84</td>
<td>12.91</td>
<td>0%</td>
<td>2.65</td>
<td>10.37</td>
<td>0%</td>
</tr>
<tr>
<td>Ln(real all industry prices)</td>
<td>3.70</td>
<td>4.66</td>
<td>0%</td>
<td>3.83</td>
<td>5.27</td>
<td>0%</td>
</tr>
<tr>
<td>Ln(real export prices)</td>
<td>0.67</td>
<td>3.31</td>
<td>0%</td>
<td>0.88</td>
<td>4.01</td>
<td>0%</td>
</tr>
<tr>
<td>Company tax rate</td>
<td>1.19</td>
<td>2.11</td>
<td>5%</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Ln(Company tax rate)</td>
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<td></td>
<td></td>
<td>0.48</td>
<td>2.12</td>
<td>5%</td>
</tr>
<tr>
<td>D_UDPT*Ln(Company tax rate)</td>
<td>0.16</td>
<td>1.61</td>
<td>13%</td>
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<tr>
<td>First order auto regression in error</td>
<td>-0.21</td>
<td>-0.87</td>
<td>40%</td>
<td>-0.30</td>
<td>-1.28</td>
<td>22%</td>
</tr>
</tbody>
</table>

Adjusted R²: 97.0%  
Observations: 23  
F-statistic: 144.1  
Durbin-Watson statistic: 1.97
1. Regression Results for Vietnam

## DEPENDENT VARIABLE

### LOG REAL CIT REVENUE

## INDEPENDENT VARIABLES, T-STATISTICS AND MODELS

<table>
<thead>
<tr>
<th>Model 1</th>
<th>Model 2</th>
<th>Model 3</th>
<th>Model 4</th>
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<tr>
<td><strong>Coefficients</strong></td>
<td><strong>t-stat</strong></td>
<td><strong>Coefficients</strong></td>
<td><strong>t-stat</strong></td>
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<tr>
<td>Intercept</td>
<td>-5.17</td>
<td>-1.10</td>
<td>-0.21</td>
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<tr>
<td>LOG GDP real (VND billion)</td>
<td>1.32</td>
<td>3.01</td>
<td>0.86</td>
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<tr>
<td>LOG CPI, BASE 2000 = 100 / deflator</td>
<td>-0.69</td>
<td>-3.17</td>
<td>-0.59</td>
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<tr>
<td>LOG EXPORT PRICE INDEX, BASE 2000 = 100/deflator</td>
<td>0.18</td>
<td>1.20</td>
<td>0.20</td>
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<tr>
<td>LOG NET OPERATING LOSSES (VND million) Real Lagged</td>
<td>0.00</td>
<td>0.15</td>
<td>-0.01</td>
</tr>
<tr>
<td>LOG BUSINESS INVESTMENT (VND billion) Real Lagged</td>
<td>0.04</td>
<td>0.92</td>
<td>0.04</td>
</tr>
<tr>
<td>CIT/GDP ratio (ATR)**</td>
<td>0.11</td>
<td>18.20</td>
<td>0.11</td>
</tr>
<tr>
<td>Time</td>
<td>-0.02</td>
<td>-0.72</td>
<td>0.01</td>
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<tr>
<td>Log Lagged Real CIT Revenue</td>
<td></td>
<td></td>
<td></td>
</tr>
</tbody>
</table>

|  |  |  |  |  |
| Adjusted R squared | 0.9996242 | 0.9996880 | 0.9998914 | 0.9998914 |

2. Results and Observations

The number of observations at 11 (annual) was too small to allow for error correction techniques beyond the use of a simple time trend variable and a lagged dependent variable. Further, the absence of an independently calculated AETR meant that the CIT/GDP ratio had to be used, while log real CIT is the dependent variable and log real GDP is an explanatory variable. However, one feature emerges – the coefficient of the tax rate is positive at 0.1 in all model specifications. This can be interpreted in the following way: a 1 unit (1 percentage point) increase in the AETR increases CIT revenue by 0.1%. An increase of the AETR from 16.4% to 20% is an increase of 3.6 percentage points, so this should raise
revenue by 0.36%. In this scenario, even with a 90% loss of potential revenue due to contraction of the base when the effective tax rate is raised, we still get some additional revenue when we impose a uniform tax rate of 20% on all firms and eliminate tax holidays and the special rate of 10%. However, if tax holidays and special rates are retained and the top tax rate is lowered as is being contemplated, the AETR can only go down, and this means that we will lose revenue at the rate of 10% for every percentage point the AETR is lowered. Since we do not have information from the Enterprise survey on firms separated by whether they are availing incentives or not, we cannot make a calculation of what the effective tax rate will be under the new regime.

To conclude, even in the most pessimistic scenario, Vietnam could reduce its CIT rate to the proposed level of 22% and maintain its revenues if it eliminates the special rate at 10% and tax holidays while retaining its current list of exempt incomes and incomes taxed on turnover. It can combine these measures by raising its CIT rate on exhaustible natural resources to a uniform level of 50%. This will ensure an attractive regime to attract investment as well as providing robust revenue for development in the future. Lowering the CIT rates on large and small companies while retaining tax holidays and incentive rates will most likely result in a fall in inflation adjusted CIT revenue in the short run.

3. Summary of Recommendations

(i) Reducing the corporate rate to 22% from 25% should be followed by elimination of concessionary tax rates of 10 or 20 percent for preferred economic investments. If this is not done, it will obviously lead to some revenue losses in the short run and perhaps even in the medium to long run.

(ii) The rate reduction should be accompanied by a rationalization of the incentive scheme where some investments presently enjoy tax exemption or 50 percent reduction in tax rates. Such incentives or tax expenditures should be carefully examined for their impact and effectiveness and compared to outcomes achievable by using other policy measures outside the tax regime such as provision of improved infrastructure.

(iii) It is proposed that the agenda for reform in the future would do away with tax holidays, reduced rates and special deductions and multiple rates and have one single non-mineral rate at 22% and a single mineral rate of 50%. As discussed, some industries/enterprises may be given tax exempt status based on a formal procedure for determination of tax-exempt status. In all other cases of socio-economic objectives, the government can use refundable or non-refundable tax credits since these are certain, equitable and explicitly accountable tax expenditures. There is already a fairly long list of exempt income for socially desirable activities and no major modification is proposed to that list.

(iv) Vietnam could reduce its CIT rate to the proposed level of 22% - 20% and maintain its revenues if it eliminates the special rate at 10% and tax holidays while retaining its current list of exempt incomes and incomes taxed on turnover. It can combine these measures by raising its CIT rate on exhaustible natural resources to a uniform level of 50%. This will ensure an attractive regime to attract investment as well as providing robust revenue for development in the future. Lowering the CIT rates on large and small companies while retaining tax holidays and incentive rates will most likely result in a fall in inflation adjusted CIT revenue in the short run.
(v) A close look at the list of possible effective CIT rates would reveal that the tax system is made very complex and opaque by the multiplicity of potential rates that a firm could pay in theory and the effects on horizontal and vertical equity are indeterminate. Thus a rationalization of this rate structure itself is an objective that the government may consider pursuing in the near future.

(vi) There is an urgent need for cleaning data and conducting a fresh Enterprise survey. For the future, it is advisable to start collecting data for enterprises that separate incomes according to the applicable tax rates. In addition to reporting total pretax profit and tax paid, firms should be asked to report income in each category, separated by tax rate. As a simple check, the individual pretax profits reported by each firm should add up to the total, and the tax paid reported should be equal to the applicable rate multiplied by the income reported in each category. Even if firms earn incomes taxed at different rates, it would then be possible to add up incomes earned at a particular rate. This will facilitate analysis of revenue impacts when rates change, adjusted for possible dynamic effects.

(vii) According to the Enterprise survey 2010, a total of 70521 firms paid CIT at an effective rate over 27% - it is unlikely that so many enterprises had mineral income, unless firms paying on turnover basis are a large proportion of this category. The policymakers may also consider for the future the excessive burden on these firms – lowering the top rate of 25% is unlikely to benefit them.
Annex

Other versions of similar models, with different data requirements are discussed for the purposes of illustration. In our opinion their data requirements are even less likely to be met than the SA model. They are presented in brief in increasing order of data difficulty to illustrate other possible approaches in the academic literature.

Abbas, Klemm, Bedi & Park (2012) adapting a model from Clausing (2007) have estimated the equation:

$$\left( \frac{\text{CIT revenue}}{\text{GDP}} \right)_{t,t} = \beta_0 + \beta_1 r_{t,t} + \beta_2 r_{t,t}^2 + \beta_3 \frac{b_{t,t}}{\pi_{t,t}} + \beta_4 \frac{\pi_{t,t}}{\text{GDP}_{t,t}} + f_t + y_t + e_{t,t}$$

where $r$ is the statutory tax rate, $b$ is the tax base, $\pi$ are profits, $\beta_j$ are coefficients, $f_t$ are country effects, $y_t$ are year effects and $e_{t,t}$ are errors.\(^{34}\)

Since the true economic base cannot be estimated directly, the authors use the ratio of true economic depreciation and the present discounted value of depreciation allowances as a proxy measure for the ratio of base to corporate profits. A proxy measure of gross operating surplus to GDP is used by the authors instead of corporate profits to GDP since the measure of corporate profits was not available to the authors. As the authors point out: (pgs 15-16) “Like Clausing (2007), we proxy the share of profits in the GDP by the gross operating surplus, which is a national accounts concept and for which some data are available. Unfortunately we do not have data on corporate profits, which are likely to be different, because the gross operating surplus includes profits from unincorporated businesses, and because there are various other accounting differences, especially in the financial sector”. Further, they are unable to split the profits to GDP ratio for reasons explained thus (Abbas et al, pg. 15) “Clausing (2007) additionally splits the ratio of profits over GDP into the product of the ratio of profits to value added and value added to GDP, but we do not have data on corporate value added.”

What does this mean for Vietnam? If we have a series for corporate value added from the national accounts for 12-15 years, and we have series of corporate profits from the tax department/enterprise survey for all years as well, we can construct the series as in Clausing (2007). We would also have to obtain the series on true economic depreciation (of enterprises assets) to depreciation allowances series for the first proxy ratio as explained above. It is obvious that this data series is more stringent than the data requirements for the SA model above that essentially provides the same elasticity – of tax revenues to tax rates.

One of the earliest models that illustrate the difference between the dynamic and static effects on revenue of a change in the CIT rate is the Ramsey model that is now almost 80 years old. A simple version is presented in Mankiw (2006). The static version is presented as:

42
Where:

\[ R \] revenue per efficiency unit of labor
\[ \tau_k \] tax rate on capital income (similar to CIT rate)
\[ r \] before-tax rate of return to capital
\[ k \] capital per efficiency unit of labor

The dynamic version of this model is presented as:

\[
\left. \frac{dR}{d\tau_k} \right|_{\text{dynamic}} = \left[ 1 - \frac{\alpha \tau_k + (1 - \alpha) \tau_n}{(1 - \tau_k)(1 - \alpha)} \right] \left. \frac{dR}{d\tau_k} \right|_{\text{static}}.
\]

Where:

\[ \tau_n \] tax rate on all labor income (similar to combined PIT and other wage taxes rate)
\[ \alpha \] share of total income (GNI) going to capital

First, the static formula implies that the effect of a change in the tax rate with a completely static base is simply the change in the tax rate times the tax base or that revenue rises or falls by the full amount of the tax change. However, the second (dynamic) equation is expressed as a percentage of the static change and could take different values based only on 3 parameters – the CIT rate, the PIT rate and the share of national income accruing to capital.

For many countries, the effective values of \( \tau_k \) and \( \tau_n \) lie in the 25% range in terms of effective tax rates if not statutory. For developed countries, the value of \( \alpha \) is below 50% normally while for developing countries it can be above 50%. Either way, these parameters can and often are computed by national accounts economists on a regular basis. Using the following ratios, Mankiw (2006) reports “Consider the empirically plausible parameter values of \( \tau_k \) and \( \tau_n =1/4 \) and \( \alpha =1/3 \). Then, (5) yields.

\[
\left. \frac{dR}{d\tau_k} \right|_{\text{dynamic}} = \frac{1}{2} \left. \frac{dR}{d\tau_k} \right|_{\text{static}}.
\]

A capital income tax cut has a long-run impact on revenue that is only half of its static impact. In other words, growth pays for 50% of a capital income tax cut in the steady state.” (pg 1419)

In the context of advanced countries many important econometric studies exist that have different specifications that attempt to estimate the effect of the CIT rate on either CIT revenues or the tax base.
The important studies are summarized in Kawano and Slemrod (2012) and the important ones referred to therein are Clausing (2007), Brill and Hassett (2007), Gravelle and Hungerford (2007), Devereux (2006) among others. Kawano and Slemrod (2012) replicate the results from these models and then carry out several different types of estimations and the first set of results is presented in the table marked table 7 at the end of this annex for comparison. The variable Big refers to country size in terms of GDP etc., international refers to whether countries use worldwide or domestic bases to tax the base, and depreciation is a measure of the PV of depreciation allowances. It can be seen that the coefficient on the tax rate variable is actually very similar to the one found for Vietnam in our regressions above, even if the variables chosen are not the same in our models.

Further surveys of the all the theoretical issues involved in these types of estimations is presented in great detail in Saez, Slemrod and Giertz (2012). One last issue is the type of models that involve the second class of dynamic modeling, the effect of tax rates on investment. Abbas et al (2012) and Klemm and Van Parys (2012) provide two good examples of such studies that include samples of developing countries. As noted above, an increase in investment may not lead to an increase in the tax base and revenues, but given that governments may be interested in promoting investment (domestic and FDI), the result is separately of interest. Abbas et al (2012) summarizes their findings as follows: “The first two regressions consider the marginal effective tax and control variables. The results show that the marginal effective tax rate has no impact on investment. This suggests that when the tax rate rises on marginal projects (i.e., projects that just break even after tax), the impact on aggregate investment is negligible. The third and fourth regressions consider instead the average effective tax rate. These results show a significant negative impact on investment. This suggests that rent-earning investments react to tax changes and that this has an impact on aggregate investment.” (Abbas et al, pg 17).

The results do not contradict those of Klemm and Van Parys (2012), which considers the effect of tax incentives on investment in selected developing countries. They find that while FDI is somewhat responsive to the tax rate and incentives, investment as a whole is not. However, as the authors have noted, different studies (such as James and van Parys 2009) have found differing effects and results and a comprehensive summary of many such studies for countries for whom data is easily available is also available in De Mooij and Ederveen (2008).
Table 7: Regressions with country fixed-effects

<table>
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<tr>
<th>VARIABLES</th>
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<th>(2)</th>
<th>(3)</th>
<th>(4)</th>
<th>(5)</th>
<th>(6)</th>
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<tr>
<td>Corp. tax rate</td>
<td>0.121*</td>
<td>0.773*</td>
<td>-0.097</td>
<td>0.040</td>
<td>0.124</td>
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<td>(0.490)</td>
<td>(0.445)</td>
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<td>Corp. tax rate (sq)</td>
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<td>-0.897*</td>
<td>-0.118</td>
<td>-0.070</td>
<td>-0.010</td>
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<td>(0.068)</td>
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<td>(0.063)</td>
<td>(0.625)</td>
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<td>GDP growth rate</td>
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<td>Unemp. rate</td>
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<td>Individual tax - corporate tax</td>
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<td>-0.009**</td>
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<tr>
<td>Dividend system=classical</td>
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<td>0.509*</td>
<td>0.392</td>
<td>0.524***</td>
<td>0.512*</td>
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<td>(0.319)</td>
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<td>-12.463***</td>
<td>-9.800***</td>
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<td>Other corp. tax rates</td>
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<td>75.1</td>
<td>36.3</td>
<td>28.5</td>
<td>76.1</td>
<td>36.6</td>
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<td>449</td>
<td>537</td>
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<tr>
<td>R-squared</td>
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<td>0.350</td>
<td>0.402</td>
<td>0.396</td>
<td>0.361</td>
<td>0.402</td>
</tr>
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</table>

Notes: Robust standard errors in parentheses. *** p<0.01, ** p<0.05, * p<0.1.
Chapter III: Expenses and Deductions, Thin Capitalization and Other Issues Connected with Transfer Pricing

Expenses and Deductions

The 2003 CIT law listed permissible expenses while stipulating certain expenses as not permissible, or not deductible. The CIT law of 2008 does not explicitly mention permissible expenses, it allows all expenses that are not specifically dis-allowed if two conditions are met - the expenses are real and were incurred for the business and they are backed by documentary evidence as stipulated and discussed in the introduction chapter.

One of the major restrictions on permissible expenses is that companies can deduct no more than 10% of all deductible expenses (excluding certain controlled activities and the cost of goods sold in the case of commercial activities) under the heading “expense of advertising, marketing, promotion, brokerage commissions; receptions, ceremonies, conferences; marketing support, expense support, payment discount; donation and offer of newspaper of the press agency directly related to production and business activities”. This limit is slightly higher for newly established enterprises at 15% for the first three years after establishment on or after January 1, 2009.

Some expenditures are excluded from this ceiling limit such as commissions paid to insurance brokers and to selling agents, certain distributors, expenses on market research and analysis, hiring consultants for such research, fairs and commercial exhibitions and certain specified donations. However, these expenditures are often regulated in other ways.

A recent survey (2012) of over 300 firms conducted by the Institute of Economics and Finance (IEF) in 3 major cities has raised some interesting issues regarding this limitation. Businesses in the fields of trade, services and foreign invested enterprises have expressed difficulties with the limit, while other firms spend amounts on advertising well below the set limits. Firms with FDI tend to find the limit low on average, while the majority of domestic firms do not express difficulty. Similar effects are noticed by size of firm, with the majority of large firms against the limit and a large majority of small firms for the limit. Most of the adverse reactions came from FDI firms, large firms and firms engaged in the banking, consumer electronics, food, beverages, and media and cosmetics sectors.

Other issues: (1) Commissions paid to agents – these costs are fully deductible without limit if they follow certain rules. This requires written contracts or the equivalent, the principal retaining ownership of either the goods or the money and the principal either fixing the sale margin of the agent or the percentage of commission on the purchase price to the agent. However, since ownership of goods is rarely retained by the principal in practice these conditions are seldom fulfilled; (2) Display costs – can be to both introduce products (which is fully deductible) or to promote sales of the goods (not fully deductible). There are no clear guidelines to separate the two cases; (3) Costs of product introduction – related to the previous point, there are no set rules for which costs are classifiable here and whether some
types of costs are fully deductible or fall within the ceiling. Compounding this confusion is the fact that for expenses on staff related to introduction of products, it is not specified if the deductibility is for new products only or all products.

These kinds of expenditures are generally legitimate and are incurred to introduce new brands in the market and serve the purpose of informing and educating the consumers. Therefore placing a restriction on the total amount that can be spent on such items is not justified. The only thing that has to be ensured is that the expenditures are genuine. One way to ensure this is that in all cases where the expenditures on these categories are above a certain limit, the accounts will be audited. This type of provision will discourage businesses to come up with spurious claims. This also obviates the need for more regulations to minimize endless disputes that arise based on narrow definitions and bickering over which costs are to be included under which provision.

The expenses on entertainment are somewhat tricky because one has to be careful when this is a legitimate business expense and when it becomes an employee benefit. There has to be clear rules about allowing entertainment as an expense. At present, Circular 01/2010/TT-BTC dated 6/1/2010 of the Ministry of Finance regulates spending to welcome foreigners to work in Vietnam; spending on organizing international conferences and workshops in Vietnam and spending on domestic guests. This Circular applies only to units using money from the state budget.

Another restriction is the provision governing deductibility of inputs. The law requires documentary proof in the form of invoices or import VAT payment vouchers and that transactions above 20 million Dongs be made through a bank. However, there is no such requirement for some firms. VAT exempt firms are allowed to purchase goods and services without making payments through a bank even if the amount exceeds 20 million Dongs. In some other cases such as payments to labor in excess of 200 hours per year for overtime; even when the businesses have legal records they cannot deduct the amounts in excess as these expenditures violate provisions of the relevant labor laws.

Recommendation:

(1) The proposed draft CIT already incorporates a provision to disallow deduction from taxable profit of value added tax already claimed as input credit while calculating VAT liability. Therefore the issue under consideration is confined to the deduction from taxable income of expenses over 20 million VND that were incurred without payment through a Bank (say by a VAT exempt firm that cannot claim input credit). The issue applies to VAT exempted and CIT taxable firms since they do not claim input credit under VAT. CIT deduction of input costs by firms that purchase deductible items without having to make payments through a bank are presently disallowed if over 20 million VND.

(2) The main point is that there is no need to have 2 sets of standards and create opportunity for evasion.

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2 Two possibilities are presented for the sake of illustration. In Malaysia, expenditures that are a benefit to customers are deductible from corporate income, while expenditures that benefit employees are not deductible. In some other countries, the expenditures that benefit employees are deductible from CIT but are taxed as fringe benefits either under the PIT or through a Fringe Benefits Tax (FBT). Since the PIT rate in Vietnam is lower than the CIT rate, taxing under PIT would lose revenue, so it is better to either disallow those expenses or tax them at an FBT rate closer to the CIT rate.
(3) It is never recommended to allow any deduction without proper records or vouchers so for all such transactions, the relevant records should be specified or ceilings prescribed.

(4) An issue may arise about genuine expenditures incurred by firms that violate some other law such as deduction for labor overtime in excess of 200 hours per year that violates the labor laws. Even though firms have incurred such expenditures, they cannot deduct such costs. Obviously expenses that are in violation of some other law cannot be allowed (such as overtime payment in excess of 200 hours), thus either one of the laws needs to be amended to prevent this.

Another issue is the requirement that Enterprises are required to set reasonable consumption limits for raw materials, materials, fuel, energy or goods used for production and business activities from the beginning of a year or a period of product manufacture and notify these limits to their managing tax agencies within 3 months after commencement of production using these consumption limits. Use of resources in excess of these limits and wasted resources pose a problem as they are governed by very strict regulations and there is delay in adjustment of norms after the tax authorities are informed.

**Recommendation:**

Remove the regulations on requiring enterprises to inform the tax authorities about the consumption of raw materials. Allow enterprises to deduct expenses for raw materials, materials, fuel, energy, according to the actual invoices if valid. Normally, tax laws incorporate provisions on how to deal with goods lost or damaged due to fire; obsolescence etc., and these can cover inputs used in production as well as wasted inputs. Issues of excessive input deductions can be dealt with through audit.

The law allows deductions for certain activities such as specified donations and grants and to finance activities for education, health, disaster recovery and “gratitude” for the poor. However many enterprises have also contributed to other socially desirable activities such as for the local implementation of road improvement, infrastructure development or implementation of the assistance program for remote areas, including the Sea Islands. Since deductions are allowed for only the 4 specified grants, there is a disincentive to fund other activities that are equally laudable but not tax-deductible. There are other issues relating to qualifying “gratitude” donations to the poor – the deductibility of certain in-kind donations or donations eventually reaching those without the appropriate “poor” certification. Even within the classes of deductible donations, some restrictions exclude certain activities while allowing others.

**Recommendation:**

Normally, donations to qualified charitable organizations etc are deductible from income subject to certain restrictions. The receiving entity in most cases will be able to register as a qualifying organization under the tax law. Any donations to taxable entities are normally not deductible - in any case the recipient would have to pay tax on income received including donations. It is also not necessary that donations made to all tax – exempt organizations should be deductible for the donor. In the US, donations made to “qualified organizations” are deductible from income tax as well as corporate income tax subject to restrictions on the receiving organization and overall limits for deduction of donations. If any such organizations qualify as tax exempt, they must be explicitly recognized by the tax authorities; in
the US the donor can verify the status of the receiving organization online in a part of the IRS website at http://www.irs.gov/Charities-&-Non-Profits/Exempt-Organizations-Select-Check to ensure that it is an authentic qualified organization. In countries such as the US, once proper proof of financing activities of a qualifying tax exempt organization is maintained, the expenditure would be deductible subject to overall limits that may be prescribed and various restrictions by type of tax and type of receiving entity. A summary of the restrictions for US PIT and CIT can be found at http://www.bbb.org/us/Charity-Tax-Deductions/. Otherwise if the receiving entity was not recognized by the tax authority as an exempt organization, the receiving entity would have to count it as income and pay tax on it. There is still no guarantee that the receiving organization’s tax exempt status automatically allows deduction of the donation. That is also further regulated by the tax authority. Once the donor has obtained proper receipt and tax identification number of the qualifying recipient, it is the recipient who has to prove that the donation/financing was used for a qualifying activity; the donor only has to prove that the valid donation was made to a qualifying organization and total deductions are within overall limits.

This also applies to the case of undistributed profits of private higher education establishments that re-invest their profits in education. There are clear rules for operation of non-profits. If an institution is set up as a for-profit, or denied the non-profit status, it is taxed like any other commercial activity. Then there are no separate rules required for these organizations, they are treated like any other company. Registered non-profits do not have to pay tax anyway. Where a non-profit engages in commercial activities, they are separated into independent companies with distinct legal status and accounts. Non-profits are also required to maintain prescribed accounts. Also, whether something is exempt from VAT or not is a related but entirely separate issue. As a non-profit, an entity can also be sales tax or VAT exempt.

The last issue relates to the non-deductibility of enterprise contributions to voluntary pension funds. Compulsory contributions to social insurance and other forms of insurance such as health and unemployment are allowed. Deduction of matching enterprise contributions to voluntary retirement funds is not included in the CIT. The language used in the draft law is:

“Contributions made to voluntary retirement funds or to funds with the nature of social security; the amount of money used to take out voluntary retirement insurance policies for employees, which is in excess of the regulated level”.

Recommendation:

Make such contributions deductible subject to a maximum upper limit at the time of contribution and partly or fully taxable under the PIT at the time of withdrawal of benefits. The government still loses revenue due to the disparity in CIT and PIT rates. Since the government wants to encourage the use of voluntary pension funds rather than only compulsory pension schemes such as social insurance (as is increasingly done in the US as well), it has to ensure that the two forms of pension are treated equally. If employers are required to contribute to voluntary pension funds of employees and cannot deduct such contributions, then they have a disincentive to contribute to such funds and would prefer the contribution to social insurance which can be deducted. If however, there is no obligation for employers to contribute to voluntary pension funds or to voluntary retirement insurance policies, then there is no need to allow
deduction – the employer can reduce his contribution by the amount of the extra tax payable on account of non-deduction.

The current tax law does not contain provisions for the determination of deductible expenses of some specific sectors (banking, insurance, securities, lottery, etc.). Guidelines of the Law (Circular No. 130/2009/TB-BTC, Circular 123/2012/TB-BTC) exclude certain deductible expenses such as “Expenses of business insurance, lottery business, securities business and a number of other specific business fails to comply with the written instructions of the Ministry of Finance.” In accordance with that, the Ministry of Finance has issued separate circulars and guidelines for specific sectors such as insurance, securities, lottery, and banking.

To clarify policy, bring transparency and improve the legal standing of the circular, the Government has proposed to insert in the CIT law under non-deductible expenses:

“Payments for business activities in banking, insurance, lottery or securities sectors; and for other specific business activities as regulated by the Ministry of Finance.”

This seems a sound proposal. As long as such expenses are governed by separate circulars there is no harm in linking them to the CIT law to give better legal standing to those circulars.

**Under Capitalization or Thin Capitalization**

In recent years, tax administrations in many countries have been concerned with the problem that the ratio of equity to debt falls short of the norm for that industry. Companies take on a large amount of debt with very little share money from shareholders. This practice may give rise to two sets of problems. First, a large amount of debt implies that interest deductibility will be high and that will erode the tax base. Second, with the shareholders stake in the business being low, this may increase the chances of bankruptcy thereby imposing costs on the economy.

The problem becomes more pronounced in the case of foreign subsidiary companies and the State Owned Enterprises (SOEs) that enjoy both explicit and implicit forms of government guarantee and therefore can raise large amounts of debt from the market. This problem has been tackled differently by different countries. In case of foreign companies, one solution could be charging a high withholding tax on interest payment to foreigners. Some countries (Belgium and Italy) judge the matter of thin capitalization on case by case basis. Other countries such as the US, Japan, Canada, Australia and France have legislated a limit on the debt/equity ratio that certain categories of industries should not exceed if their interest is to be fully deducted. According to the US law, a debt equity ratio above 1.5 to 1 may jeopardize interest deductibility.

Another incentive for doing this and sometimes even disguising return on equity as interest payment is due to preferred tax treatment of interest payment compared to dividend payment which is often subject to double taxation, first at the company level and then at the personal level. Interest on the other hand is taxed only once at the personal level. Some of the other restrictions imposed by a few countries include:

✔ The loan cannot be obtained from shareholders or other related parties:
✓ The loan interest conforms to the market interest and is not excessively high;
✓ The amount of interest payable is not related to the profits or some other performance measure of the company.

To mandate for a debt-equity ratio may be better because banning the loan from certain quarters and putting conditions about interest rate may not be efficient and may affect the company’s financing decisions adversely. It is also difficult to administer. The important point to note is that it does not matter what debt-equity ratio exists in practice but what matters is the ratio allowed for tax deduction. Debt-equity ratio in this sense limits the interest deductibility.

The 2006 law on foreign investment does not provide any regulations on thin capital. The CIT law of 2008 has the following provisions:

✓ Loan interest payments for production and business of enterprises that are not credit institutions or “economic organizations”, in excess of 150% of basic interest rate announced by the State Bank of Vietnam at the time of borrowing are not deductible;
✓ The payment of loan interest for capital contribution or payments of loan interest on loans taken to make up the deficit in the declared equity base are not allowable.

Current CIT Law does not contain provisions to control expenses in the case of “thin capital”.

The debt-to-equity ratio for Vietnam Enterprises as a whole was calculated to be 1.32 times in 1999, 1.93 times in 2000 and 1.96 times in 2002. On 1/1/2010, the average Vietnamese private enterprise had liabilities at 2.1 times equity on average, while this number for State enterprises was 3.09.

The results of the program named “The implementation of policies, laws, and use of state assets in the group, the state corporation” of the National Assembly in 2009 also showed that 30-40% of the total number of enterprises have the ratio of liabilities to equity of 3 times or more. In particular there are a number of companies in the state whose debt is more than 10 times higher than the norm. This is particularly of concern in the context of transfer pricing by foreign owned or invested enterprises. For example, the subsidiary in Vietnam borrows a large amount of money from the parent company. Interest expense paid to the parent company is subject to foreign contractors tax (FCT) at 5%. However, borrowing costs are deducted from taxable income and this will reduce corporate income tax. Standard CIT rate is 25%. Thus, parent company could have the benefit of a 20% reduction in the corporate income tax. In contrast, the Vietnam State budget will lose this amount.

**Recommendation:**

There should be regulations on deductible expenses of borrowing costs in the case business loans ratio to total equity is too high. This regulation will ensure financial security for businesses and for the economy, and moreover, this will act against transfer pricing. To this end, the draft law provides clear roadmap from to enterprises. Enterprises have time to be active in business restructuring and rebalancing the sources of working capital. On the other hand the draft law provides for the exclusion of interest expense only for loans arising from or on 01/01/2016.
International experience shows that in many countries with thin capital regulations, where interest paid for the loan exceeds a certain percentage (ratio of loans to equity) the countries do not allow total cost to be deducted when calculating the corporate income tax. OECD recommendations suggest a maximum debt/equity ratio of 3:1. In fact, in many countries such as Taiwan, Japan, Poland, Spain, Chile, Peru, South Africa, Portugal and Brazil loan provisions of business on equity in excess of 3:1 shall be considered as thin capital; some countries specified lower rate as Canada (2:1), France, the United States (1.5:1), Venezuela (1:1). Some countries apply this rate depending on the type of company. For example in China the prescribed ratio is 2:1 for normal business and 5:1 for financial institutions; Russia has a prescribed ratio of 3:1 for regular business and 12.5:1 ratio for banks and other financial institutions; Korea has 3:1 ratio if the loans are raised from of foreign shareholders and 6:1 ratio for businesses such as financial institutions. Accordingly, the interest charged in excess of capital is considered to be thin and shall not be included in deductible expenses when calculating income tax liability.

Provisions of Some Other Countries:

- New Zealand - The applicable ratio was decreased from 75% (3:1) to 60% (3:2) as of 2011/12 income year. Additionally, debt must be in excess of the specified D: E ratio, and also greater than 110% of the worldwide debt percentage.

- Germany - German rules were previously based on a 1.5:1 ratio and a de minimus safe harbor (virtually safe or too small to be of concern) of euro250k. This was replaced effective 2008 with a general limitation on interest deductions exceeding 30% of EBITDA (with exceptions, such as threshold of euro 3m etc).

- Australia - whilst the 3:1 ratio is used, it is a safe harbor. Entities with debt in excess of 3:1 (20:1 for financial entities) may demonstrate that the debt is at arm's length (i.e. independent parties could raise that level of debt). There are also other safe harbors for de minimus interest deductions (less than AUD 250k) and for worldwide gearing ratio (ratio of equity to debt or equity to asset base).

- Netherlands - until 1 Jan 2013 Netherlands denied deductions for excessive debt (debt exceeding 3:1) provided the excess exceeded euro 500k. As of 1 Jan 2013 new rules focusing on excessive debt in participating subsidiaries were introduced.

- In Vietnam real estate business must have a minimum of 20% equity investment in the project (ratio 4:1), to ensure conditions on the financial ability to undertake a real estate project. Businesses BOT, BTO, BT now also have to meet the equity ratio from 20% to 30% (4:1 or 3.3:1), depending on the individual project, to be able to participate in the project.

- Circular No.TT 13/2010/TT-NHNN of State Bank has regulations mandating the ratio of capital to ensure safety in the operation of credit institutions is 9% which is effectively a 10:1 D/E ratio.

The introduction of thin capitalization rules is in line with international trends (in particular the current focus on base erosion and profit shifting), as is the basis for the proposed rule, being a ratio approach of a 4:1 debt to equity ratio (and 10:1 D:E ratio for financial institutions). For completeness, it is however noted that more recently several countries have moved to an "earning stripping approach" to dealing with excessive interest (% of EBITDA - see Italy and Germany for example). Ratios of 2-3.5 are
common, so in this regard it is noted that a ratio of 4:1 is reasonably generous. One risk is that companies currently capitalized at a lower ratio might take the opportunity to introduce further debt to the maximum allowed under the legislation. The Law should include a provision that would disallow interest on new debt for which there is no commercial or business purpose. The drafting team may consider taking a two-prong approach: a d/e approach and an interest stripping approach\(^3\), perhaps restricting interest to 30% EBIT.

Delayed implementation mechanism - The proposed roadmap for implementation (delayed until 2016) is important as it gives time for enterprises to review their arrangements and make necessary adjustments. What is unclear however is how the rules will apply whereby an enterprise has a combination of loan (debt) instruments with different commencement dates. It is proposed that a blanket start date of 1 Jan 2016 may be considered (i.e. for all debt in existence at the relevant measurement time, including those concluded pre-2016). The impact of this on enterprises with significant debt from independent parties could be limited through the possibility for an arm's length alternative, and the impact on parties with related party debt is addressed by providing sufficient notice (over 2 years) for them to reconsider their financing arrangements. This would also prevent erosion of the tax base through "gearing up" by enterprises in order to exploit the delayed implementation.

On the reference to loans “as opposed to “debt, it is suggested that the definition of debt could use a “catch all” phrase, such as “Debt means any form of financial instrument on which interest or similar payments are made that are allowable as a deduction in a computation of taxable income”.

It is important to have clear definitions of the various terms. Introduction of rules based on a D:E ratio requires clear and comprehensive definitions of "debt", "equity" and "interest" in the CIT Law. A clear definition of "credit institutions and banks" would also be necessary to ensure appropriate scope and application of the proposed rule (and again, to limit any major economic distortions). For example some, countries also allow higher ratios not only to banks, but also securities dealers and similar firms (Australia). If the term “credit institutions and banks” is interpreted very liberally, the much higher D:E ratio will apply to a much wider range of institutions and may cause a distortion in the financial markets as firms seek to alter their economic activities to qualify as credit institutions to avail the higher interest deductions. How certain items are to be valued (debt, assets, capital) also requires careful consideration, in many countries reference is made to accounting standards. The applicable accounting standards in Vietnam and their interaction with the tax law (including relevant definitions) will therefore need to be reviewed.

When are debt levels to be measured? Under the proposed rule it is not clear as to the "timing" of measurement of the D:E levels. i.e. should the D:E ratio be measured (1) at year end, (2) as average ((a) opening and closing balance method, (b) multiple measurement points, (c) monthly etc.)? Clear guidelines on this are necessary to reduce uncertainty.

\(^3\) Interest stripping refers to the rules that disallow interest deductions in excess of a certain percentage of taxable income, and generally apply to corporations that have a debt to equity ratio in excess of the prescribed limit. This prevents erosion of the CIT base by restricting total deductions for interest payment to a certain percentage of income, payments in excess of that amount are “stripped” or removed or deferred and deduction is not allowed in the current tax year.
Approach of proposed rule and the possible impact on economic behavior: the proposed rules are based on a ratio approach, which is to be applied rigidly. This has the potential to distort economic behavior. Whilst many countries have adopted D:E ratio approaches, numerous have specified these as safe harbors⁴, providing that interest on debt exceeding such ratios will still be deductible provided the taxpayer can demonstrate that the level of debt is arm's length (see for example Australia).

On the point of the “arm’s length let over-ride”, this means that taxpayers need to show that, had they been independent and free-standing, they would have been able to borrow more from a third party lender. The GDT would need to counter this if this point is raised.

More fundamentally, it is not clear about the scope of these rules. They appear to apply to purely domestic loans as well as cross-border loans (which may be intentional, as the TP rules also apply domestically), but also to loans from any lender (whether related or not) – with the implication that the rules apply to stand-alone companies that are not members of a group. The assumption is that Vietnam intends these rules to apply to interest deductions arising in members of a MNE or Vietnamese group – perhaps this should also be clarified.

Application to SMEs etc.: The proposed rule appears to apply to all corporate enterprises with no threshold. A significant number of countries that have thin capitalization rules in place provide "de minimus" safe harbors, whereby the interest will be deductible regardless of the D:E ratio or other applicable thin capitalization rules (i.e. Arm’s length principle (ALP) or % of taxable earnings before interest, taxes, depreciation and amortization (EBITDA) ratio) provided the total interest deduction is below a specified amount.

Administration, monitoring and information: Monitoring the application of thin capitalization rules by the Tax Administration will require certain specific information. It will therefore be necessary to ensure that the tax filings require disclosure of debt and equity levels and information concerning application of thin capitalization rules.

Taxation of Foreign versus Domestic Companies

There is no differential treatment between taxation of domestic and foreign corporations. As part of Vietnam’s efforts to meet the criteria for accession to the World Trade Organization, the Vietnam’s National Assembly has unified principles relating to investment in Vietnam by foreign and domestic investors. Foreign invested enterprises are treated on the same footing as Vietnamese companies. This is the consequence of the national treatment principle that Vietnam has attempted to adhere to since the conclusion of bilateral trade agreement with the US.

Capital Gains

Income from capital transfers and from real property transfers; income from the ownership of or right to use assets; income from transfer, leasing out or liquidation of assets are included in “other

⁴ A legal provision to reduce or eliminate liability as long as good faith is demonstrated; in this case the interest deduction ceiling based on D:E ratio would apply except in those cases where firms can demonstrate that the deduction is valid, and at “arm’s length” interest rates.
income” when calculating taxable income and are thus taxable in Vietnam. The various methods of calculation of capital gains are:

- Taxable income of real property transfer equals (=) assessable income minus (-) the loss during the real estate transfer in the previous years (if any). Assessable income of real estate transfer is calculated as revenue earned from the real estate transfer minus the cost the real estate and the deductible expenses incurred on the real estate transfer;
- Taxable income from transfer or liquidation of assets other than real estate is the sum of money collected from asset transfer or liquidation minus (-) the book value of assets at the time of transfer or liquidation and deductible expenses directly related to the transfer or liquidation;
- Taxable income from capital transfer (excluding income from securities transfer) is the total sum of money collected under a transfer contract minus (-) the purchase price of the transferred capital amount, minus (-) expenses directly related to the transfer;
- Taxable income from securities transfer is the sale price minus (-) the purchase price of the transferred securities, minus (-) expenses directly related to the transfer;
- Taxable income from intellectual property copyright or technology transfer, is the total collected sum of money minus (-) the cost or expense for creating the transferred intellectual property right or technology, minus (-) the expense for maintaining, upgrading or developing the transferred intellectual property right or technology, and other deductible expenses.

As discussed above and in chapter 1, capital gains are now taxable in Vietnam. However, there is no provision for indexation of the purchase price. In situations of high inflation this leads to over taxation of the capital gains since the selling price increases both due to increase in real value of the asset as well as inflation. To estimate the true capital gain, the purchase price should also be appropriately adjusted for inflation. Using the historic purchase price rather than an inflation indexed purchase price overstates the extent of the capital gain and may discourage genuine long-term investment in assets. To discourage short-term speculation in liquid assets, some countries place restrictions on indexation for assets held for periods less than 1-3 years, but indexation is usually desirable for long-term investments.

**Regulation of Transfer Pricing**

Originally, transfer pricing provisions did not exist in the Vietnamese CIT law. They do, however, form a part of their Double Tax Avoidance Agreements. Transfer pricing adjustments however cannot be made only on the basis of treaty law. The force for carrying out an adjustment under the transfer pricing regulations must come from the domestic law. In international law on taxation it is commonly understood that the taxpayer can rely on whatever is more beneficial to him, treaty law or domestic law. This situation has now been remedied. Where the agreement on avoidance of double taxation which the Socialist Republic of Vietnam has signed has different provisions on the permanent establishment, the provisions of that Agreement shall apply.

The corporate/business enterprise tax rate of 25% was low and comparable to the tax rates in the region and countries with whom Vietnam does business. With a number of deductions and exemptions provided in the tax laws, the effective tax rate was even lower than 25%. Vietnam has gone for a lower rate for all non-mineral companies. One way to avoid conflict and foster a favorable business climate
without losing revenues is for the tax authorities to adopt regulatory criteria that have the support of international bodies. Fortunately a consensus exists among the OECD, the UN and the EU that a single guideline should be employed both by the enterprises in setting transfer prices and by the taxing jurisdictions. The basic guideline is the “arms-length-criterion”.

Arms-length price is the price that would have been negotiated between two unrelated parties for similar transactions under similar circumstances. To prevent the misuse of transfer pricing, most countries establish their legal right to adjust the reported transfer prices to conform to an arms-length standard. It may, however, be noted that implementing arms-length pricing has been a difficult task in practice both for the multinationals and the taxing jurisdictions.

The main provisions for transfer pricing in the CIT law in Vietnam are laid down as follows.

**Provisions to Regulate the Expenses of Business Management Allocated by Parent Companies Abroad to Permanent Establishments in Vietnam**

**CIT Law 2008 has the following provision:**

“Article 9. Deductible expenses and non-deductible expenses when determining taxable income

2. The following items shall be non-deductible expenses when determining taxable income:

(d) That part of business management expenses allocated by a foreign enterprise to its resident establishment in Vietnam which exceeds the level calculated by the allocation method stipulated by the law of Vietnam.”

The allocation method referred to above is defined in the following law:

**Circular No. 123/2012/TT-BTC:**

“Article 6. Deductible and nondeductible expenditures upon determination of taxable income

2.25. The expenses of business management allocated by company abroad to permanent establishments in Vietnam in excess of the expenses calculated by the following formula:

<table>
<thead>
<tr>
<th>Expenses of business management allocated by foreign company to permanent establishment in Vietnam in tax period</th>
<th>Taxable revenue of permanent establishment in Vietnam</th>
<th>Total expenses of business management of foreign company in tax period</th>
</tr>
</thead>
<tbody>
<tr>
<td>Total revenue of foreign company including revenues of permanent establishments in other countries in tax period</td>
<td></td>
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</tbody>
</table>
This method ensures that the total administrative or business management cost of the parent company of the Vietnam PE allocated as an expense to be deducted from the PE’s income while calculating Vietnam CIT liability does not exceed the same proportion as its revenue. It means that total business management (overhead or administrative) costs deductible in Vietnam under this head has to be in the same proportion as Vietnam PE’s earning to total earnings of the parent company, subject to certain restrictions on start dates, availability of audited financial records and compliance with Vietnam’s regulations on accounting, etc.

There are further provisions to regulate business transactions between associated parties: Circular No. 66/2010/TT-BTC dated April 22, 2010 – guiding the determination of market prices in business transactions between associated parties allows the following 5 methods to determine the “arm’s length price” or its substitute that can serve as a basis for determining the true value of deductions or taxable income for related parties. The methods allowed are:

- The comparable uncontrolled transaction price method;
- The resale price method;
- The cost plus method;
- The comparable profit method;
- The profit split method.

Current Issues

(1) The Allocation of Business Management Expenses:

The general management costs from all areas of business and activities-including business activities not related to the subsidiary in Vietnam are distributed to the subsidiary in Vietnam by the parent company abroad. This can cause a loss to the subsidiary in Vietnam.

(2) The Most Common Forms of Transfer Pricing:

The subsidiaries in Vietnam usually reduce income tax in Vietnam by doing the following:

- Raise the value of tangible fixed assets imported from their offshore parents and associated companies thereby increasing cost, as well as depreciation and reducing the CIT payable in Vietnam;
- Raise the price of raw materials imported from the parent company or a companies who are members in the group in order to increase deductible expenses;
- Raise the value of intangible assets acquired such as royalty payments, fixed payments for use of brand names etc.;
- Lower selling price of output products by export contract through its parent company or associated companies abroad in order to reduce the revenue and reduce the amount of income tax payable in Vietnam;
- Subsidiary in Vietnam provide services to foreign associated companies at prices lower than the market price or free of charge. Conversely, they pay the service fee to the parent company or its foreign associated companies at very high prices;
✓ Subsidiary in Vietnam takes loans from the parent company or associated companies abroad in the same group at very high interest rate.

Management costs allocated to the subsidiaries in Vietnam must be cost incurred for general management of the parent company for the region and related business activities in Vietnam, which does not include administrative costs for each private business activity of the head office and other expenses incurred for other areas, or for production and business activities that do not take place in Vietnam. The maximum allocated expenses must be limited to 8% -12% of the total costs incurred in Vietnam. Since the method of calculation of apportionment of the costs stated above does not rely on costs in Vietnam, but takes the total administrative cost of the parent company and allot it to Vietnam PE in the proportion of income of the Vietnam PE to total income, it could happen in case of the total business management cost being very high that the allocated cost could be higher than 12% of the Vietnam PE’s total costs (excluding the allocated business management cost).

These regulations to limit the allocation of administrative overheads are applied in many countries such as France and Belgium. It is also suggested that the “thin-capital” regulations which have been proposed in the CIT Law draft should be applied and the content of transfer pricing should be included in the Enterprise Income Tax Law to raise the legality of these regulations. When combined with the low uniform tax rate and abolition of tax incentives, these measures should help control transfer pricing more effectively. Training to appropriate officers in this area should also be considered.

Paragraph 3 of Article 2 of the Law on income tax 2008 regulates the term “Resident establishment” in order to determine the tax payers covered under the CIT and the CIT calculation method.

CIT Law 2008: "3. Resident establishment of a foreign enterprise means a production and/or business establishment via which a foreign enterprise conducts part or all of its production and/or business activities in Vietnam which earn income, comprising …”

The additional conditions "earn income" for the concept of resident establishment places a restriction on the scope of this provision making it narrower than international regulations and agreements thereby affecting the tax base in Vietnam. Business establishments may not be considered as resident establishment in Vietnam when they have no earned income.

Thus, the CIT Law draft removes the phrase "earning income" in the definition of resident establishment.

This is a good proposal; otherwise a PE that successfully transfers all its income out of Vietnam may completely evade the provisions of the CIT law.

The definition is still not in line with international standards found in tax treaties. In this regard, it is noted that the definition provides taxing rights beyond those generally afforded in tax treaties (i.e. providing for services PE and not providing exclusion for independent agents), however this is not an issue provided that tax treaties, where applicable, override Vietnam domestic CIT law. Moreover, the core definition of PE does not implement the "fixed place of business PE" in the same way as tax treaties as it refers to examples and not a clear requirement such as "fixed place of business". As a result there
may be instances whereby activities of a non-resident would comprise a PE under the tax treaty but not under the CIT law.

**Tax Integration and Flat Tax Rates**

The CIT laws exempt many enterprises receiving dividends from paying CIT on dividends received under certain circumstances. However, the PIT law requires any person who has dividend income to pay tax on that income at 5%.

The matter of tax integration arises because of the notion that corporate income tax and personal income tax result in double taxation of income. The presumption is that ultimately even the income from the companies accrues to individual shareholders and when dividends are subject to personal income taxation, it amounts to double taxation of income.

Classical method and full integration are at the two ends of the spectrum in this regard. In classical method (US, Switzerland) the corporate income and dividends are taxed separately and shareholders bear a double tax burden. In Full integration, tax on business profits is withheld by the full amount and claimed as a credit when personal income tax is computed. The final effective tax rate in this case is at the personal income tax rate and company income tax is just a withholding device. No country has tried full integration. The US and a few other countries, however, effectively adopt this method in case of small companies with a limited number of owners (less than 35 in US).

Most countries have adopted some form of partial integration methods in which some relief is granted either at the corporation level or the shareholders level. These are discussed in detail in the final chapter on international experience of taxation of corporate income.

**Flat Tax**

Slovakia has adopted a flat rate system under which all tax rates are at 19 per cent – rates for personal income tax, corporate income tax and value added tax. For tax integration, they have taken a rather bold approach. They have abolished the dividend taxation completely. Since both personal income and corporate income are taxed at 19 per cent, this approach has made the taxation of income fully neutral in terms of the source of income and there is no incentive either way - to incorporate or not to incorporate – for tax planning purposes.

Russia has also adopted a flat rate personal income tax with a single tax rate of 13 per cent in addition to zero per cent. But in their case, the federal corporate income tax rate is 30 per cent and the combined rate becomes 35 per cent because local municipalities have been allowed to impose a corporate income tax of 5 per cent. The rate of dividend taxation was first raised from 15 per cent to 30 per cent in year 2000. This was, however, accompanied by a credit for the underlying corporate income tax paid. Later on the imputation credit was withdrawn and a low dividend tax at the rate of 6 per cent and now at 5% has been applied. Thus both corporate income and dividend income are taxed but the dividends are not taxed at the normal PIT rate but at a much reduced rate. This is not a full tax integration system but closer to a partial integration system (to the extent that dividends are taxed at a much lower rate than the PIT), as long as the same income is not taxed again under the PIT.
Since the scope of this report does not include PIT, we will not make further suggestions on that account. However, it may be said that notwithstanding the deduction of 5% tax on dividends at the corporate level, there are still two issues that arise: (1) whether to tax realized capital gains from retained earnings as well to maintain parity between tax payable at the personal level between dividends and capital gains; (2) whether the government sees it as an issue of providing strong incentives to all classes of income earners to become shareholders, or whether the government views income from corporations as primarily a source of income for the rich that should be taxed.

If the government wants to maintain strong incentives to invest (especially in the long-term) in companies, then it can continue to exempt the capital gains portion and do the following for distributed dividends (details above):

1. Dividend tax credit or imputation system with refund at personal level
2. Single Stage System
3. Dividend deduction at personal level (partial taxation at PIT level)

If, however, the government feels that dividends and capital gains accrue mostly to the rich and they are not likely to correctly pay PIT on dividends (or capital gains), then the government should apply as much of the tax as it can at the corporate stage. Instead of 5%, the dividend tax can be raised to 10%. This has two risks: (1) smaller shareholders returns will fall, and may exceed their liability under PIT; (2) if capital gains are not taxed a second time, shareholders will prefer to receive profits through this mechanism rather than dividends.

Therefore, the government should consider a proper method of partial integration. It can withhold dividend tax at a higher rate of 10-15% at the corporate stage, but provide a credit of the tax paid to PIT paying shareholders if they file a PIT return and if dividends are taxed like other income at progressive rates. Then the government should also include short-term capital gains from shares at the same rate in the PIT to maintain parity.

Suggestions to Improve Conditions for the Selection of Accounting Practices for Taxation Purposes

Generally as a rule all businesses - big or small - maintain some accounts so as to know their margin of profit. The corporate sector has to maintain accounts in the manner prescribed by the company law. It is understood that accounts by companies are maintained and audited by chartered accountants. These are few and their level of competency is not known. The tax laws do not prescribe any method of maintaining accounts. Some provisions exist in the law on value added tax but not in the CIT laws.

Small businesses with low turnovers cannot be expected to get their accounts audited as the costs may be too high for them. The tax statute should provide that the profits disclosed should be reflected in the accounts maintained and shown to the tax officer. If the accounts are not maintained in a credible manner from which the profits can be properly deduced, then the accounts would be liable to be rejected and the profits estimated by the tax officer. The tax officer would be also entitled to resort to an estimation of income even in cases where no accounts are maintained or not produced by the taxpayer before the tax department. Vietnam has the following provisions for non-business enterprises that cannot account for taxable profit in the normal fashion.
Non-business units that indulge in goods and services business subject to enterprise income tax who can account for their revenue but not account for cost and income of the business operation shall declare and pay enterprise income tax as a percentage on the revenue of sales of goods and services, as follows:

- For services: 5%
- For goods business: 1%
- For other activities (including activities of education, health, art performance): 2%

There is no information of the number of companies that apply this method. Moreover, there is no revenue limit when applying this method. All non-business units that meet requirements can apply.

Large businesses with a turnover over a particular amount and companies should be obliged to maintain accounts and get them audited by an Accountant. It should be mandatory to file the audited balance sheet and accounts along with the return of income so as to prevent any manipulation after the return is filed.

Accounts for the small businesses, may be allowed to be kept, either on receipt or mercantile basis. A taxpayer should not be allowed to move from one system to another from year to year. If he is allowed to do so then certain items of income would never be taxed. In one year a sale may be made but sale proceeds may not be received in that year. If accounts are maintained on a receipt basis then that sale would not be accounted for in the income for that year. If the person is allowed to switch to the mercantile system of accounting in the following year then that specific sale would not be disclosed again as in this year there is no accrual, the sale having taken place in the earlier year.

For large businesses and companies, accounts should be kept only on the mercantile basis and in accordance with international accountancy norms (double entry book keeping) - you book an expense when you incur it and not when you pay for it. Similarly you book a receipt when you raise an invoice or make a sale and not when you actually receive the moneys. In this manner the fact as to whether an expense has been incurred and whether it is allowable only has to be examined. Likewise the sale of an item does not have to be linked with the receipt, which may be in a later year. Tax evasion will consequently be checked by the statute prescribing methods of how accounts should be maintained as also what forms and registers are necessarily to be kept by different kinds of businesses.

Before prescribing methods of accountancy and their audit, a check should be made of the number of qualified accountants that would be available in the next few years. It is important to know the appropriate time for the introduction of the scheme of maintenance and audit of accounts. It is also equally important to train officers of the tax department in accountancy. Audit division of the tax department would then be able to examine and audit the accounts of small and large businesses.

The scheme of maintenance of accounts should be laid down in the tax law and the rules and not through circulars. Apart from the fact that the law on the subject would be available at one place, the penalty for any infringement thereof would also get legal backing.
Suggestions to Impede Tax Planning

Dubious debts and attribution of unrecoverable debts to expenditure if detected are tax evasion and not just tax planning. The latter is considered to be within the four corners of the law and is known as tax avoidance. There is a very thin line to distinguish the two and most countries follow the principle of substance over form.

One of the methods of countering tax evasion attempts by showing incorrect debts/ or expenditures, is by introducing the methods of accountancy onto the statutes. The audit by accountants would further impede fudged accounts in this regard. Lastly the accountants should be made responsible for the accounts audited and certified by them by providing laws to make them accessories to the detection of a wrong claim. Penalty and prosecution should be prescribed for the taxpayer and the accountant signing the certified accounts found to be incorrect on the score of wrong debt claims etc. In the audit form accountants would have to certify a debt and how it has become bad according to the norms laid down by the Government. This would act as a deterrent and taxpayers may desist from this tax evasion technique.

Laws curbing the debt claims or putting a ceiling in place are not recommended as these create distortions of their own. This is true particularly for economies of developing countries like Vietnam. Also thin capitalization rules may be imposed as mentioned earlier although this may result in somewhat decreased flow of investment into the country.

In addition to the accountancy set up, tax officers would still have to deal with delinquents. Tax enforcement machinery should be strengthened and the knowledge of accountancy of the officers upgraded. Examination of Accounts is an art which comes through knowledge and experience and due regard should be given by the administration in the placement of officers in taxing jurisdictions. The suggestions made would hold good for detection from the accounts of any kind of fraud and not only dubious debts.
Chapter IV: Tax Treatment of Special Entities

This chapter deals with the taxation of certain special entities under the CIT. Certain classes of organizations are regulated by laws other than the CIT law and conflicts arise when the regulating laws contain provisions inconsistent with the CIT laws. Some of the cases currently under discussion in this context are highlighted in this chapter and some of the solutions proposed are discussed.

It should be mentioned at this stage that two general provisions are normally recommended in the case of all taxation world-wide from the point of view of both optimizing tax policy and revenue and facilitating tax administration: (1) No provision on taxation, and tax revenue should be issued as a part of laws outside the tax law unless they are intended to reference whole or part of an existing tax law; (2) Even if such measures exist in other statutes governed by ministries other than the Finance ministry, unless they are re-issued by the competent authority to issue legislation on tax matters they should be removed from the law.

This will ensure that no agency other than the agency responsible for collecting taxes makes any decisions that affect the collection of taxes that are independent of the tax authorities and that conflicts between laws are minimized and that tax collection remains the primary responsibility of the tax administration. Otherwise, if the ministry of mines, for example, issues a law that grants concessional rates to certain projects, it can lead to a rush of such proposals from other ministries. It is the primary responsibility of the Ministry of Finance and the tax authority to collect taxes. Unless they are informed of any measure that may affect tax collection and have a chance to examine its implications and give their consent or present their objections, they will find it very difficult to implement a consistent and rational tax policy and meet their revenue targets. Secondly, this will also minimize conflicts between different laws and classes of taxpayers if all tax related provisions are issued by the authority that regulates tax laws only.

Undistributed Incomes of Private Higher Education Establishments

The CIT law of 2008 does not have any provision to exempt the undistributed incomes (profits) from CIT. The net effect of this is that many not for profit organizations such as British Council, the French Community, Education Center of the Council of Ministers of ASEAN countries, etc. become liable to pay CIT on their incomes despite being involved in socially desirable activities. Three alternatives have been suggested in this regard:

(1) Undistributed profits of all organizations should be exempt from tax. This is clearly not a viable option. It is another matter to say that undistributed profits should be exempt from double taxation (not charged capital gains tax or taxed under PIT) but if this is removed from the ambit of CIT all companies will have an incentive to evade CIT by not distributing any profits.

(2) Tax exemption for undistributed profit of private higher education institutions implemented through the CIT law. This is a more realistic option, but it can be taken further. It has been discussed in the previous chapter in the context of donations to charitable activities that organizations that are primarily engaged in socially desirable activities can be granted a “not – for – profit” status under the CIT
law. This will not only enable their income used for charitable purposes to be tax–exempt, but also allow donations to these organizations to be deducted from taxable income of other entities. Required restrictions on their activities can be prescribed in the CIT law itself or a supporting act and it is the job of the tax authorities to ensure only that they fulfill the restrictions required for their tax exempt status. In the US, such organizations are identified in the tax code and the IRS issues them a “determinations” letter confirming their tax–exempt status on successful application.

(3) Not adding the proviso on tax exemption in the CIT law, but continue to allow it under the law on tertiary education. This is not a good idea for reasons discussed above. The standard and best practice around the world is that tax related provisions are regulated by the tax authorities through the tax law. If non tax authorities start granting tax exemptions without the knowledge and concurrence of the tax authorities, it will become impossible to have any control over tax collections and ultimately, the budget.

Income from Transfer of Certified Emission Reductions

The CIT law of 2008 does not have a provision for the exemption of income from the transfer of certified emission reductions. In 2008, a one-year exemption to such income was granted by decree. Vietnam has many Clean Development Mechanism (CDM) projects, of which 164 projects are internationally recognized, thus being ranked fourth in the world in this area. With 7 million tons of CO₂ Carbon Emissions Reduction (CERs) certificates, Vietnam is ranked ninth in the world in the number of CERs certificates. The transfer of CERs is a source of income for businesses and it is a part of assessable income when calculating the corporate income tax. The corporate income tax on income received on the transfer of CERs not only reduces the benefits of the business transfer, but also does not encourage businesses to invest in CDM projects.

Some countries such as Thailand, Malaysia, South Africa, and China have tax exemption on income from the transfer of CERs. For example, the Thai law applies tax exemption on income from the transfer of CERs for 3 years consecutively after the project receives written approval of the Greenhouse Gas Management Organization Thailand. South African law applies the income tax exemption from the first transfer; the income from the subsequent transfer of CERs is taxed.

It is a matter of government policy on environment and development as to how far the government of Vietnam wants to encourage such businesses from the point of view of attracting internationally mobile investment that is also beneficial to the environment as well as the local economy. On the other hand, income from CERs is also a form of corporate income and there is no particular reason to exempt it as it supplements normal business income.

Since we are recommending that Vietnam remove its tax holidays, have one positive corporate tax rate for non-mineral income and one for mineral income, while not expanding the list of exempted incomes, it is really a matter of the potential loss of revenue from this exemption. It does not make any sense to exempt the first transaction only and not subsequent ones. The total revenue from this source should first be computed. Many of these companies may already be enjoying a tax holiday or a reduced rate of tax and paying less than the prescribed rate on such income. If tax holidays are removed and there is only relatively low CIT rate the government can include this income in the list of exempted incomes if
the revenue loss is small. If this is expected to be a major source of income in the future, the government should tax it. There are international practices both ways and it is really a matter of taking a policy decision one way or the other.

**Income from the performance of duties by the State Development Bank Vietnam (VDB), Bank for Social Policy (BSP)**

The VDB and BSP perform activities that are often developmental in nature. The current CIT Law does not provide for the tax exemption for the income from many activities of VDB and VBSP. In practice, the banks comply with the Regulation on Financial Management for Banks, while the tax authorities charge taxes under the CIT Law. This causes some conflicts.

The main activities of these banks are non-profit business. In some cases, they operate using funds bearing subsidized interest rates received from the Government. Therefore, the income of these banks should be exempted from tax and these contents need to be reflected in the CIT Law to ensure consistency when it is implemented. Income from the state development investment credit activities, and the state export credit activities of BDV should be exempted from taxes; income from credit activities for the poor and other policy beneficiaries of BSP is tax exempt income. However, the activities of the two banks have expanded recently, and are similar to activities of professional commercial banks. So CIT Law needs to clarify unambiguously which incomes should be exempt from CIT.

There is another approach that may be preferable. If the principle of allowing organizations to register as tax-exempt organizations under the CIT law is followed and the two banks are granted this status, their incomes become exempt. However, profit-making activities would then be disallowed, or shareholders would not be able to receive those profits. The question is really one of ownership and intent. If the government owns these organizations completely (all the share capital) and subsidizes them (through funds at low interest rates), it does not make much difference whether they are taxed or not. It is re-routing money from one government account to another.

However, if there is a component of private capital then part of their income goes to private shareholders and it also does not make sense for the government to subsidize and then exempt incomes of private persons. If the organizations are wholly-owned by the government and all their income belongs to the government, they can very well be taxed. If they are some form of Private-Public Partnerships, then the taxation of these entities should be handled differently, taking into consideration the subsidy component, equity contributions and other factors to maintain efficiency and market discipline. To save on administration and compliance costs, it is recommended to get organizations wholly-owned by the government registered as not-for-profit and exempt them. However, such organizations normally do not undertake activities for the purpose of earning profits. It would also not be in keeping with their status as not-for-profit organizations if they do. Recovering cost plus a margin for contribution to fixed costs and cross-subsidizing loss-making activities is another matter and may be permissible.

To emphasize again, if these are wholly owned by the government, and the government grants them exempt status, the government does not lose anything as it gets the surplus they generate, while saving on administrative and compliance costs. In general, to implement this type of provision, a whole new set of provisions have to be added to regulate “not-for-profit” entities in the tax law on the lines of
the US tax code and practice in other countries. However, normally “not-for-profit” organizations do not work for profit, and if they do, they have to be taxed – they cannot use the status as a tax shelter. Normally, if commercial activities have to be undertaken, those activities are separated from the tax-exempt entity; it is set up as a separate corporate entity that is not tax-exempt and taxed accordingly.

Income from transfer of investment projects; income from transfer of exploration rights, mining and mineral processing; income from transfer of contributed capital - the right to participate in investment projects

“Other income” is taxable under the CIT law in addition to income earned from manufacturing and services businesses. Other taxable income comprises income from capital transfers and from real property transfers; income from the ownership of or right to use assets; income from transfer, leasing out or liquidation of assets; income being interest on deposits, loans or sales of foreign currency; income being recoveries from contingency reserves; income earned from bad debts which were written-off and are now recoverable; income being debts payable to unidentifiable creditors; income from business omitted in previous years, and other income including income receivable from activities of production and/or business outside Vietnam.

Income from transfer of investment projects; income from the transfer of exploration, mining and mineral processing claims; income from transfer of contributed capital, the right to participate in investment projects etc. are all new forms of income generated in the economy and are quite common in a modern business oriented economy. These earnings are not mentioned in the new CIT Law and are only prescribed in the bylaws of the Decree. Some businesses do not accept this as an assessable income because it is not prescribed in the Law on CIT, causing difficulties for the implementation of the CIT Law.

These incomes are incomes of enterprises and should be considered a part of assessable income as has been discussed in chapter 1. As discussed therein, there is also no need for a proposal to club and set off losses from these incomes separately. If it is necessary, this may be made explicitly clear in the CIT law.

Income earned from activities of production and/or business in goods and services by enterprises employing specified numbers of disabled people, reformed addicts and people infected with HIV

Through several decrees and circulars, the government has provided tax exemptions to two classes of enterprises: (1) Those that employ disabled, rehabilitated and HIV positive to the extent of 30% or more of their labor force (subject to a minimum of an average number of 20 laborers in their workforce during the year) – excluding enterprises in the real estate or finance sector; (2) Those enterprises receiving income from job-training activities exclusively for ethnic minority people, people with disabilities, children in extremely disadvantaged circumstances, persons involved in social evils, persons undergoing detoxification, and detoxified and HIV-infected persons. If an establishment also provides job training to others, tax-exempt income shall be determined based on the ratio between the number of ethnic minority people, people with disabilities, children in extremely disadvantaged circumstances, persons involved in social evils, persons undergoing detoxification, and detoxified and HIV-infected persons and the total number of job trainees of the establishment.
These regulations are not a part of the CIT law itself and are governed by other provisions. More importantly, there are two possible viewpoints on whether these provisions should exist at all. The first viewpoint is that this is socially desirable from many points of view and reduces the government’s subsidy burden or the expenditure the government would have to undertake in the absence of training and employment to such persons. The second view is that these incentives should not be included in the CIT Law. The integration of social policies in the CIT law makes tax policy more complex, difficult to manage, creates loopholes for companies to take advantage of lower tax payable and causes horizontal inequity between companies. There are three clear reasons for this.

- First: In practice, it is very difficult to calculate the income earned from activities of production and/or business in goods and services by enterprises especially reserved for employees who are disabled people, reformed addicts and people infected with HIV. There are some criterions required in the Decree No. 122/2012/ND-CP and Circular No. 123/2012/TT-BTC, but it is still difficult for the tax authorities to understand and manage these provisions.

- Second: The fact that only enterprises that have tax payable could benefit from this tax incentive. This means that employees that are disabled people, reformed addicts and people infected with HIV will have differential benefits from tax incentive policy depending on the profitability of the business they work for.

- Third: in some instances, this regulation leads to abuse. Enterprises can manage to have the names of wounded soldiers or people with disabilities on their payroll to meet the CIT Law requirements in order to enjoy tax incentives. However, in many cases, these individuals do not participate or do not directly work in the business.

The integration of social policy in the tax incentives could make the tax policy more complicated. In addition, it does not play its full role in addressing social policy and it is easy for enterprises to abuse the tax incentives to evade and avoid tax. Therefore, in the future there is a need to restrict the integration of social policy in the tax incentives, and try to achieve socially desirable outcomes through other measures, such as direct support from the state budget for social policy beneficiaries.

If this is not possible, then the use of a refundable tax credit should be pursued rather than allowing exemption/deduction. This has the advantage that the amount of tax benefit does not vary with the tax rate applicable to the company or the taxable profit, the amount per employee is fixed and received by the company whether it makes a profit or loss, the government can exactly account for the amount of tax revenue it loses because of this provision and it will take care of some of the issues of having to calculate income properly as per the law attributable to these persons and make it revenue neutral to the enterprise to employ such persons if the benefit is calculated accurately by the concerned government authorities.
Chapter V: Tax Incentives

I. Tax Incentives

The Corporate Income Tax in Vietnam provides for a series of tax incentives for different types of industries and their geographical location. These tax incentives are listed in detail in the annex I to this chapter. These are in addition to exemptions from tax provided to certain sectors and incomes discussed in previous chapters.

An analysis of these tax incentives reveals their complexity. Some incentives are available if the investment is made in specific sectors, and specific geographical locations. Others are applied if the enterprise meets some social criteria like employing certain number of labor force, female labor or handicapped people. Another category of enterprises eligible for tax incentives is the investments made in special economic zones.

The tax incentives may be broadly placed in two categories: first, where preferential or reduced rates of 20 and 10 percent tax rates are applicable and second, where outright tax exemption or tax holiday for prescribed period of time followed by 50 per cent tax liability for a few more years. It is also stipulated in these provisions that if an enterprise is starting a new business or expanding an existing business, it must separately identify the profits of each of those units in order to claim the benefits of tax incentives. However, Article 18 – Circular 123/2012/ TT-BTC allows firms that cannot separate their taxable profit to allocate deductible expenses to incentive availing income in the same proportion as incentive eligible income to total income.

Different types of tax incentives both in terms of rate reduction and duration of application are available depending on different criteria such as:

(a) Whether the investment is in geographical areas included in the appendix to the Decree No. 124/2008/ND-CP of December 11, 2008, detailing and guiding the implementation of a number of articles of the Law in Enterprise income tax, or economic zones or hi-tech parks established under the Prime Minister’s decisions;

(b) Whether it is located in sectors such High technology as prescribed by law; scientific research and technological development; Development of water plants, power plants, water supply and drainage systems; bridges, roads, railways; airports, seaports, river ports; airfields, stations and other infrastructure works of special importance as decided by the Prime Minister; Manufacture of software products. In some of these cases the benefit may be extendable to a maximum period of 30 years;

(c) Whether the investment belongs to point (b) above and is located in geographical areas included in point (a) above;

(d) Whether the investment is made in industries located in Economic Zones.
Eligibility Criteria

The criteria for receiving tax incentives are outlined in detail in the law but their multiplicity is bound to create practical problems. For instance, it would not be easy to separate profits of existing establishment from its expanded part or relocated unit or from application of renewed technology.

There is a separate provision of tax incentives to industries established within the economic zones and hi-tech zones. There is no apparent reason for doing this. Economic zones already offer several advantages to investors and any additional benefits under the corporate income tax are not necessary and simply lead to avoidable revenue leakage.

Tax Holiday or Tax Exemption

It is now a well-established fact that outright tax exemption or tax holidays are not cost-effective. It is more or less a blunt and opaque system of taxation in which there is no direct linkage between incentive and investment and the government is not able to evaluate the amount of revenues lost. It is also not unusual for companies to establish businesses so that they just fulfill the conditions of enjoying a tax holiday, then disappearing at the end of the period and reappearing again as a new enterprise to claim tax holiday/exemption afresh.

In conclusion, it may be noted that the present regime of tax incentives is very complex and needs to be greatly rationalized. It not only lacks transparency resulting in higher compliance costs to businesses, it offers avenues that may be abused by corporations for tax avoidance which increases the cost of administration and is also likely to result in loss of revenues.

Therefore, our recommendation is to do away with tax holidays, and multiple rates and to have one single non-mineral rate at 22%, a single mineral rate of 50%, abolish all tax holidays, reduced rates and special deductions. As discussed elsewhere, some industries/enterprises may be given tax exempt status based on proper procedure and a formal procedure for determination of tax-exempt status. In all other cases of socio-economic objectives, the government can use refundable or non-refundable tax credits, since these are certain, equitable and explicitly accountable tax expenditures. In the present CIT draft law, the government has sought to exclude certain incomes from the purview of tax incentives, such as:

(a) Income from transfer of capital, transfer of capital contribution; income from transfer of property (other than social housing provisions), income from transfer of investment projects, transfer of Joint franchise investment, transfer of exploration, mining and mineral processing; foreign income received in Vietnam;

(b) Income from operations search, exploration and exploitation of oil and gas, and other precious resources and income from mining activities;

(c) Income from business services which are subject to special sales tax;

(d) Other cases as prescribed by the Government.
If our recommendations are accepted, this becomes unnecessary. However, the draft law of June 19, 2013 proposed the following:

The scope of investments entitled to preferential tax incentives has been broadened. Article 13 has been substantially revised. Clause 1(b) now includes preferential tax at 10% for enterprises engaged in software production, production of composite materials, light construction materials, and precious materials, the production of renewable energy, clean energy, waste energy, development of biological technology, and environment protection.

A new Clause 1(d) now offers preferential CIT rate at 10% to large manufacturing projects in excess of VND 6,000 billion (approximately US$300 million) and investment projects in selected industrial zones. New provisions in Clause 2(b), 2(c) and 2(d) now extend the 10% rate to projects investing in social housing, incomes of mass media and publishing houses, and corporate incomes from planting, caring, and protecting of forests; agricultural, forestry, and aquatic production in locations that have extremely difficult socio-economic conditions; and investment in the preservation of agricultural, aquatic, and food products.

The new Clause 3(b) now provides for a preferential tax rate of 20% for a larger list of industries. These include investments in energy-saving projects, manufacturing of irrigation equipment; production and processing of cattle, poultry and fishery feed; and the development of traditional trades. Starting from January 1, 2016 the corporate incomes under this clause will be taxed at 17%.

The incentives in the form of duration of tax exemption and reduction in tax rates has also been revised in Article 14. A new provision in Clause 4 now extends the duration of concessional CIT rates to enterprises that wish to expand the productive scope, increase their capacity or renovate their productive technology.

II. Experience of Other Countries on Tax Incentives

Tax incentives, tax holidays in particular, used to be quite popular especially in the developing countries about ten to fifteen years back. This trend has been undergoing change in the past few years as a series of studies have clearly shown that tax incentives do not have a significant impact on flow of investment in a country. As a result, tax holidays have completely disappeared from developed countries.

It has been borne out that the following factors play a significant role in attracting investment:

- Economic and political stability
- A well administered and stable tax system with moderate tax rates
- Adequate infrastructure – both physical and social
- Untapped but trainable labor force
- Existence of natural resources

Now OECD countries only use investment tax credit or accelerated depreciation both of which are quite well targeted to investment. Developing countries including the ASEAN do maintain a variety of incentives.
1. Types of Tax Incentives and Their Implications

For corporate income tax, most common incentives include tax holiday, investment tax credit or allowance, and accelerated depreciation.

1.1. Tax Holidays

Zero tax rates are applied during holiday period and positive tax rates after the period comes to an end. Sometimes a reduced rate is applied for some time before applying the normal tax rate.

It is one of the most common forms of tax incentives and is widely in use.

It is a “blunt” tax instrument. Tax holidays and general corporate income tax rate reductions have been empirically found to be cost-ineffective.

1.2. Investment Tax Credit

As the name suggests, it is a credit given to the investor against his tax liability. In order to take the benefit of a tax credit in the initial year when tax liability may be small or zero, the individual or the company should have tax liabilities somewhere else. Otherwise the credit may be carried forward.

With an Investments tax credit of K per cent, if the purchase price of an asset is = I, then the investment tax credit is KI. The net cost of investment then becomes I-KI = I*(1-K). This would naturally increase the rate of return on the investment I.

1.3. Investment Expense Allowance

If the rate of allowance is K, then instead of a tax credit, the amount KI is deducted from taxable income.

European countries in transition like Czechoslovakia, Poland, Hungary, and Romania apply this type of investment incentive.

1.4. Accelerated Depreciation

a. Main issues related to depreciation

- Two components of depreciation: “wear and tear”; and technical obsolescence.
- Ideal case when “true” reduction in value of investment item (economic depreciation) is used.
- However it is hard to estimate economic depreciation, hence in tax codes depreciation rates or depreciation schedules are arbitrarily specified (fiscal depreciation).

b. Some types of fiscal depreciation

b.1. Straight line depreciation:
When the same rate of depreciation is applied over the project’s life.

Illustration

Assume an asset with 5 years of life and purchase price $1,000 and corporate income tax rate of 40% and 8% as cost of funds or discount rate. The depreciation allowance each year is US$200.

<table>
<thead>
<tr>
<th>Year</th>
<th>1</th>
<th>2</th>
<th>3</th>
<th>4</th>
<th>5</th>
</tr>
</thead>
<tbody>
<tr>
<td>Straight Line depreciation</td>
<td>200</td>
<td>200</td>
<td>200</td>
<td>200</td>
<td>200</td>
</tr>
<tr>
<td>Tax savings @ 40%</td>
<td>80</td>
<td>80</td>
<td>80</td>
<td>80</td>
<td>80</td>
</tr>
<tr>
<td>Present value of savings @ 8%</td>
<td>80</td>
<td>74.1</td>
<td>68.6</td>
<td>63.5</td>
<td>58.8</td>
</tr>
<tr>
<td><strong>Total savings in present value</strong></td>
<td><strong>345.0</strong></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
</tbody>
</table>

b.2. Accelerated depreciation:

Assume a straight line depreciation in 3 instead of 5 years of normal life. It will reduce tax liability during early years and thus the present value of total taxes paid decreases which would improve the project’s viability.

<table>
<thead>
<tr>
<th>Year</th>
<th>1</th>
<th>2</th>
<th>3</th>
<th>4</th>
<th>5</th>
</tr>
</thead>
<tbody>
<tr>
<td>Straight Line depreciation</td>
<td>333</td>
<td>333</td>
<td>333</td>
<td>0</td>
<td>0</td>
</tr>
<tr>
<td>Tax savings @ 40%</td>
<td>133</td>
<td>133</td>
<td>133</td>
<td>0</td>
<td>0</td>
</tr>
<tr>
<td>Present value of savings @ 8%</td>
<td>133</td>
<td>123</td>
<td>114</td>
<td>0</td>
<td>0</td>
</tr>
<tr>
<td><strong>Total savings in present value</strong></td>
<td><strong>370</strong></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
</tbody>
</table>

- The present value of tax savings is more with an accelerated depreciation. This would encourage investment.
- Accelerated depreciation encourages projects with long term investments since the present value of tax savings in higher in this case.

b.3. Immediate expensing

In immediate expense, full amount of depreciation is deducted in the first year of production. Immediate expensing provides the largest tax savings and, therefore, encourages investment most. In this case, however, the government does not collect any tax revenues.

b.4. Declining-balance method

- Currently applied by countries like Japan, Switzerland, and Spain.
- Assuming that investment cost of $1 depreciates at the rate of r. Depreciation schedule is as shown in the table below.

<table>
<thead>
<tr>
<th>Year</th>
<th>0</th>
<th>1</th>
<th>2</th>
<th>3</th>
<th>...</th>
<th>t</th>
<th>...</th>
</tr>
</thead>
<tbody>
<tr>
<td>Investment</td>
<td>$1</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Depreciation Allowance</td>
<td>r</td>
<td>(1-r)r</td>
<td>r(1-r)^2</td>
<td>...</td>
<td>r(1-r)^t</td>
<td>...</td>
<td></td>
</tr>
<tr>
<td>Book value of assets</td>
<td>1-r</td>
<td>(1-r)^2</td>
<td>(1-r)^3</td>
<td>...</td>
<td>(1-r)^t</td>
<td>...</td>
<td></td>
</tr>
</tbody>
</table>
1.5. Neutral Tax Incentives

The design of incentives requires a good deal of care so that it does not affect the "neutrality" of the tax. Neutrality is achieved when an incentive does not induce new covered investments with low rates of social yield, while failing to induce covered investments with higher rates of social yield.

Some neutral tax incentives - Incentives that do not distort investment decisions:

- Musgrave neutrality;
- Samuelson Neutrality;
- Harberger-Bradford neutrality.

a. Musgrave Neutrality

It entails:

- Immediate deduction (expensing) of investment from taxable income, and;
- Full taxation of future income streams and no depreciation allowed.

Immediate expensing does not change project rankings. If the taxable income is Y and depreciation is D, the present value of investment is PV (Y+D). With immediate expensing, the project gains t*(PVY+PVD) at the very outset. Since there is nothing to depreciate in future, it pays tax on (Y+D) and loses t*(PVY+PVD) during its life time.

The net gain/loss of the project is: \( PV(tY) + PV(tD) - PV(tY) - PV(tD) = 0 \)

Note that under immediate expensing, government does not collect any tax, it rather becomes a partner in investment. Hence this incentive should be used rarely and is a preferred instrument only for promoting environmentally friendly machinery and equipment.

If there is a 50 per cent tax rate and all investment is immediately expensed, the government in effect becomes a 50 per cent partner in the venture. It contributes half the amount invested in the corporation by off-setting 50 per cent of taxes which the company would have paid otherwise. From the stream of benefits generated by the project every year, the government takes exactly half of it (as its share) each period.

b. Samuelson Neutrality

It entails:

- There is no immediate deduction of the investment, and;
- Tax is applied to income net of economic depreciation.

Tax impact on the project = PV (-tY).

The PV of project income after tax = PV (Y-tY) = PV [Y (1-t)]

The PV of income decreases by the same fraction as the tax rate among all projects. As Rate of return is determined based on net-of-tax income, the returns of all the projects decrease by the same fraction.
and hence the ranking of the projects does not change. If a project has an internal rate of return \(r\), then the net of tax return becomes \(r(1-t)\).

c. Harberger-Bradford Neutrality

It combines immediate expensing (Musgrave neutrality) with economic depreciation (Samuelson neutrality). A fraction of the investment cost (say \(\alpha\)) is immediately expensed and the remaining \((1-\alpha)\) part is deducted as economic depreciation over the asset's life.

The ranking of projects will not change again.

2. Tax Incentives in ASEAN

2.1 Indonesia

General Income Tax Exemptions.- The CIT law exempts: Aid payments or donations; dividends from retained earnings, retained capital, and profits or dividends received by venture capital companies not listed in the stock market. The PIT law exempts: the after-tax profits from a partnership or similar association; gifts, donations and inheritances; proceeds of life and health insurance; compensation in-kind; and Social Security benefits (death and accident), except Old Age Pensions.

Contribution to Development.- Industries that significantly contribute to national industrial development are benefited by:

- Additional deduction of 5% of the realized capital investment, for six years.
- Option to used accelerated tax depreciation (double normal rates).
- Loss carry forward for 10 years.
- 10% withholding tax (or lower DTA rate) on dividends to non-resident shareholders.

Economic Development Zones (KAPET).- These industries are granted, in addition to the last 4 incentives mentioned beforehand:

- Suspension of import duties on the import of capital goods, equipment and raw materials;
- Reduction of import duty to 5% for machinery.
- No collection of VAT and Sales Taxes on Luxury Goods on transfers of goods within the Zone.
- Relief from Income Tax on imported goods for production activities.
- Deductions of benefits in kind provided to employees and expenses on social community development.

Other Import Duties Privileges.-

(i) Free Trade Zones (FTZ) and Free Port Areas (FEA) do not apply import duties and other taxes on imports of goods.
(ii) Exemption from or reduction of taxes on imported capital goods (applicable to New Capital Investment Enterprises). Way in which exemption/reduction of import duty applies:

- Main machinery: 100%
- Supplementary machinery: 50%
- Spare parts: 100% (up to 5% of main machinery)

(iii) Exemption from or reduction of taxes on imported raw materials (applicable to New Capital Investment Enterprises): 2 years exemption from the date of commercial production.

Takeovers, Mergers and Acquisitions.- The benefits offered under takeovers, mergers and acquisitions are:
any asset can be transferred at book value; partial relief from the 5% transfer of title tax on land and buildings, and full relief from 5% income tax on the transfer of land and buildings.

Aid Funded Projects.- Construction equipment, goods and other materials for projects financed by foreign aid should be exempted from import duty, VAT and sales taxes and income tax from contractors, consultants and suppliers (which is borne by the government).

Export Manufacturers.- Receive VAT and import concessions.

Additional Exemptions from VAT.- Activities and products which are relief from the VAT charge are:
mining or drilling goods; necessities; money; financial, manpower, social, health, religious and educational services; public transportation, postal and governmental services; entertainment and hotel services; machinery and specific capital equipment; electricity not exceeding 6600 watts; piped water; livestock, poultry and fish feed; agricultural crops; seeds; polio vaccines; textbooks; ships used by national shipping and fishing companies; aircrafts used by national airlines; national railway trains; construction and sale of houses; equipment and supplies for Defense and Police forces.

Additional Exemptions from Tax on Land and Buildings.- Buildings with FMV of less than RP 8,000,000, besides to land and buildings that are used for non-profit activities, archaeological purposes, natural reserves, diplomatic, consulates and international organization offices. A 50% tax reduction is allowed for hospitals, nursing homes, orphanages and non-profit schools.

2.2 Malaysia

General Income Tax Exemptions.- The CIT law exempts dividends coming from a single-tier company. The PIT law exempts: income below RM 2,500; interests; pensions; dividends from tax exempted accounts; and certain benefits in kind from employers and unemployment compensation.

Pioneer Status.- Companies granted Pioneer Status are exempted from income taxation in 70% of their income for up to 5 years, applying 25% on the remaining 30% of statutory income for a total effective tax rate of 7.5%. From 2009, companies whose pioneer period expired after October 1, 2005, can carry forward unabsorbed losses and capital allowances.
Investment Tax Allowance (ITA).- As an alternative to Pioneer Status, a company may apply for Investment Tax Allowance. A company granted Investment Tax Allowance will be given an allowance of 60% in respect to the qualifying capital expenditure incurred within 5 years from the date on which the first qualifying capital expenditure is incurred. The allowance can be utilized to offset against up to 70% of the statutory income in the year of assessment; 30% of the statutory income will be taxed at the prevailing company 25% tax rate.

Infrastructure of Business operating in Promoted Areas.- Allowance of 100% of the capital expenditure incurred offsetting up to 100% of the statutory income.

Reinvestment Allowances.- A company that incurs expenditure in qualifying projects in Malaysia is entitled to a Reinvestment Allowance equivalent to 60% of such expenses, to offset up to 70% of the statutory income (this percentage could come up to 100% if the company’s efficiency ratio exceeds the yearly industrial average). This benefit is provided for 15 consecutive years from the year of its claim, and will not extend to companies already favored by the Pioneer Status or the Investment Tax Allowance. Any unutilized allowance can be carried forward to subsequent years until the whole amount has been used up.

Approved Service Projects (ASPs).- Projects within the services sector could be benefited by either an Income Tax Exemption in 70% of the statutory income for 5 years (as in Pioneer Status) or an Investment Allowance for up to 60% of the qualifying capital expenditure incurred the presiding 5 years to offset up to 70% of the statutory income (as in Investment Tax Allowance).

Services Sectors that Increase Exports.- A tax exemption on statutory income is provided for this sector, equivalent to 50% of its increased exports. VAT is not applied to exports either.

Inward Reinsurance and Offshore Insurance.- The income tax deriving of profits from those sources is taxed at 5%; or exempted in the case of dividends in the hands of the company’s shareholders derived from such profits.

Shipping Incentives.- Income of a resident person derived from transporting passengers or cargo by sea on board of Malaysian ships, or that one that comes out of chartering a Malaysian ship owned by him on a voyage or time charter basis, or income of a non-resident from ships’ rentals, is exempted from tax.

Double Deduction of Expenses.- Expenses for promotion of goods or services exports, insurance premiums for import or export of cargo, R&D and research purposes, remunerations to handicapped employees, advertizing of Malaysian products and fees paid to brand management companies which promote such names are provided double deduction allowances.

Operational Headquarters Companies (OHC); International Procurement Centers (IPCs) and Regional Distribution Centers (RDCs).- The income from a OHC that derives from the provision of certain services is exempted from income tax for a 10-year period. IPCs and RDCs are eligible for tax exemption on their income and any redistribution of such by corporate shareholders dividends for 10 years.
**Imported Capital Goods.-** Most machinery and equipment not produced locally are not subjected to import duty and sales tax. However, machinery and equipment with import duty and sales tax can be considered for exemption if:

- They are used directly in the production process, and
- The equipment is used for controlling environmental pollution, recycling, product testing and quality control.

**Imported Raw Materials.-** The level of exemption from import duty granted on raw materials/components depends on whether the finished products are sold in the domestic market or are exported.

(i) **Manufacture of Goods for Export.-** In the case of companies manufacturing finished products for the export market, full exemption from import duty on direct raw materials is normally granted, provided the raw materials/components are not manufactured locally or, where they are manufactured locally, are not of acceptable quality and price.

(ii) **Manufacture of Goods for the Domestic Market.-** Partial exemption from import duty on direct raw materials and components that are not manufactured locally can be considered for any manufacturing company if it complies with the equity condition as stipulated in the manufacturing license. Until the year 2000, companies are given the waiver from compliance to the equity condition.

(iii) **Full exemption from import duty is normally given if:**

- The finished product made from dutiable raw materials/components is not subjected to any import duty.
- The manufacturing company has complied with the government policy guidelines in terms of equity participation, management and employment structure in all categories.
- Companies are located in the States of Sabah and Sarawak and the designated 'Eastern Corridor' of Peninsular Malaysia.

In all other cases, (except for the assembly industry) partial exemption can be considered where manufacturers are normally required to pay import duty of 2% or 3% ad valorem. For raw materials which are subjected to import duty of 3% or less, applications for exemption will not be considered.

To encourage the manufacture of local components for the assembly industry, imports of components which attract import duty of 5% ad valorem and above will be required to pay an import duty of at least 5% ad valorem.

**Other Incentives:**

- Incentives for Strategic Projects
- Incentives for Small-Scaled Companies
✓ Small Value Assets: 100% accelerated capital allowances and their carry forward to offset business income.
✓ Incentives for High Technology Industries
✓ Incentives for Industrial Adjustment
✓ Incentives for Training
✓ Incentives for R&D
✓ Incentives for Multimedia Super Corridor and Software Development
✓ Incentives to Strengthen Industrial Linkages
✓ Incentives for Storage, Treatment and Disposal of Toxic and Hazardous Wastes
✓ Incentives for the Agricultural Sector
✓ Incentives for the Tourism Industry

2.3 Philippines

General Income Tax Exemptions.- The CIT law exempts: mergers and consolidations’ exchanges of stock resulting in change of control; dividends from a domestic company; and income from depository banks, investment in securities, from public utility or a governmental function. The PIT law exempts minimum wage earners; life insurance proceeds; gifts and bequests, pensions and interest income from long term deposits or investments. VAT relief for transactions below PHP 150,000 (subjected instead to 3% Tax on Sales or Receipts).

Enterprises Investing in Preferred or Export Oriented Areas.- Incentives applicable to national preferred investments and to exports oriented Filipino-owned enterprises, that devote at least 50% of their production to exports, or those which are foreign-owned in majority (more than 40% equity) but devote 70% of production to exports, are:

✓ Income tax holiday of 6 years from the start of commercial operations for newly registered pioneer projects, as well as companies located in less developed regions in the Philippines (not including investment in mining and forestry, or processing of minerals and forest products). A new non-pioneer project can receive a tax holiday of 4 years, and an expansion project can receive a tax holiday for 3 years.

✓ During the first 5 years from registration, such enterprises can deduct as labor expenses 50% of wages paid to new employees under specific conditions.

✓ They also benefit from tax credit for taxes and duties on raw materials to produce their export products.

✓ Deduction of infrastructure expenses, if located in less developed areas.

✓ Tax free imports of required supplies and spared parts for consigned equipment.
Exemptions of exports duties.

**Investments in Less Developed Areas.**

- Income tax holiday for 6 years.
- Deduction of 100% of infrastructure expenses.

**Freeport Zones and Special Economic Zones.**

- Exemption from customs and import duties on imports of raw materials, capital goods and equipment.
- Exemption from indirect taxes on consumption and excises on the sales of goods and services.
- Zero-rate for VAT purposes on the purchase of raw materials, capital goods and equipment.
- Exempted from income taxation if not more than 30% of their income derives from the Zone.
- Tax holidays from 4 to 6 years, and the option to replace this benefit by a 5% preferential treatment of flat tax rate applicable on gross income.

**Regional Headquarters and Operating Headquarters.**

- Preferential 10% tax rate of corporate income tax (only to Operating Headquarters).
- Exemption of local taxes, fees or charges, except real property tax on land improvements and equipment.
- Tax and duty free import of materials and equipment for training and conference purposes that are not locally available.
- Generally VAT exempted, and zero-rate applicable to the sale or lease of goods, property or services (only to Regional Headquarters).
- Exemption of local taxes, fees or charges, except real property tax on land improvements and equipment.

**2.4 Thailand**

**General Income Tax Exemptions.** The CIT law exempts net profits lower than THB 150,000; dividends from shares owned by at least 6 months; and income derived during and approved BOI period. The PIT law also exempts income below THB $150,000. The law also provides an exemption of VAT to unprocessed agricultural products; textbooks; healthcare and educational services; rent of immovable property and internal transport by land.

**Projects Investing in Economic Development.** Such as, research and development activities, trade and investment, are granted:
✓ Exemption or reduction of import duties on imported raw materials, components and machinery.
✓ Tax holiday from 3 to 8 years.
✓ Losses carry forward and their expense deduction for up to 5 years after the end of the income tax holiday period.
✓ Exclusion of such enterprises’ dividends if provided during the holiday period.

Additional incentives for Special Investment Promotion Zones.- (In addition to those mentioned in General Income Tax Exemptions).

✓ Reduction of 50% CIT for 5 years after termination of the holiday period or from the date on which income is earned.
✓ Double tax deductions for the cost of transportation, electricity and water supply expenses.
✓ Deduction of 25% of the investment costs of installing infrastructure facilities for 10 years from the date when income was earned.

Additional incentives for Export Oriented Enterprises.- (In addition to those mentioned in General Income Tax Exemptions).

✓ Exemption from import duties on imported raw materials, components and re-exported items.
✓ Exemption from export duties.
✓ Deduction of 5% of the exports’ income increments over the previous years (excluding insurance and transportation costs).

ROH.- These are offices that offer services to their subsidiaries or branches in Thailand and other countries that are benefited by:

✓ 10% of CIT rate applicable on net profits in general, on those coming from royalties derived from R&D, or those coming from interests received on loans.
✓ Exemption from income tax on dividends received from subsidiaries or paid to foreign companies.
✓ 25% tax deduction for ROH building costs in the acquisition year; depreciating the remaining 75% over 20 years.
✓ Exemption from PIT to expatriate employees for work performed outside Thailand in the first 4 year of the ROH (not deductible for the ROH).
✓ 15% flat Personal Income Tax rates in the first 4 years of the ROH.

2.5 Vietnam [Other than CIT]

General Income Tax Exemptions.- The CIT law exempts income from R&D; sales of products in their testing or application of new technology periods; services for agricultural production; vocational training;
trading of goods reserved for disabled employees; and transfer of technology. The IPT law exempts income coming from night-shifts, hardship, responsibility, severance, redundancy and location allowances; and interests.

Exemption/ Reduction of Taxes on Imported Capital Goods.- An enterprise with foreign-owned capital and parties to business cooperation contracts shall be entitled to exemption from import duties in respect of the following:

- Equipment and machinery imported as part of the fixed assets of the enterprise or as part of the fixed assets for the implementation of the business co-operation contract.
- Specialized means of transport which form part of the technological process imported as part of the fixed assets of the enterprise or as part of the fixed assets for the implementation of the business co-operation contract, and means of transport used for transporting employees (automobiles of 24 or more seats and watercraft).
- Components, parts, spare parts, support structures, moulds and accessories of the above equipment, machinery, specialized means of transport and means of transport.
- The exemption of import duties applicable to the above equipment, machinery and means of transport shall also be applied in the case of expansion of a project and replacement or renewal of technology.
- In addition to the equipment, machinery, and specialized means of transport imported for the purpose of forming the fixed assets of an Enterprise which shall be exempted from import duties, enterprises engaging in hotel industry, offices and apartments for lease, residential premises, commercial centers, technical services, supermarkets, gold courses, training, culture, finance, banking, insurance, auditing and consultancy services shall be permitted to once-off exemption from import duties in respect of equipment provided for in Appendix II.B, Decree 10/1998/ND-CP.

Exemptions/Reduction of Taxes on Imported Raw Materials.

- Raw materials and supplies imported for the implementation of BOT, BTO and BT projects.
- Species of plants and animals or specialized agricultural chemicals permitted to be imported for the implementation of agricultural, forestry and fishery projects.
- Construction materials imported for the purpose of forming the fixed assets which have not been produced locally.
- Raw and other materials imported for manufacturing machinery and equipment used in a technological process, or for manufacturing components, parts, spare parts, support structures, appliances, moulds and accessories accompanying the above equipment and machinery.
- Other goods and materials required for projects in which investment is especially encouraged as determined by the Prime Minister.
The above mentioned exemption from import duties in respect of raw and other materials shall also be applied in the case of expansion of a project and replacement or renewal of technology.

- Investment projects included in the List of projects where investment is especially encouraged and investment projects in mountainous, remote or distant regions as stipulated in Appendix I attached to Decree 10/1998/ND-CP, shall be exempted from import duties in respect of raw materials used for production for a period of five (5) years from the commencement of production.

**Other Incentives.-**

- The transactions of goods that cannot be produced in Vietnam are exempt from VAT.
- During business operation, the Enterprise with foreign-owned capital shall be permitted to carry forward losses incurred in any tax year to the following tax year and set them off against the profits of subsequent years for a maximum of five (5) years. Where reinvestment is made in encouraged investment projects, the total or a part of the profits tax paid in respect of the reinvested profits shall be refunded.

### 2.6 China

**General Tax Exemptions.-** The CIT law exempts income from certain projects in agriculture, forestry, animal husbandry or fisheries; interests on foreign government loans to the PRC government; interests on loans with preferential terms made to the PRC government or resident enterprises by international financial organizations; income from the securities investment funds from the security market, including profits from stock and bond trading, dividend distributions, interests on bonds, etc.; income derived by investors from security investment funds or that derived by their managers from stock trading and bond premiums/discounts; interest on State Treasury bonds; and income of NGOs.

**Tax Reductions.-**

- Small-scale and low-profitability enterprises, and advanced and new technology enterprises.
- Enterprises engaged in growing flowers, plants and water agriculture.
- Non-resident enterprises without permanent establishment with PRC-sourced income, or when they have a permanent establishment but their income is not PRC-sourced.

**Combination of Tax Exemptions and Tax Reductions.-**

- Exemption of CIT for 5 years (from the first profit-making year), for enterprises producing integrated circuits and have operating periods exceeding 15 years; this is followed by another 5 years on which a reduction of 50% of the tax rate applies.
- Exemption of CIT for 3 years (from the first profit-making year), for enterprises investing in and operating public infrastructure projects and engaging in qualified environmental protection and energy or water conservation projects; this is followed by another 3 years on which a reduction of 50% of the tax rate applies.
Exemption of income derived from qualified technology transfers that not exceed RMB 5 million; once exceeding such ceiling, income coming from this source will be taxed at rates reduced in 50%.

**Accelerated Deductions.**- Fixed assets subject to frequent upgrades and replacements due to technical advances and exposed to constantly high levels of vibration or corrosion are allowed to accelerated depreciation, shortening up to 60% of the prescribed period of their class (either double-declining-balance or the sum-of-the-year-digits method may be adopted).

**Other Incentives.**-

- The sale of real estate is exempted from VAT.
- R&D activities are provided a bonus deduction from their expenditures.
- Venture capital enterprises that have invested for more than 2 years in equity of advanced and new technology SMEs that are not listed in the stock exchange market can reduce their taxable income by up to 70% of the amounts invested.
- Enterprises whose production required the synergistic utilization of prescribed resources can include 90% of their revenue as taxable income.
- Enterprises that acquire and use specialized equipment for environmental protection, energy or water conservation or production safety, can credit 10% of the amounts invested against CIT.
- Salary expenses to employment of certain disable persons can be deducted in 100%.

**Grandfathering and Transitioning.**-

The incentives under the Foreign Enterprise Income Tax (FEIT) regime no longer in place are grandfathered and/or accelerated during a transitional period to the new CIT law for 5 years (tax rates increments are going to be gradual). If a company has not yet started to enjoy its tax holidays under the previous incentive scheme due to losses, these are deemed to have started applying since 2008, with the implementation of the CIT law.

Certain enterprises located in the Western region of the PRC will continue enjoying from the 2001 incentive scheme, while the new beneficial regime in favor of Advanced and New Technology Enterprises established in certain Special Economic Zones and the Shanghai Pudong New Area was implemented (January 2008).
Annex: Tax Incentives (CIT)

I. Sector, Industry Incentives - Regulations

1. CIT Law 2008

Article 13: Incentives being Preferential Tax Rates

1. The tax rate of ten (10) per cent shall apply for fifteen (15) years to newly established enterprises from investment projects in areas with specially difficult socio-economic conditions, in economic zones and in high-tech zones; and to newly established enterprises from investment projects in the sectors of high technology, scientific research and technological development, investment in development of specially important infrastructure facilities of the State, and production of software products.

2. The tax rate of ten (10) per cent shall apply to enterprises operating in the sectors of education and training, occupational training, health care, culture, sport and the environment.

3. The tax rate of twenty (20) per cent shall apply for ten (10) years to newly established enterprises from investment projects in areas with difficult socio-economic conditions.

4. The tax rate of twenty (20) per cent shall apply to agricultural service co-operatives and to people's credit funds.

5. The duration of preferential tax rates may be extended in the case of large scale and high-tech projects which particularly need to attract investment, but the duration of extension shall not exceed the duration stipulated in clause 1 of this article.

6. The duration of the preferential tax rates stipulated in this article shall be calculated from the first year in which the enterprise has turnover.

The Government shall provide detailed regulations and guidelines for implementation of this article.

Article 14: Incentives being Duration of Tax Exemption and Reduction

1. The following enterprises shall be exempted from corporate income tax for a maximum period of four (4) years and shall be entitled to a fifty (50) per cent reduction of the amount of corporate income tax payable for a maximum period of nine (9) subsequent years: Newly established enterprises from investment projects in areas with specially difficult socio-economic conditions, in economic zones and in high-tech zones; newly established enterprises from investment projects in the sectors of high-tech, scientific research and technological development, investment in development of specially important infrastructure facilities of the State, and production of software products; and newly established enterprises operating in the sectors of education and training, occupational training, health care, culture, sport and the environment.

2. The following enterprises shall be exempted from corporate income tax for a maximum period of two (2) years and shall be entitled to a fifty (50) per cent reduction of the amount of corporate income tax payable for a maximum period of four (4) subsequent years: Newly established enterprises from investment projects in areas with difficult socio-economic conditions.
3. The duration of tax exemption and reduction stipulated in this article shall be calculated from the first year in which the enterprise has taxable income; if an enterprise does not have taxable income in the first three years as from the first year in which it has turnover, then the duration of tax exemption and reduction shall be calculated from the fourth year.

The Government shall provide detailed regulations and guidelines for implementation of this article.

**Article 15: Other Cases of Tax Reduction**

1. Enterprises engaged in production, construction or transportation which employ many female employees shall be entitled to a reduction of corporate income tax equal to the additional amount of expenses incurred for female employees.

2. Enterprises employing many ethnic minority people shall be entitled to a reduction of corporate income tax equal to the additional amount of expenses incurred for employees being ethnic minority people.

The Government shall provide detailed regulations and guidelines for implementation of this article.

2. **Decree No. 124/2008/ND-CP of December 11, 2008, detailing and guiding the Implementation of a Number of Articles of the Law in Enterprise Income Tax**

**Article 15: Tax Rate Incentives**

1. The incentive tax rate of 10% for 15 years is applicable to:

   a/ New enterprises established under investment projects in geographical areas with extreme socio-economic difficulties specified in the Appendix to this Decree, economic zones or hi-tech parks established under the Prime Minister’s decisions;

   b/ New enterprises established under investment projects in the domains of:

      - High technology as prescribed by law; scientific research and technological development;

      - Development of water plants, power plants, water supply and drainage systems; bridges, roads, railways; airports, seaports, river ports; airfields, stations and other infrastructure works of special importance as decided by the Prime Minister;

      - Manufacture of software products.

2. For new large and hi- or new-tech enterprises established under investment projects in the domains specified at Point b, Clause 1 of this Article in which investment should be specially attracted, the duration for application of the incentive tax rate may be extended but must not exceed 30 years. The Prime Minister shall, at the proposal of the Minister of Finance, decide on the extension mentioned in this Clause.

3. The tax rate of 10% is applicable to incomes of enterprises operating in education-training, vocational training, healthcare, cultural, sports and environmental domains (below collectively referred to as socialized domains) throughout their operation duration.

The Prime Minister shall promulgate a list of socialized domains mentioned in this Clause.
4. The incentive tax rate of 20% for 10 years is applicable to new enterprises established under investment projects in geographical areas with socio-economic difficulties specified in the Appendix to this Decree.

5. The incentive tax rate of 20% is applicable to agricultural service cooperatives and people’s credit funds throughout their operation duration.

After the expiration of the duration for application of the tax rate of 10% specified at Point a, Clause 1 of this Article, agricultural service cooperatives and people’s credit funds shall switch to enjoy the tax rate of 20%.

6. The duration for application of incentive tax rates specified in this Article is counted consecutively from the first year an enterprise has turnover from activities eligible for tax incentives.

Article 16: Tax Exemption and Reduction

1. Tax exemption for 4 years and 50% reduction of payable tax amounts for 9 subsequent years are applicable to:

   a/ New enterprises established under investment projects specified in Clause 1, Article 15 of this Decree;

   b/ New enterprises operating in socialized domains in geographical areas with socio-economic difficulties or extreme socio-economic difficulties specified in the Appendix to this Decree.

2. Tax exemption for 4 years and 50% reduction of payable tax amounts for 5 subsequent years are applicable to new enterprises operating in socialized domains in geographical areas outside the list of those with socio-economic difficulties or extreme socio-economic difficulties specified in the Appendix to this Decree.

3. Tax exemption for 2 years and 50% reduction of payable tax amounts for 4 subsequent years are applicable to new enterprises established under investment projects in geographical areas with socio-economic difficulties specified in the Appendix to this Decree.

4. The tax exemption or reduction duration specified in this Article is counted consecutively from the first year an enterprise has taxable income from an investment project; in case an enterprise has no taxable income during the first three years, counting from the first year it has turnover from an investment project, the tax exemption or reduction duration is counted from the fourth year.

   In the first tax year, if an enterprise’s production and business duration eligible for tax exemption or reduction is less than 12 (twelve) months, the enterprise is entitled to tax exemption or reduction right in that year or may register with the tax agency for enjoyment of tax exemption or reduction from the subsequent tax year.

Article 17: Tax reduction in other cases

1. Production, construction or transport enterprises which employ many female laborers are entitled to reduction of enterprise income tax amounts equal to additional expenses paid for female laborers, including:

   a/ Expense for job re-training;
b/ Salaries and allowances (if any) for teachers in crèches or kindergartens organized and managed by the enterprises;

c/ Expense for additional medical check-ups in a year;

d/ Post-natal allowances for female laborers. The Ministry of Finance shall, pursuant to the labor law, coordinate with the Ministry of Labor, War Invalids and Social Affairs in specifying allowance levels mentioned in this Clause;

e/ Salaries and allowances for female laborers who return to work during their prescribed maternity leave.

2. Enterprises which employ ethnic minority laborers are entitled to reduction of enterprise income tax amounts equal to additional expenses for job training, housing subsidies, social insurance premiums and health insurance premiums for these laborers, if they have not yet received the State’s supports under regulations.


11. To amend and supplement Clauses 3 and 5 of Article 15 (above on pg 88) as follows:

“3. The tax rate of 10% is applicable to incomes of enterprises operating in education-training, vocational training, healthcare, cultural, sports and environmental domains (below collectively referred to as socialized domains), and income from publication activities under the Law on Publication throughout their operation duration.

The Prime Minister shall promulgate a list of socialized domains mentioned in this Clause.

4. The incentive tax rate of 20% is applicable to agricultural service cooperatives, people’s credit funds and microfinance institutions throughout their operation duration.

After the expiration of the duration for application of the tax rate of 10% specified at Point a, Clause 1, Article 15 of Decree No. 124/2008/ND-CP, agricultural service cooperatives, people’s credit funds and microfinance institutions shall switch to enjoy the tax rate of 20%.

Microfinance institutions specified in this Clause are institutions established and operating under the Law on Credit Institutions.”

II. Tax Incentives for Investment to Expand - Regulations

1. The Enterprise Income Tax Law No.09/2003/QH11

Article 18. Tax exemption and/or reduction for business establishments investing in building new production lines, expanding their production, renewing technology, improving the ecological environment or raising their production capacity

Production establishments investing in building new production lines, expanding their production, renewing technology, improving the ecological environment and raising their production capacity shall be
exempt from enterprise income tax on their increased incomes brought about by such investment for 4 years at most and a 50% reduction of payable tax amounts for 7 subsequent years at most.

The Government shall prescribe the methods of determining the increased incomes brought about by investment, and tax exemption or reduction duration for each case prescribed in this Article.

2. The Enterprise Income Tax Law No. 14/2008/QH12 (w.e.f 01/01/2009)

There is no corporate income tax incentive for investment to expand (preference only reserved for expansion projects completed and went into production in 2009).
Chapter VI: International Experience in Taxation of Corporate Income

1. CIT Base and Rates

In most developed countries income arising from all sources including business, trading as well as non-business income is included in the tax base. Although it may be hard to find formal definitions of taxable income, as a rule it is computed under the principles of ‘sound commercial accounting practice’ and following the generally accepted accounting principles maintained by the accounting profession in a country. Increasingly countries are aligning their accounting standards with international financial reporting standards (IFRS). In most countries, it is based on profits shown in the company’s profit and loss accounts or the changes in the assets and liability statements over a year.

Tax rates in developed countries also vary considerably. One trend, however, is clear that the top CIT tax rates have been declining over the years. This has been often attributed to tax competition. According to the OECD report on the fundamental reform of CIT (OECD (2007), and Fundamental Reform of Corporate Income Tax, OECD Tax Policy Studies, No. 16, OECD Publishing, although corporate tax rates have been declining during the last decades, larger-sized OECD countries continue to levy corporate taxes at higher rates than the smaller-sized OECD member countries. However, despite the reduction in statutory corporate tax rates, corporate tax revenues have kept pace with – or even exceeded – the growth in GDP and the growth in revenues from other taxes in many OECD countries. This might partly have been caused by the broadening of corporate tax bases, for instance through the provision of less generous tax depreciation allowances.

For OECD countries, table 1 below shows clearly the downward trend in CIT rates over time. The US is the only country that increased the CIT rate over the 2000-10 periods over the average of the previous decade, but that may also be a consequence of the fact that it is the only major country in the world that does not have a VAT/GST at the federal level. For many countries in Asia, the CIT plays a major role when it comes to revenue. This may be due in part to the fact that developing countries do not have PIT systems to match those of OECD countries and therefore find the tax handle offered by the CIT more convenient. As table 2 below shows, Indonesia and Malaysia are the two countries in the region that collect substantially more revenue than Vietnam through CIT.

One reason for imposing a corporate tax is that the tax plays an important withholding function, acting as a “backstop” to the personal income tax. The corporate tax might be needed to avoid excessive income shifting between labor income and capital income. The corporate tax also acts as a withholding tax on equity income earned by non-resident shareholders, which might otherwise escape taxation in the source country. Moreover, governments might levy a corporate tax because firms earn location-specific rents and/or because capital is not perfectly mobile.
Table 1: Evolution of Statutory Tax Rates in OECD Countries

<table>
<thead>
<tr>
<th></th>
<th></th>
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</tr>
</thead>
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<td>Australia</td>
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<td>30.0</td>
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</tr>
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<td>18.2</td>
</tr>
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<td>United States</td>
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</table>

Source: OECD tax database.

According to the OECD report (2007), the main drivers of corporate income tax reform are the tax-induced distortions under current corporate income tax systems from a domestic and international tax point of view. The corporate income tax is likely to distort the total amount of investment and the type of investment projects that are undertaken, the corporate sources of finance and uses of profits, the location of the corporate tax base, the choice of a business’s legal form and the fact that tax might have an impact on corporate mergers and acquisitions.
Table 2. General Government: Tax Structure and Tax levels for Selected Asia and Pacific Countries, 2011
(In Percent of Total Tax Revenue)

<table>
<thead>
<tr>
<th>Country</th>
<th>Year</th>
<th>Total Revenue and Social Security Contributions (%)</th>
<th>Tax Revenue (%)</th>
<th>Other Revenue (%)</th>
<th>Total (%)</th>
<th>Individual (%)</th>
<th>Corporations and Other Enterprises (%)</th>
<th>Unallocable (%)</th>
<th>Property Taxes (%)</th>
<th>Total (%)</th>
<th>General Sales, Turnover, or VAT (%)</th>
<th>Excises Other (%)</th>
<th>Other Trade (%)</th>
<th>Other Taxes (%)</th>
<th>Social Security Taxes (%)</th>
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<td>7.1</td>
<td>6.4</td>
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<td>Bangladesh 1/</td>
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Unweighted average (Excluding Vietnam) 130.9 100.0 12.4 34.7 10.9 24.9 1.2 2.9 47.2 29.6 13.1 4.1 13.2 3.5 6.5

Source: IMF estimates.
1/ Central Government Revenue is used to approximate General Government Revenue.
2/ Budgetary Government Revenue is used to approximate General Government Revenue.
Tax revenue and tax complexity considerations are important drivers of corporate income tax reform. Some important sources of tax complexity are the different tax treatment between debt and equity, the existence of different types of legal forms that are taxed differently, the tax rules with respect to business restructurings and the tax rules with respect to the transfers of business assets.

Most developed countries tax capital gains at the full corporate income tax rate while a few countries exempt capital gains if reinvested in business. Subject to restrictions in some countries to prevent tax avoidance, all expenses incurred wholly and exclusively in earning the income or maintaining the assets are tax deductible. However, there are always some grey areas where interpretations may differ. By early 1990s, all OECD countries allowed a company to carry forward losses for a period which ranges from five years to unlimited period. Countries such as the US also allow loss carry backward from one to three years. All the countries provide for depreciation allowance but the way of doing it differs. Many OECD countries have tried to keep depreciation rules such that tax depreciation is as close to economic depreciation as possible including both wear and tear and obsolescence. Since accurate computation of economic depreciation is technically and administratively difficult, some standardized method like straight line or declining balance method is followed. In some countries these depreciation rules are more generous than others. When it comes to tax incentives, it generally takes the form of accelerated depreciation at a higher rate than the normal. Tax holidays are not offered by OECD countries.

In what follows, we have compared the CIT systems of 15 countries in three groups of five countries each: OECD, BRICS (Brazil, Russia, India, China and South Africa) and Vietnam’s neighbors. The chosen OECD countries are UK, USA, South Korea, Singapore and Australia. The neighbors chosen are Cambodia, Laos, Indonesia, Malaysia and the Philippines. The CIT in those countries have been compared across the following dimensions: Main tax rate and other tax rates and taxes on corporations, residence versus source of income principle of taxation, depreciation, deductions and expenses, capital gains, inventory valuation, treatment of losses, treatment of charitable contributions and prevention of base erosion. Relevant tables are presented in this chapter and the source is mainly Price Waterhouse Coopers’ Worldwide Tax Summary 2012-13 supplemented by Deloitte’s country tax highlights for 2013.

Thin capitalization and the international experience in that area have been discussed in detail in the chapter on expenses and are therefore not discussed in this chapter. Transfer pricing is also discussed in the chapter on expenses and is not discussed here in detail, except to indicate some country experiences in preventing base erosion.

Tax incentives are also not discussed as the complete system of incentives in ASEAN countries has already been presented as an annex in the relevant chapter. After the discussion on tax integration, we compare the CIT systems of the 15 countries. Annex A to this chapter describes international trends and experience of Tax Policy Reform globally but with examples from some specific countries.

2. Tax Integration and Taxation of Dividends

After the corporate tax is paid at the company’s level, the net of tax profits are distributed, in part or in full, to the shareholders and then they are subject to personal income tax other than in cases where the shares are held in a tax free pension or mutual fund. This raises the issues that with taxation of dividends, corporate income tax and personal income tax result in double taxation of income. The presumption is that ultimately
even the income from the companies accrues to individual shareholders and when dividends are subject to personal income taxation, it amounts to double taxation of income. When it comes to taxation of foreign companies under the CIT, most countries tax dividends through a flat rate withholding before profits are repatriated to the home country. The home country may give tax credits for the taxes paid in the host country when charging tax on the dividends received.

Broadly there are three options for dividends received by taxable individuals. First, apply CIT on company’s profits and then tax dividends fully under the personal income tax. This is the “classical” system where both incomes are taxed and there is no integration between the two (US until recently when it introduced a reduced tax rate on tax-paid dividends, and Switzerland).

Second, integrate the two taxes completely by giving full credit for CIT paid when calculating the PIT liability. This is the case of full integration. In this case, tax on business profits is withheld by the full amount and then it is claimed back as a credit when personal income tax is computed. The final effective tax rate in this case is at the personal income tax rate and company income tax is just a withholding device. The US and a few other countries effectively adopt this method in case of small corporations or so-called S-corporations with a limited number of owners (less than 100 in US) and for all limited liability companies (LLC) and partnerships (LLP). In these latter cases of the S-corporation, LLC and LLP, no corporate tax is charged. All income is reported as personal income of the individual shareholders or partners. However if a country has a weak PIT system that raises little revenues by way of taxes and this may not be a good model. In the UK, 10% tax is withheld from dividends distributed by resident companies, and for individual taxpayers in the lowest taxable bracket the personal tax rate is also 10% so the credit of tax effectively equals the personal income tax (PIT) payable. For taxpayers in higher brackets, the 10% tax on dividends withheld by the company is available as a credit against PIT payable.

Third, integrate the two taxes partially by giving partial credit for taxes paid at the corporate level. There can be several variations of partial integration approach and most countries have adopted some form of this type of integration in which partial relief is granted either at the corporation level or the shareholders’ level. Below are listed some alternative ways to do this.

✓ Dividend deduction system where all or part of the corporate income that is distributed as dividends can be deducted against the company’s corporate income tax liability.

✓ Split-rate system where the profits distributed as dividends are taxed at a lower rate than the part that is retained, but dividends are also taxed at individual level.

✓ Dividend tax credit or gross-up and imputation system where the entire corporate income is taxed, but that part of tax attributable to dividends is credited back as tax credit to shareholder. Thus dividends are ultimately taxed at personal income tax rate and retention at corporate income tax rate.

✓ Dividend deduction at personal level where corporate tax rate is charged on all income, but distributed dividends are only partially taxed or are partially tax exempt or are taxed at a reduced rate.

✓ Tax credit method where it provides credit to shareholders against their personal income tax usually specified as some proportion of the dividends received.
Single Stage System is more common in developing countries where only the return to equity at the corporate level is taxed and dividends are not included in income at the personal level. A big advantage is its simplicity. This may lead to a net gain in revenue if all shareholders are taxed at lower tax rate under the PIT than the CIT applied to the company profits. In such a situation, if the dividends were exempted from CIT, the PIT collected after distribution would be less than the CIT collected at the company level.

Where adjustments are made to dividend taxation at the personal level that assume that taxes have been paid at the corporate level (such as the single stage system that exempts dividend income or the dividend tax credit that pays a credit at the statutory CIT rate) then the individual may be benefitting when for some reason no or low taxes have in fact been paid at the corporate level. As a result mechanisms have been devised to ensure that a minimum amount of tax has in fact been paid. One such system that is used internationally is the Dividend Tax Account that checks whether sufficient taxes have been paid currently or in the past by the corporation whenever it pays out dividends. If not, the tax deficiency has to be paid. This is an excellent system not only to ensure tax integration system is correctly applied, but that in the long-run corporations pay their fair share of taxes on distributions out of the company.

The taxation of dividends is treated differently in different OECD countries. Australia, France and Italy apply the full integration where CIT is only a withholding tax and the final tax is at the rate of personal income tax. Japan, Netherlands, Spain, Sweden and the US take the classical approach where both incomes are taxed separately.

3. Main Tax Rate, Other Tax Rates and Taxes on Corporations

The tax rate within the selected OECD countries varies from a low of 17% in Singapore to an average federal rate of 35% for companies in other countries. Australia and Singapore have flat rates while US, Korea and UK have a progressive rate structure either through multiple CIT rates for different slabs of income or a large threshold exemption or both. In the US, most state governments also impose CIT while in Korea there is a 10% surcharge on CIT for resident companies. Korea, Singapore and the UK either exempt income or have lower rates for small companies or both, while the US allows companies to register as “S” corporations that are exempt from CIT. While the US is the only country in this group that imposes a CIT at the state/local level, almost all countries have other taxes applicable to corporations, especially on the mining sector.

Within BRICS, rates on average are higher though not as high as in the US. They vary from a low of 20% in Russia to effective highs of over 30% in India and Brazil (due to clubbing with other taxes as in Brazil or surcharges as in India). All countries except China augment the CIT with a variety of other social contributions charges, and South Africa has an elaborate regime for graduated taxation based on company turnover. India has a minimum alternative tax system that aims to tax 20% of adjusted net book profits for resident companies, while the Russian CIT is split between the central government and states with the major share going to the provinces.

Vietnam’s neighbors also impose CIT rates in the 20%-30% range, with Philippines, Laos and Cambodia maintaining minimum alternative tax regimes based on taxable turnover. Philippines and Indonesia also impose some other local and regional taxes on businesses. Malaysia has a higher rate for
petroleum. While some countries in the group impose some extra taxes on corporations and others grant exemptions.

<table>
<thead>
<tr>
<th>COUNTRY</th>
<th>REGIME</th>
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<tbody>
<tr>
<td><strong>OECD</strong></td>
<td></td>
</tr>
<tr>
<td>AUSTRALIA</td>
<td>Main flat federal CIT rate is 30%, no state or local CIT Fringe Benefits Tax (FBT) at 46.5% is charged on employers on the grossed up value of non-salary and non-wage fringe benefits provided by employers, and FBT is deductible for PIT purposes Mineral Resource Rent Tax on mining profits on iron ore and coal at an effective rate of 22.5%; applies in addition to normal income taxes but are deductible for income tax purpose Petroleum Resource Rent Tax @ 40% on profits from this sector. Applies in addition to normal income taxes but are deductible for income tax Withholding taxes on interest, dividends and royalties paid to non-resident entities whether treaty or non-treaty range between 0%-30%</td>
</tr>
<tr>
<td>KOREA</td>
<td>The CIT rate is 10% on the first KRW 200 million of taxable income, 20% on taxable profit above KRW 200 million up to KRW 2 billion and 22% on the rest Local tax surcharge of 10% on CIT for residents 20% agriculture and fishery surtax for certain companies Corporate taxpayers are subject to a minimum tax that is imposed at a rate of 10% on taxable income up to KRW 10 billion, 12% on taxable income above KRW 10 billion up to KRW 100 billion and 16% on taxable income over KRW 100 billion of income before exemptions and deductions under the CIT regime (called adjusted taxable income) Small and Medium Enterprises (SMEs) pay either 7% of adjusted taxable income or actual liability – whichever is greater A securities transactions tax at 0.5% on value of securities transferred Registration tax between 0.1%-5% on registration of title or right and incorporation, may be up to 3 times higher for location in large cities Nonresidents are taxable on Korean source income at CIT rates if they have a place of business in Korea, if not they are subject to withholding taxes (WHT). If located in a notified tax haven, this income is withheld at 20%. WHT rates on dividends, interest and royalties varies from 0% - 30%.</td>
</tr>
<tr>
<td>SINGAPORE</td>
<td>Tax rate is 17% on Singapore source income, and on foreign source income when remitted or deemed to be remitted to Singapore Up to SGD 152000 out of the first SGD 300000 income is exempt For qualified startups the first SGD100000 are exempt for 3 years, while SGD 100000 out of the next SGD 200000 are also exempt for 3 years A foreign workers levy is payable by the employer at a maximum monthly rate of SGD 470 per foreign worker hired; the rate varies based</td>
</tr>
</tbody>
</table>
on several factors related to the firm and employees

For 2012, a one-time cash grant of 5% of revenue (subject to SGD5000 ceiling) is available to companies that have contributed to the Central Provident Fund (must have had at least one citizen or permanent resident employee)

Nonresidents are charged WHT on interest, royalties, fees and rentals etc when arising in Singapore

Domestic companies paying non-residents (other than those who have PEs and/or carry on business in Singapore) for interest on loans and rentals from movable property have to deduct WHT which represents a final tax at 15%, and for royalty at 10%, technical assistance and other fees at 17% (not a final tax), and these WHTs may be reduced or waived by a treaty: dividends have been reduced to 0% for all regardless of treaty or residence for WHT, and interest and royalty WHT varies form 0%-15% depending on treaty status

<table>
<thead>
<tr>
<th>UK</th>
</tr>
</thead>
<tbody>
<tr>
<td>Standard rate for 2012-13 was 24%, proposed to be reduced to 22% by 2014-15 and applicable only to companies with more than GBP 1.5 million in profits</td>
</tr>
<tr>
<td>UK residents with taxable profit below GBP 300000 apply the rate of 20%, and companies between GBP 300000-150000 apply a graduated schedule</td>
</tr>
<tr>
<td>For groups, total profit is divided by the number of active companies worldwide</td>
</tr>
<tr>
<td>Special regimes for (1) oil and gas in UK and its continental shelf – 30% CIT and 19% for small business plus 32% on ring-fenced group profits but with 100% capital expenditure allowance on most capital (2) for life insurance business with special rates as well as special rules for profit determination</td>
</tr>
<tr>
<td>Petroleum revenue tax (deductible from base for CIT) on profits from oil and gas fields licensed before 1993 at 50%</td>
</tr>
<tr>
<td>UK CIT system applies to nonresidents only for trading income from PEs. Other UK source income accruing to nonresidents taxed at a flat rate of 20% with no allowances (subject to relief from DTAAs)</td>
</tr>
<tr>
<td>No local or provincial income taxes</td>
</tr>
<tr>
<td>Bank levy as an annual tax on specified liabilities of most UK banks and building societies levied since 2013 @ 0.105% of short-term liabilities and 0.0525% of long-term liabilities, excluding the first 20 billion GBP and this levy is not deductible from CIT base</td>
</tr>
<tr>
<td>Insurance premium tax @6% on insurance premiums for most general insurance for risks located in UK, except life and other long-term insurance; higher rate of 20% applies to insurance sold by suppliers of specified goods and services such as mechanical breakdown, travel, TV and car rental etc</td>
</tr>
<tr>
<td>Employers have to pay national insurance contributions based on a</td>
</tr>
</tbody>
</table>
percentage of each employee’s salary @ 13.8% on earnings above GBP 140 per week – reduced for those on private pension schemes, in addition there is a pension protection fund levy for pensioners and employees of failed pension schemes
Local governments charge a tax based on deemed rental value of properties occupied by businesses, and are mostly deductible from CIT subject to conditions
Branches are taxed at normal CIT rates but may not apply the “small profits” rates unless allowed by DTAA, no WHT on transfer of branch profits to head office
No requirement to withhold tax on dividends
20% WHT on interest paid to nonresidents other than with PEs on loans longer than one year subject to some other restrictions and exemptions
20% WHT on most royalties arising in the UK unless given relief under DTAA
No WHT on dividends, WHT of 20% on payments of interest and royalties to most non-treaty, non-resident companies, rates between 0%-20% for nonresidents from treaty countries

<table>
<thead>
<tr>
<th>USA</th>
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</thead>
</table>
| CIT rates apply to several slabs starting at 0 USD of taxable income to USD 18,333,333 with rates between 0%-39%. An alternative minimum tax applies at 20% with fewer deductions. On average, most large corporations are expected to pay 35% of taxable profit to the federal government, or the flat Alternative Minimum Tax (AMT) at 20% on a wider base. Special rates apply to companies to personal services and personal holding companies. The AMT applies to large corporations (turnover over USD 7.5 million on average for 3 years) and has an exemptions of USD 40000, but the tax base is wider than for ordinary taxable income
Corporations are divided into “C” and “S” corporations. C corporations are taxed under the CIT while S companies are treated more like limited liability partnerships, and may not have more than 100 shareholders none of whom may be companies. Thus S corporations do not pay CIT or AMT
Foreign corporations are subject to a gross transportation income tax @4% on US source gross transportation income not effectively connected with US trade or business
State governments in US also impose CIT at rates between 1%-12%, most commonly on a modified version of the federal tax base, with an income allocation formula to each state based on capital, labor and sales. States may also impose franchise taxes or taxes on capital, with all these taxes being deductible for federal income taxes
In some cases C corporations may be liable to an accumulated earnings tax @ 15% of its accumulated income if dividends are consistently not paid and earnings retained, similarly a personal holding company tax |
@15% of undistributed personal holding income may be applied to corporations receive large passive income and are closely held
A federal unemployment insurance tax applies to corporations at 6.2% on the first USD 7000 of wages paid to certain employees and state taxes on the same account also exist. Corporations also have to pay 7.65% social security contribution on wages up to $110000 and 1.45% Medicare tax on higher amounts
Foreign corporations pay at CIT rates on US income effectively connected with US trade or business, and 30% on the rest of US income Branch profits effectively connected with a US business are subject to a 30% branch profits tax (in addition to normal CIT unless lowered by treaty) and this tax may also apply to interest paid by US branch to foreign lenders
30% WHT applies to US companies making payments to foreign entities subject to existence of treaties. Treaty rates for dividends, interest and royalties may be reduced to 0% in some cases or apply rates between 0%-30%

<table>
<thead>
<tr>
<th>BRICS</th>
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</table>
| BRAZIL | Main CIT rate at 15% on annual taxable income assessed using either “actual profits” or” presumed profits” methods. Only imposed at federal level and a surcharge applies to annual taxable income in excess of BRL 240,000 @10%
Social contribution charge at 9% (15% for finance and insurance) of profit before tax(adjusted) not deductible for CIT
Tax on financial transactions @6% such as loans, forex operations, insurance, securities, gold
Cofins (Contribuicao para o Financiamento da Seguridade social)and PIS (Programa de Integraiao Social) (federal contribution taxes) , both monthly social assistance contributions on revenue @ 7.6% and 1.65% respectively
CIDE (Contribution for the Intervention in the Economic Domain) is a contribution that is levied @10% on corporate remittances for royalties and technical assistance provided by non-residents, 25% for non-resident companies in tax havens
No withholding taxes on profits/dividends whether for residents or non-residents; WHT on payments for services to nonresidents between 15%-25%, WHT on payments for interest and royalties to nonresidents varies from 10%-25% |
| CHINA | Main federal CIT rate is 25%
Reduced rates for qualifying businesses (1) new/high tech (15%) (2) Large specified integrated circuit producers (15%) (3) “Key” software producers (10%) (4) Certain specified technology advanced service providers (15%) (5) Qualified small and thin profit enterprises (20%) (6) Encouraged enterprises in the western regions (15%) |
No local or provincial income taxes
An urban and township land-use tax is levied on taxpayers who utilize land within the area of city, country, township, and mining districts and is computed annually based on area actually occupied by a taxpayer. Arable land occupation tax is levied on companies and individuals who build houses or carry out non-agricultural construction on arable lands and is charged lump-sum.
A land appreciation tax is levied on the gain from the disposal of properties at progressive rates from 30% to 60% and is deductible for CIT purposes.
The exploitation of crude oil and natural gas is subject to resource tax on sales turnover. Other natural resources, including coal, other raw non-metallic metals, raw ferrous metals, non-ferrous metallic minerals, and salt (including solid and liquid salt), is subject to resource tax on volume.
Nonresidents without PEs either pay a flat 10% on China source income from dividends, lease, royalties, interest etc. or a treaty reduced rate that can vary from 5-10% in most cases.

INDIA
Indian companies pay CIT at 30% (plus surcharge (5% of CIT if total profit exceeds INR 10 million), education cess (2%) and secondary and higher education cess (1%)). Foreign companies operating in India are taxed at 40% (plus surcharge (2%), education cess (2%), and secondary and higher education cess (1%)). Resident companies are liable to pay Minimum Alternative Tax MAT on their adjusted book profits (except for life insurance business) where the tax liability for the year is less than 20.01% at 20.01% of the adjusted book profits.
Non-resident companies are liable to pay MAT on their adjusted book profits from India source income where the tax liability for the year is less than 19.44% of the adjusted book profits from India-source at 19.44% of the adjusted book profits of the company from India-source income.
Surcharge is payable only where total taxable income exceeds INR 10 million.
<table>
<thead>
<tr>
<th>Country</th>
<th>Notes</th>
</tr>
</thead>
</table>
| | distributing dividends except certain holding companies  
| | A securities transactions tax at 0.1% is payable on specified financial transactions in shares and other securities that is tax deductible while paying income tax on the income from such transactions  
| | All companies are liable to pay wealth tax at 1% of the value of specified net assets if the value of net wealth exceeds INR 3 million  
| | No WHT on profits repatriated by branch to head office. Interest income received by a non-resident company is taxable at 20% subject to conditions specified  
| | A very elaborate system of WHT is in place for both residents and nonresidents, the obligation being on the payer (called deduction at source) based on thresholds for different categories of payments ranging from 1%-20% for payments made by residents and 0-40% (without thresholds) for payments to non-resident companies. These rates may be mitigated in some cases by treaties  

<table>
<thead>
<tr>
<th>Country</th>
<th>Notes</th>
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</table>
| RUSSIA | Main profit tax rate is 20% (2% for center and 18% for regions)  
| | Regions may reduce their own contributions so the rate may be as low as 15.5% in total  
| | Russian corporations pay on worldwide income, but foreign tax credit is available  
| | Foreign entities pay 20% on Russian income if derived through Permanent Establishment (PE), in other cases pay WHT on Russian source income at rates between 10%-20%  
| | No local income taxes  
| | Special transport taxes may be applicable at specified fixed rates that can vary by region  
| | Social contributions levied at 30% on salary paid up to RUB 512000 p.a. per employee, and additional 10% on salaries above that; for foreign employees who are not highly qualified and exempted specialists or whose contract does now exceed 6 months, the charge is 22% up to RUB 512000 p.a. per employee for pension insurance contributions and 10% “top up charge” on salaries exceeding 512000 RUB  
| | Interest income taxed at accrual at 20% unless it is derived from government securities when it will be taxed at 0%, 9% or 15% depending on source, or unless reduced by treaty  
| | Income received by foreign company without Russian PE is subject to WHT in Russia such as 15% on certain dividends, 10% on freight income, 20% on royalties and interest or 20% of either revenue or net capital gains in other cases of gains from sales of property. To avoid taxation of revenue rather than taxation of net gains, proper documents must be furnished. Rates on dividends, interest and royalties may be reduced to between 0%-15% by a tax treaty  

| SOUTH | Main CIT rate is 28% |
### AFRICA

| | Small companies (as defined in law) are taxed at a graduated scale with three slabs (0%, 7% and 28%)  
Very small companies can elect to pay a presumptive tax on turnover at rates between 0% and 6% depending on size of turnover  
Special rates and systems apply to long term insurance companies  
No local income taxes  
A securities transaction tax payable at 0.25% by the issuer on the higher of market value or sale proceed declared  
A 1% payroll levy called a “skills development levy” is imposed on all employers, but companies with annual payroll costs below ZAR 500,000 are exempt  
The employer must contribute the equivalent of 1% of gross income for each employee up to a maximum amount plus a similar 1% deduction from the employee(withheld by the employer) to the Unemployment Insurance Fund  
Employers have to make contributions annually to the fund for compensation for occupational injuries and diseases based on payroll but without deducting it form salary, at varying rates based on industry  
Donations (gift) tax is payable by a donor at 20% of the value of property donated by South African residents including on disposal of assets below market value after deducting ZAR 10000 annually, certain exemptions apply such as to donations by public companies and between group companies, and for certain charitable donations  
10% WHT on certain interest payments to nonresidents that are not controlled foreign corporations, to be withheld by the resident payer (unless reduced by treaty)  
A dividend WHT applies to the beneficial owner if an SA resident at 15% regardless of the residency of the payer of dividend, to be withheld by the payer  
Royalties paid to a nonresident subject to 12% WHT or the reduced treaty rate, to be withheld by the payer and treated as a final tax  
The WHT rates for dividends, interest and royalties may be reduced further for treaty countries to between 0%-15% |

### NEIGHBORS

| CAMBODIA | Tax rates vary by “regime” and classification of taxpayers. “Real” regime taxpayers include large registered taxpayers. The standard rate of tax on profit for real regime taxpayers is 20%  
Insurance companies 5% of gross premiums and 20% on other income subject to modifications for net interest income  
Petroleum and gas and exploration (specified) 30% rate  
A separate minimum tax at 1% of turnover for all real regime companies except qualified investment projects is due whenever the 1% of taxable annual turnover exceeds 20% of taxable profits  
No local income taxes |
A small patent tax is payable on registration and annually on turnover thereafter, in practice always at the top band rate regardless of turnover. Employers are responsible for withholding tax on salaries and tax on employee fringe benefits.

Dividends, royalties (including rent and other payments connected with the use of property) and interest paid to a nonresident are subject to withholding tax of 14 percent. Other non-resident payments include compensation for management or technical services, and are also subject to withholding tax of 14 percent. Dividends received from resident companies are not subject to income tax. Dividends received from non-resident companies are subject to income tax in Cambodia. Additional Profit Tax on Dividend Distribution (APTDD) is applicable on the distribution of retained earnings/annual profit as follows.

<table>
<thead>
<tr>
<th>CIT Rate</th>
<th>Additional Profit Tax on Dividend Distribution is</th>
</tr>
</thead>
<tbody>
<tr>
<td>For companies taxed at 0%</td>
<td>20%</td>
</tr>
<tr>
<td>For companies taxed at 20% - 30%</td>
<td>0%</td>
</tr>
</tbody>
</table>

Dividend distributions to Cambodian resident taxpayers, after payment of the dividend tax are PIT exempt.

INDONESIA

Flat CIT rate of 25%

Public companies that meet listing specifications entitled to a reduced rate of at least 20%

Small companies (turnover < 50 billion IDR) get 50% off the standard rate on the taxable income arising from turnover up to IDR 4.8 billion.

Certain types of income subject to final income tax without deducting expenses at rates between 0.1% (sale of shares listed on ISE) and 20% (interest on certain time deposits) with rates between 2%-6% for construction and 5%-10% on activities related to land and buildings.

Special provisions may apply to mining companies governed by concessions before 2009.

Corporate taxpayers may be liable to regional taxes at 1.5%-35% on reference values set by regional governments ranging from hotel and restaurant taxes to a “swallow-nest” tax.

Foreign companies and PEs have to pay the same CIT obligations, either by direct payments, third party withholdings, or a combination of both, while non-residents without a PE in Indonesia have to withhold the tax on their Indonesia-sourced income via the Indonesian party paying the income.

Mostly collect CIT through an elaborate system of WHT from the payer and extends to dividends, interest, royalties and branch profits at rates between 0%-20% to resident and non-resident corporations from treaty and non-treaty countries as specified in Articles 23/26 of the income tax law.

LAOS

Standard profit tax rate is 28%, reduced rates and holidays are available.
to countries that qualify as promoted investment enterprises
No local or provincial income taxes
Minimum tax applicable to loss making or low profit companies, unless
certified by specified independent auditors at 0.25% of gross receipts for
manufacturing companies and 1% for trading and service companies
All companies registered in Laos pay taxes at the same rates
Fees are payable to the government for licenses, permits broadcasting
rights and other such items
WHT is charged on payments made to all corporate recipients for
dividends, profits from sale of shares and interest at 10% and royalties
at 5%; VAT of 10% is charged on the WHT and in case of foreign
recipients WHT is considered a final tax. In the case of the few
countries with DTAA the reduced rates are 0% and  5% in some cases
A foreign contractor withholding tax payable by the Laos consumer is
applicable when a Lao company contracts with a foreign company with
no licensed presence in Laos regardless of where services are provided;
this tax is intended as a final tax equivalent to profits tax plus VAT and
is applied by withholding a percentage of turnover separately for PT and
VAT at the following rates: commerce (1.75%), production (2.8%),
transport and construction (3.5%) and service (7%)

MALAYSIA

Resident company: 25%  but resident company with taxable profit
below MYR 2.5 million that is not controlled by or does not control a
company with profit above MYR 2.5 million pays 20% on first 500,000
MYR and 25% thereafter.  Non-residents pay 25%
Exclusive petroleum income tax of 38% from petroleum operations in
Malaysia
Windfall profit levy on palm oil at a maximum of MYR 50/ton if price
exceeds MYR 2500-3000/ton depending on location
Human resource development levy for units in manufacturing and
services that employ more than a specified number of workers at 1% of
monthly wage bill on monthly basis
Corporations making payments for royalties, dividend, interest and other
types of income such as rentals have to withhold WHT at the rates of –
payments to residents (0%), payments to non-residents – dividends
(0%), interest (0%-15%), royalty and others (0%-10%) depending on
whether they recipient is a non-treaty or treaty entity.

PHILIPPINES

For domestic corporations standard CIT rate is 30% on total net income
Minimum CIT of 2% of gross income if this amount is higher than 30%
CIT after the 4th year of operations
CIT of 10% for private educational institutions and non-profit hospitals
if their other income is less than 50% of total income
Exclusively non-stock, non-profit educational institutions are exempt
Corporations that allow income to accumulate rather than distributing it
are subject to a 10% improperly accumulated earnings tax on income,
public enterprises, financial and insurance companies are excluded
A local business tax or permit fee up to 3% imposed based on last year’s gross sales by local governments
Resident foreign corporations taxed in the same way as domestic with some exceptions on Philippines source income
Nonresident foreign companies are mostly taxed on Philippines source income at 30% of gross income with exempt reinsurance premiums and interest on foreign loans at 20%. Fringe benefits tax is imposed at 32% (payable by employer) on monetary value of fringe benefits provided by the employer (divided by 68%) to managerial and supervisory employees with some specified exemptions Branch profits taxed at CIT rate, profits remitted abroad subject to 15% on gross of tax basis except where reduced by treaty, regional operating HQs pay 10% on taxable income Interest income received from a domestic company from domestic or resident foreign companies subject to a final tax of 20% from most sources, with 7.5% and 10% for some specified incomes Royalty income received from a domestic company from domestic or resident foreign companies subject to a final tax of 20% Several types of specified financial incomes exempt from CIT Corporations making royalty, interest and dividends payments (among others) to nonresidents have to withhold 30% for payments made to nonresident foreign companies (25% for nonresidents not involved in trade or business) which may be lowered by tax treaty for dividends, interest and royalties to rates between 7.5%-25%


4. Residence versus Source Principle

In the OECD countries studied, resident companies are taxed on worldwide income in all countries with the exception of Singapore where all companies are taxed on Singapore source income only, unless foreign income is received in Singapore or deemed to be received. All countries have well defined permanent establishment (PEs) laws, normally based on OECD model based on a fixed place of business and in some cases where dependent agents exist or effective control is exercised. PEs are taxed on domestic source income. Residency is determined by differing criteria in different countries: sometimes based on incorporation in domestic country (Australia, UK, and USA) and in other cases on place where directors meet or place where effective control is exercised (Korea, Singapore).

These patterns are repeated in almost all BRICS and Vietnam’s neighbors in our sample of countries. India taxes residents on India source income only, as does Malaysia, while Laos and Russia do not have well defined residence/PE laws. Practices of taxing branch profits vary widely across countries as do policies on imposition of withholding on repatriation of profits by branches.
<table>
<thead>
<tr>
<th>COUNTRY</th>
<th>REGIME</th>
</tr>
</thead>
<tbody>
<tr>
<td>OECD</td>
<td></td>
</tr>
</tbody>
</table>
| AUSTRALIA | Resident companies are taxed on worldwide income  
In case of countries with DTAA, Australia’s right to tax is limited to profits attributable to PEs  
Resident companies are ones incorporated in Australia, or if not, then carries on business in Australia and its management or control or its majority shareholders are Australian  
Well defined PE laws exist and are consistent with most DTAAas |
| KOREA    | Residents are taxed on worldwide income. Nonresidents with PE taxed on Korean source income. Other nonresidents taxed through WHT on items of income separately. Companies with head offices or place of effective management in Korea are considered resident. With some exceptions, companies with fixed place of business, dependent agents or employees of 2 years standing are considered PEs. |
| SINGAPORE | Taxes on Singapore source income for all companies and on foreign source income when remitted to Singapore  
Residence defined by central management and control location in most cases where directors meet  
Since Singapore taxes on source, PE is not an important issue except for treaty purposes and WHT, but a PE is taken as a clear indication of source. Based on OECD definition a PE is generally defined as a fixed place of business including branches, or providing services through Singapore employees for specified periods or agents who can negotiate and contract  
Branches taxed as normal CIT. No branch profits remittance tax on profit transfer to head office  
Foreign income of resident as well as nonresident corporations is taxable in Singapore when received in Singapore (or deemed to be so). Foreign tax credit is available for treaty countries, and unilateral credit for non-treaty countries. Foreign dividends, foreign branch profits, and foreign service fee income remitted to Singapore may be exempt from tax subject to specified conditions |
| UK       | UK residents taxed on worldwide profits; UK incorporated companies treated as UK resident, unless otherwise specified in a treaty, companies incorporated abroad may also be treated as UK resident is effective management and control resides in UK  
A nonresident has a UK PE if it has a fixed place of business in UK or an agent unless of a preparatory or auxiliary nature  
PEs taxed in same way as domestic companies, except that small profits rate is not available for a PE unless allowed by DTAA; specific rules exist for PE profit determination – evaluated as if a separate (standalone) company for financing arrangements but allowed to allocate part of head office costs |
UK residents and PEs have to separately calculate net income from each source of business and total taxable capital gains. Starting point for determining trading income is book profits worldwide, and these are adjusted for dividends and income from property (non-trading income) and capital expenditure and then capital allowances, pensions contributions etc.
While residents are taxed on worldwide income, a group may make a one-time election to exempt all non-UK branches from taxation in UK; if they do not elect this, foreign tax credits are still applicable either through treaties or unilaterally

<table>
<thead>
<tr>
<th>USA</th>
<th>Resident corporations taxed on worldwide income</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>Foreign company engaged in US business taxed on CIT rate on income effectively connected with US business, and at 30% on US income not effectively connected with US business</td>
</tr>
<tr>
<td></td>
<td>Any company organized or created in US is a domestic corporation even it has no business or property in USA</td>
</tr>
<tr>
<td></td>
<td>PE is fixed place of business</td>
</tr>
<tr>
<td></td>
<td>Branches pay CIT on branch profits and 30% (or lower due to treaty) branch profits tax on a foreign company’s effectively connected income in US through a branch; the 30% branch profits tax may also be levied on interest payments by a US branch to foreign lenders</td>
</tr>
<tr>
<td></td>
<td>US corporations pay US tax on worldwide income including branch profits, though a system of foreign tax credits or deductions is in place</td>
</tr>
</tbody>
</table>

**BRICS**

| BRAZIL               | Resident companies taxed on worldwide income. Non-resident companies registered subsidiaries, branches and PEs taxed on local income and WHTs may apply |
|----------------------|Residents companies – those incorporated in Brazil, tax domicile – when HQ is located. Rules regarding taxable presence of foreign companies or permanent establishments are sparse outside of treaty arrangements |

| CHINA                | Tax resident enterprises (TREs) are taxed on worldwide income |
|----------------------|Non TREs with PE in China are taxed on China source income and worldwide income effectively connected to the Chinese PE|
|                      | Enterprises incorporated in China are TREs; a nonresident with a place of effective management in China is also a TRE |
|                      | PE in China – defined as an establishment or place undertaking production and business operations, including management organizations and representative offices, factories, farms, and places where natural resources are exploited, places where labor services are provided, places where contractor projects are undertaken and business agents |

| INDIA                | Branch income received, accruing or arising in India is taxed at the same rate applicable to foreign companies |
A resident company is either an Indian company or one whose management and control is located in India during the tax year, and similar conditions apply for limited liability partnerships. An Indian PE is a fixed place of business through which the business of an enterprise is wholly or partly carried on. A resident company is taxed on income received in India while a non-resident is taxed on income arising, accruing or received in India or deemed as such.

**RUSSIA**

No specific provisions for corporate residence, but law specifies Russian and foreign legal entities depending on where incorporated. A Permanent Establishment (PE) is defined as a fixed place (branch, division, bureau, agency or any other place) for regular business in Russia or even an agent in some cases, although it may be defined differently under a treaty. Russian companies taxed on worldwide income, foreign tax credit applies. Foreign companies pay on Russian income (PEs), and (Withholding Tax) WHT applies to foreign companies with no PE. Foreign companies pay tax on profits earned by a PE in Russia on the same basis as Russian companies and deduct mostly the same expenses. Treaties may include provisions for deductibility of HQ expenses incurred abroad for its PE in Russia. New provisions introduced guide the determination of taxable income of a PE based on functions, assets and risks. A Permanent Establishment is considered to be formed if a foreign legal entity provides free of charge services to third parties in Russia; in such cases, the tax base is 20% of its expenses on these activities. and may allow taxation at 20% of expenses even if services are provided free of charge by a foreign entity in Russia to third parties.

**SOUTH AFRICA**

Resident company if it is incorporated in South Africa or effectively managed in South Africa (unless a corporation is excluded by virtue of a DTAA with another country). Residents are taxed on worldwide income, nonresidents are taxed on South Africa-source income and on capital gains arising from the disposal of immovable property and assets of a permanent establishment in South Africa. Normally, other income of PEs is subject to CIT in SA only if derived in SA. Branches generally are taxed in the same manner as subsidiary companies, they are not considered separate entities, taxed at 28% and not subject to dividends tax or branch profits repatriations tax. Foreign income of an SA company taxed on receipt or accrual, whichever is earlier, unless remittance prevented by law of foreign country.
<table>
<thead>
<tr>
<th>NEIGHBORS</th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td>CAMBODIA</td>
<td>For real regime taxpayers’ taxation is on worldwide income for residents and on Cambodian income for non-residents and PEs. Resident companies include those incorporated or controlled or primarily conducting business in Cambodia. Rules for PE include consideration of permanent place or entity through which business is conducted or the length of time of the agency’s activity on behalf of a non-resident.</td>
</tr>
<tr>
<td>INDONESIA</td>
<td>Resident companies pay on worldwide income, as are PEs generally. Foreign companies and PEs have to pay the same CIT obligations, either by direct payments, third party withholdings, or a combination of both, while non-residents, without a PE in Indonesia, have to withhold the tax on their Indonesia-sourced via the Indonesian party paying the income. Branch profits are taxed at 25% (ordinary CIT), and after tax branch profits are subject to WHT of 20% regardless or repatriation, which may be lower for treaty countries. Under controlled foreign company (CFC) law, foreign income of Indonesian company is taxable as Indonesian company (subject to specifications on coverage) and this rule applies even if the CFC is not in a tax haven; the exception is a case where the shares of CFC are listed on a stock exchange SE.</td>
</tr>
<tr>
<td>LAOS</td>
<td>No definition of residence or PE in the law. All companies registered under Profit Tax (PT) law in Laos are subject to CIT on worldwide income. Foreign companies operating in Laos are taxed on Laos source income, as are branches of foreign companies.</td>
</tr>
<tr>
<td>MALAYSIA</td>
<td>Taxation on Malaysia source income for both residents and nonresidents. A company is Malaysia resident if at any time during the financial year its management and control are exercised in Malaysia – such as at least one board meeting during the relevant financial year in Malaysia. A PE of a non-resident exists in Malaysia if it has a fixed place of business, or a dependent agent or carries on supervisory activities for 6-9 months for certain industries such as construction etc. There is no CFC provision to tax undistributed income of foreign subsidiaries. In some cases Malaysian resident companies are taxed on worldwide income – sea/air transport, banking and insurance, except for profits and remittances from new subsidiaries and branches abroad for the first 5 years.</td>
</tr>
<tr>
<td>PHILPPINES</td>
<td>Domestic company is one incorporated locally, foreign resident company is licensed to operate in Philippines. PE arises when services are provided in the Philippines for a specified length of time.</td>
</tr>
</tbody>
</table>
Domestic company taxed on worldwide income (either when accrued or realized for foreign income depending on accounting method)
Resident foreign companies taxed in same way as domestic company but only on Philippines source income except when tax treaty allows otherwise
Nonresident foreign companies are taxed through WHT on gross income, normally at 30% unless reduced by treaty or otherwise specified
Regional headquarters (HQs) of Multinational companies (MNCs) with no Philippines source income are exempt
Branch income taxed as normal CIT with 15% extra on profits remitted abroad, except for units in economic zone and regional HQs
Income earned through foreign subsidiary taxed only when received as dividend by resident shareholder, but for foreign branch taxed on accrual
Credit for foreign taxes or deduction are available at the choice of the taxpayer


5. Capital Gains

In all the OECD countries covered, capital gains are taxable at the ordinary CIT rates. In the sample, only the UK currently allows for inflation adjustment of acquisition cost in the calculation of capital gains, subject to the condition that this does not give rise to losses. In all cases, capital losses can only be set off against capital gains in the ordinary course, while the UK has several provisions in this regard to set off losses against other group company gains and to carry forward some losses. The US and the UK both allow losses to be carried forward while the US allows 3 year carry back as well.

Within the BRICS there is more variation in the treatment of capital gains and losses. China simply adds realized gains to ordinary income on realization. India has the most elaborate laws on separation of short term from long term gains, indexation and differential treatment of gains form shares and securities. South Africa taxes gains as ordinary income but only to the extent of 2/3 of the gains. All the countries place restrictions on set off of capital losses against gains rather than general income except Brazil that allows set off against any income in the year the loss is incurred.

The picture is generally diverse in Vietnam’s neighbors as Cambodia and Laos (except for buyer withholding on gains from shares in Lao) have no separate provisions for gains and include them in taxable profit; Indonesia does the same but has special provisions for land, buildings and shares and Philippines and Malaysia do not tax capital gains except form property, land and buildings.

<table>
<thead>
<tr>
<th>COUNTRY</th>
<th>REGIME</th>
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</thead>
<tbody>
<tr>
<td>OECD</td>
<td></td>
</tr>
<tr>
<td>AUSTRALIA</td>
<td>Capital gains on assets acquired after September 1985 are taxed at the normal CIT rate.</td>
</tr>
<tr>
<td>Country</td>
<td>Description</td>
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<tr>
<td><strong>Assets acquired between September 1985 and September 1999</strong> can have their cost base inflated by the CPI up to 30 September 1999, and no price adjustments are allowed after October 1999. Capital losses are not allowed cost base inflation adjustments. Disposal of plant and equipment is kept out of the purview of capital gains tax (CGT) rules. Residents are taxed on worldwide gains subject to DTAAAs. Since 2006 nonresidents are subject to Australian CGT where the assets are taxable Australian property.</td>
<td></td>
</tr>
<tr>
<td><strong>KOREA</strong></td>
<td>Capital gains from the sale of assets and shares are normally taxable at standard CIT rates as part of income: generally calculated as sale proceeds less acquisition cost. Unrealized gains or losses on foreign currency assets may be recognized at the choice of the taxpayer.</td>
</tr>
<tr>
<td><strong>SINGAPORE</strong></td>
<td>No separate tax on capital gains, but for a series of transactions involving relatively short holdings of assets, tax authorities may tax the trading profits from those. This guided by the UKs “Badges of Trade” system that guides judicial determinations on these issues and takes into account several features of these transactions. After 2012, gains from equity sales will not be taxed unless at least 20% of the shares of the company whose shares are being transacted have been held for at least 2 years.</td>
</tr>
<tr>
<td><strong>UK</strong></td>
<td>Capital gains from assets taxed at CIT rates. Calculated as sales proceeds minus cost of purchase and improvements, transactions costs and allowance for inflation. Inflation indexation cannot be used to create or increase capital loss. Losses can be offset only against gains and can be carried forward indefinitely but not carried back. Capital gains can be deferred for certain assets if sale proceeds reinvested in similar assets within 3 years. Elaborate rules for anti-avoidance in the area of capital losses for intragroup transactions and mergers and acquisitions (M&amp;A) exist. Foreign exchange (unrealized) losses on debt and derivatives may be allowed on accrual or on accounts basis, except in the case of gains or losses on other capital assets that are allowed on realization as described above. Detailed rules for loss offsets. In some cases carry back and sideways (offset against other gains) relief possible, carry forward mostly allowed without time limit, group set off may also be allowed. Trading losses possible set off against any other profit or gain in the same year, carry back one year (3 years if the trade ceases) against any profit or gain, or carry forward against same trading profit only without time limit. Property losses carried forward without time limit against any type of</td>
</tr>
<tr>
<td>Country</td>
<td>Description</td>
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<td>---------</td>
<td>-------------</td>
</tr>
<tr>
<td>USA</td>
<td>Gains recognized by corporations on capital assets in accounts are taxed at same rate as ordinary income. Capital losses can be deducted only against capital gains. DTAAAs may provide relief from capital gains for nonresidents without a PE for non-real property gains. 3 year carryback of capital losses in a year allowed to set off against gains, and 5 year carry forward allowed under same restriction. Sale of certain non-reidential real property used in a trade or business - net gains less than or equal to the depreciation/cost recovery are taxable as ordinary income, with any remainder generally treated as capital gain. Sale of other trade or business real property - to the extent that the depreciation or cost recovery claimed exceeds the straight-line amount net gains generally are taxed as ordinary income, with any remainder treated as capital gain. Long term capital gains rates on current transactions same as CIT rates, differences may arise when Alternative Minimum Tax (AMT) applies.</td>
</tr>
</tbody>
</table>

**BRICS**

<table>
<thead>
<tr>
<th>Country</th>
<th>Description</th>
</tr>
</thead>
<tbody>
<tr>
<td>BRAZIL</td>
<td>Capital gains from sale of assets and rights including shares taxed as ordinary income. Capital losses can only be set off against capital gains except in the year incurred. Unutilized capital losses are treated in the same way as ordinary income tax losses for carry forward and limits on use. Capital gains by non-residents from Brazilian assets are taxable in Brazil.</td>
</tr>
<tr>
<td>CHINA</td>
<td>Treated in the same way as ordinary income of tax resident enterprises, taxed only at realization except for foreign exchange gains and losses.</td>
</tr>
<tr>
<td>INDIA</td>
<td>Capital gains divided into short and long term. Short term gains – assets held for less than 36 months (12 months for most financial assets), others are long term. Long term capital gains from shares and qualifying securities subject to the securities transactions tax are exempt from capital gains taxation (but subject to minimum alternative tax), other long term gains subject to 20% plus surcharges and education cess(es). Long term capital gains are taxed after indexation of the purchase price and other adjustments as prescribed (cost of improvements) and</td>
</tr>
<tr>
<td>Country</td>
<td>Details</td>
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</tr>
<tr>
<td><strong>RUSSIA</strong></td>
<td>Subject to 20% profits tax and added to the pool of ordinary taxable income&lt;br&gt;Losses are separated into “baskets” and can generally only be set off against income from the same basket, except for income from listed derivatives that can be included in the general tax basket. Income from non-listed securities and from non-listed derivatives can only be set off against gains from the same basket.&lt;br&gt;CG from fixed assets and property calculated as difference between sale price and net book value for tax purposes. Capital losses have to be deducted over the period of nominal useful life after the date of sale in equal monthly installments&lt;br&gt;For certain shares in Russian companies (non-listed securities, or listed in hi-tech sectors) held for more than 5 years, a 0% CG may apply&lt;br&gt;Forex gains and losses recognized on accrual, but settlement of gains and losses in local currency arising from foreign currency positions taxable on payment</td>
</tr>
<tr>
<td><strong>SOUTH AFRICA</strong></td>
<td>Taxed at normal CIT rate but only 2/3 of capital gains included in taxable income</td>
</tr>
<tr>
<td><strong>NEIGHBORS</strong></td>
<td>No special provisions for capital gain, they are part of taxable profit</td>
</tr>
<tr>
<td><strong>CAMBODIA</strong></td>
<td>Capital gains included with ordinary income and taxed at normal CIT rate with following exemptions:&lt;br&gt;CG from sale of land and buildings subject to final income tax at the higher of (1) 5% of transaction value (2) value determined by government&lt;br&gt;Listed shares subject to final WHT of 0.1% of gross sales, with additional 0.5% on founder’s shares at initial public offering (IPO) – either this tax is paid, or normal CG at time of sale will apply at CIT rate&lt;br&gt;Gains and losses from currency fluctuations recognized on accrual basis</td>
</tr>
<tr>
<td><strong>INDONESIA</strong></td>
<td>No separate provisions on CG, except for 10% on profits from sale of shares to be withheld by the buyer; unrealized gains or losses are not</td>
</tr>
<tr>
<td><strong>LAOS</strong></td>
<td></td>
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</tbody>
</table>
recognized either

<table>
<thead>
<tr>
<th>COUNTRY</th>
<th>REGIME</th>
</tr>
</thead>
<tbody>
<tr>
<td>MALAYSIA</td>
<td>Real property gains tax on disposal of property land or rights on land, or shares of a company that holds 75% of its assets as land or rights to land; imposed on land held for 2 years or less at 10% and between 2-5 years at 5% with no tax on long term capital gains over 5 years Generally no tax on gains from other capital assets</td>
</tr>
<tr>
<td>PHILIPPINES</td>
<td>CG mostly not subject to CIT Capital assets (land and buildings used in business) of a corporation held for any period may be subject to a 6% final tax on the gross selling price or fair market value (whichever is higher) – withheld by buyer on sale. On stocks not listed and traded on SE, a 5% tax on the gain below PHP 100,000 and a 10% tax on gains above PHP 100,000, for listed stocks in most cases a stock transaction tax of 0.5% of gross selling price applies. Capital gains on other securities with maturity greater than 5 years are not taxed. Gain on sale of fully depreciated property taxable as ordinary income</td>
</tr>
</tbody>
</table>


6. Treatment of Losses

All OECD countries allow loss carry forward and also allow some form of loss carry backwards for one or two years. While Singapore allows 10 year loss carry forward and US allows 20 years, the other countries allow unlimited loss carry forward for normal trading income. There is generally also a built in anti-avoidance rule in that the ability to carry forward losses may be constrained by significant changes in ownership.

None of the BRICS allow loss carry back, while all allow varying types of carry forward. Brazil allows carry forward without any time limit, subject to tax loss utilization in any year not reducing taxable income by more than 30%, China allows 5 years carry forward, Russia allows carry forward unrestricted for 10 years. Losses from sale of fixed assets can be deducted over remaining useful life on pro-rata basis, and losses from separate “baskets” can only be set off against gains from same basket in most cases. For India no carry back but carry forward allowed for different periods for different losses: unused depreciation (no limit); other non-speculative business losses (8 years), speculative business losses (4 years) and capital losses (8 years). Finally, for South Africa, indefinite carry forward allowed to firms if active and uninterrupted and similar operations conditions are met.

For Vietnam’s neighbors there is no loss carry back in the sample, and all allow loss carry forward, but only Malaysia allows indefinite carry forward (subject to some restrictions); while others allow for 3-5 years. In practice all countries impose some restrictions on carry forward.
<table>
<thead>
<tr>
<th>Country</th>
<th>Description</th>
</tr>
</thead>
<tbody>
<tr>
<td>KOREA</td>
<td>Since 2008, 10 years carry forward allowed for all, and carry backs are only allowed for SMEs for 1 year</td>
</tr>
<tr>
<td>SINGAPORE</td>
<td>Losses up to SGD 100,000 incurred in the current year can be carried back 1 year. Unlimited carry forward of losses and depreciation allowances, may be subject to restrictions on change of ownership and nature of business that can be allowed by tax authorities if no tax avoidance motives are involved</td>
</tr>
<tr>
<td>UK</td>
<td>Carry forward indefinite for income losses and set off against any type of non-trading profit. Trading losses carried forward and set off only against profit of same type. Trading losses can be carried back to last 12 months period if same activity was also carried on in previous 12 month period. More limited 12 month carry back for non-trading losses (only for certain types). Losses may also be surrendered to other group companies, except for capital losses that may be allocated on an asset by asset basis to another group member through joint election. Capital losses carried forward indefinitely, no carry back, and cannot be offset against any type of income unlike income losses that can be offset against capital gains in the same accounting period. Complex anti-avoidance measures on losses when there is a change in ownership.</td>
</tr>
<tr>
<td>USA</td>
<td>Loss carry back 2 years, carry forward 20 years. Special rules for qualified disaster areas, as well as specified liability losses, some states may not have carry back or forward for calculating state CIT. Significant changes in ownership may impact ability to carry forward losses.</td>
</tr>
<tr>
<td>BRICS</td>
<td>Carry forward allowed without any time limit, subject to tax loss utilization in any year not reducing taxable income by more than 30%, no carry back allowed</td>
</tr>
<tr>
<td>BRAZIL</td>
<td>No carry back, carry forward for 5 years after the actual loss year</td>
</tr>
<tr>
<td>CHINA</td>
<td>No carry back but carry forward allowed for different periods for different losses: unused depreciation (no limit); other non-speculative business losses (8 years), speculative business losses (4 years) and capital losses (8 years)</td>
</tr>
<tr>
<td>INDIA</td>
<td>No carry back. Carry forward unrestricted for 10 years. Losses from</td>
</tr>
</tbody>
</table>
sale of fixed assets can be deducted over remaining useful life on pro-rata basis, and losses from separate “baskets” can only be set off against gains form same basket in most cases

<table>
<thead>
<tr>
<th>Country</th>
<th>Loss Carry Forward Rules</th>
</tr>
</thead>
<tbody>
<tr>
<td>SOUTH AFRICA</td>
<td>No loss carry back allowed. Indefinite carry forward if active and uninterrupted and similar operations</td>
</tr>
<tr>
<td>CAMBODIA</td>
<td>No loss carryback, loss carry forward allowed for 5 years and can be used in that period except in those years where there is a unilateral reassessment, and it is subject to a condition of continuity of ownership and activity</td>
</tr>
<tr>
<td>INDONESIA</td>
<td>Carry forward for 5 years, no carry back, no offset of losses within a corporate group</td>
</tr>
<tr>
<td>LAOS</td>
<td>Carry forward for 3 years, no carry back, change in control does not impact stock of losses, and capital losses are included as ordinary losses</td>
</tr>
<tr>
<td>MALAYSIA</td>
<td>For active companies, loss can be carried forward indefinitely. Losses in current year can be set off against any income but carried forward losses can be set off against business income only, and similar restrictions for set off exist for capital allowances carried forward. Dormant companies must pass a continuity test to carry forward losses</td>
</tr>
</tbody>
</table>
| PHILIPPINES | NO loss carryback
Loss carry forward for 3 years after loss year, except losses incurred in tax exempt years
Mines (excluding oil and gas wells) can carry forward losses (calculated without specified incentives) from the first 10 years of operation for the next 5 years |


7. Depreciation

All OECD countries in the sample allow either straight line or reducing balance depreciation over useful life or a combination of both. All countries have some form of immediate expensing or accelerated depreciation of extra investment/depreciation allowances for specified classes of assets or taxpayers. Australia, Singapore, USA and UK have “clawback” provisions to capture excess depreciation on sale of assets. US, UK and Australia allow depreciation of goodwill and other intangibles subject to some conditions.

Similarly BRICS countries mostly use straight line depreciation over useful lives and some countries allow reducing balance. Russia and South Africa are more conservative than OECD countries in allowing depreciation of intangibles and goodwill.

The picture is similar for Vietnam’s neighbors with straight line over useful life and reducing balance being the dominant methods, with some variations. Normally buildings have the longest useful
lives, accelerated depreciation may be available for some assets of types of companies and the treatment of goodwill and intangibles varies over the sample.

<table>
<thead>
<tr>
<th>COUNTRY</th>
<th>REGIME</th>
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</thead>
<tbody>
<tr>
<td>OECD</td>
<td></td>
</tr>
<tr>
<td>AUSTRALIA</td>
<td>Intangibles allowed depreciation – certain mining items and rights,</td>
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<tr>
<td></td>
<td>intellectual property, in house software etc.</td>
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<tr>
<td></td>
<td>Large and medium enterprises must use straight line or diminishing</td>
</tr>
<tr>
<td></td>
<td>value methods (200% of straight line since 2006) over an asset’s</td>
</tr>
<tr>
<td></td>
<td>effective life. The life can be chosen by the taxpayer or follow a</td>
</tr>
<tr>
<td></td>
<td>published official determination.</td>
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<tr>
<td></td>
<td>Small taxpayers (turnover less than AUD 2 million) have a simpler</td>
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<tr>
<td></td>
<td>regime with more attractive rates and can immediately expense assets</td>
</tr>
<tr>
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<td>less than AUD 6500</td>
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<tr>
<td></td>
<td>“Project pool” rules allow expenditures other than those above to be</td>
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<tr>
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<td>deducted over the life of a taxable project and they include items such</td>
</tr>
<tr>
<td></td>
<td>as site preparation expenses, costs of feasibility and environmental</td>
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<tr>
<td></td>
<td>assessment studies etc.</td>
</tr>
<tr>
<td></td>
<td>“Blackhole” expenditure provisions allow a five year straight line of</td>
</tr>
<tr>
<td></td>
<td>capital expenditures for a taxable project not elsewhere adjusted or</td>
</tr>
<tr>
<td></td>
<td>disallowed</td>
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<tr>
<td></td>
<td>Losses on sale of depreciable asset are deductible and gains are taxed</td>
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<tr>
<td></td>
<td>either as excess depreciation recaptured or the gain in excess of that</td>
</tr>
<tr>
<td></td>
<td>amount.</td>
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<tr>
<td></td>
<td>Certain luxury cars have maximum upper value limits for depreciation</td>
</tr>
<tr>
<td></td>
<td>purposes</td>
</tr>
<tr>
<td>KOREA</td>
<td>Straight line, declining balance used with service-output method</td>
</tr>
<tr>
<td></td>
<td>allowed in mining</td>
</tr>
<tr>
<td></td>
<td>Tax law specifies methods permitted for different classes of assets</td>
</tr>
<tr>
<td></td>
<td>and straight line is mandatory for plant, buildings and intangible</td>
</tr>
<tr>
<td></td>
<td>assets</td>
</tr>
<tr>
<td></td>
<td>Salvage value zero in straight line method, mandatory 5% in declining</td>
</tr>
<tr>
<td></td>
<td>balance method</td>
</tr>
<tr>
<td></td>
<td>Tax law specifies the useful lives of assets which can be varied by 25%</td>
</tr>
<tr>
<td></td>
<td>in either direction by the taxpayer and then consistently applied</td>
</tr>
<tr>
<td></td>
<td>Generally (useful life) years of machinery and vehicles (5), ships and</td>
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<td>aircraft (12), non-steel frame buildings (20) and steel and stone frame</td>
</tr>
<tr>
<td></td>
<td>buildings (40); for intangibles useful life in years varies from 5 for</td>
</tr>
<tr>
<td></td>
<td>goodwill to 50 for right to use dams</td>
</tr>
<tr>
<td>SINGAPORE</td>
<td>Machinery and equipment allowed on straight line basis over useful</td>
</tr>
<tr>
<td></td>
<td>life, or businesses may opt for accelerated depreciation over 3 years</td>
</tr>
<tr>
<td></td>
<td>instead</td>
</tr>
<tr>
<td></td>
<td>Immediate expensing allowed for computers, robots, pollution control</td>
</tr>
<tr>
<td></td>
<td>and energy efficient equipment etc</td>
</tr>
<tr>
<td></td>
<td>Intellectual property can be amortized straight line over 5 years,</td>
</tr>
</tbody>
</table>
subject to conditions
For specified limited periods, and for the first SGD 400,000 of annual expenditure on each category, 400% deduction may be available for automation equipment, staff training, intellectual property, R&D and design
Claw back provisions exist for depreciable assets that sell above tax value, taxed as ordinary income for the difference between sale proceeds and tax depreciated value allowed
Payments to acquire goodwill generally not deductible
Writing down allowances may be available for certain expenses incurred before operations start such as acquisition of plant and R&D deemed to be from the first day of start of business

<table>
<thead>
<tr>
<th>Country</th>
<th>Description</th>
</tr>
</thead>
<tbody>
<tr>
<td>UK</td>
<td>No depreciation deductions on tangible assets, instead “capital allowances” given. For specified machinery and equipment, allowance is 18% of cost in first year and then 18% in subsequent years on reducing balance basis. For many types of machinery and equipment that are long lived assets (useful life over 25 years) purchased after 1996 the annual capital allowance is 8% Capital allowances given for cars based on emissions Additional investment allowance available to all businesses on the first GBP 25000 of each qualifying asset expenditure at 100% in each year Additional allowances at 100% of expenditure available for qualifying energy saving expenditures No capital allowances generally given for buildings 10% reducing balance capital allowance on cost of acquiring mineral assets and 25% allowance on reducing balance on qualifying expenditures on minerals extraction may be available Recapture of excess allowances on sale of assets governed by complicated regulations that create groups (pools) of assets, no recapture for sale of industrial buildings Special regime for intangibles including goodwill and royalties, non-traders can even carry back the loss on intangible fixed assets for 1 year, use in current year or carry forward indefinitely</td>
</tr>
<tr>
<td>USA</td>
<td>Modified accelerated cost recovery system Tangible asset recovery periods 3,5,7,10,15,20,27.5,31.5 and 39 years For assets in 3,5,7 &amp; 10 year categories, 200% declining balance at first and switch to straight line when this method gives higher deduction For assets in 15 or 20 year categories, 150% declining balance at first and switch to straight line when this method gives higher deduction May use straight line method over useful life instead at discretion, or longer than useful life, or 150% declining balance over normal recovery period for non-real property (required for AMT) Non-residential real property straight line over 39 years if in service</td>
</tr>
<tr>
<td>BRICS</td>
<td></td>
</tr>
<tr>
<td>---</td>
<td>---</td>
</tr>
</tbody>
</table>
| BRAZIL | after 1993, 31.5 years for older  
Restrictions and special rules for vehicles  
Accelerated depreciation for certain pollution control facilities  
Tax and book depreciation need not conform, recapture of tax depreciation on sale when gains are taxed as ordinary income to the extent of depreciation  
Most intangibles depreciated over 15 years  
Section 179 expensing up to specified annual maximum (USD 25000 at present) for certain specified assets used in trade or business, further limited to total taxable income of business in a year, unless increased for qualified disaster areas  
Special bonus depreciation of 50% available to certain assets in first year subject to restrictions (mostly during recession period 2007-10)  
Cost depletion available for certain exhaustible natural resources the estimate of the total number of units is reduced by number extracted and sold during the year on a percentage basis, limited to between 5%-25% per year and 50% of total taxable income for the year (100% for oil and gas for certain specified products/producers only)  
Goodwill depreciated over 15 years |
| CHINA | Mostly straight line method, with accelerated depreciation allowed in some cases  
CIT law allows minimum useful lives of certain assets in years; buildings (20), vessels (10), production appliances/tools (5), transport equipment other than vessels (4), Electronics (3), forestry biological assets (10), livestock biological assets (3)  
Patents, trademarks, copyrights, and land use rights can be amortized over a period of not less than ten years. If obtained through capital contribution or assignment, an intangible asset can be depreciated according to the useful life prescribed. Acquired goodwill is not deductible until the invested enterprise is entirely transferred or liquidated. |
<p>| INDIA | Two methods used are straight line method and written down value (WDV) method |</p>
<table>
<thead>
<tr>
<th>Country</th>
<th>Description</th>
</tr>
</thead>
<tbody>
<tr>
<td>RUSSIA</td>
<td>Straight line and declining balance methods allowed, years of useful life specified by the government. Examples are: personal computer (2 to 3 years) to aircraft (10 to 15 years) to blast furnaces (20 to 25 years). Accelerated depreciation at up to 3 times the normal rate available (for most cases) for leased property. A one-time initial investment allowance of 10%-30% of the cost of purchased fixed assets allowed in the first month with recapture provision for assets sold before 5 years allowed. Intangibles to be depreciated over 10 years (unknown life) or useful life (if known) Provisions for depreciation and calculation of goodwill also exist (to be amortized over 5 years) but are rarely used in practice.</td>
</tr>
<tr>
<td>SOUTH AFRICA</td>
<td>No statutory depreciation (wear and tear allowances), but table of useful lives from tax authority, straight line or declining balance used. Examples: used machinery – 20%/year over 5 years, new machinery – 40% in first year and 20% over next 3 years. Accelerated depreciation allowance available for certain sectors. Buildings get an annual allowance that may be 5% per year or accelerated to 20% in some cases or may get an additional allowance such as for low income housing in urban development zones. Recoupment provisions exists that tax sale proceeds minus taxable base of an asset to the extent of allowances granted as part of income, while proceeds greater than cost are taxed as capital gains. Book and tax depreciation need not conform, and no cost or percentage depletion for natural resources available. Deduction for goodwill not normally allowed. When assets are acquired in return for shares, the expenditure on those assets are valued at the lesser of the market value of assets or shares immediately after transaction.</td>
</tr>
<tr>
<td>Country</td>
<td>Description</td>
</tr>
<tr>
<td>--------------</td>
<td>---------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------</td>
</tr>
<tr>
<td>CAMBODIA</td>
<td>Property (excluding land) has to be depreciated in the following manner: Building and structure using straight line at 5%; computers and electronics (50%), vehicles (25%) and all other tangible property (20%) using declining balance Intangible property at 10% per annum or amortized over life of property For certain assets used in manufacturing and processing, accelerated depreciation is allowed if tax holidays are not claimed Purchased goodwill is also a depreciable asset, taxed in the same manner as intangible property</td>
</tr>
<tr>
<td>INDONESIA</td>
<td>Includes tangibles and intangibles including costs of acquiring and using rights, for useful life over 1 year, excludes land for business Straight line or declining balance on individual assets Useful life for assets other than buildings are classified into assets lasting 4,8,16 and 20 years on straight line basis, with double the rate for declining balance For buildings, straight line useful life is 5% for permanent and 10% for non-permanent, with no declining balance rates specified Special sectors may have separate rules, and tax and book depreciation need not be compatible Mining, oil and natural gas rights with useful life greater than one year apply the production unit method usually (except for oil and natural gas) @ below 20% p.a. Certain startup costs for specified enterprises may also be amortized as above</td>
</tr>
<tr>
<td>LAOS</td>
<td>Tax and book depreciation need not be compatible, tax depreciation on straight line basis over useful lives prescribed such as 20 years for industrial buildings 20 years old or less and 40 years for others, 10 years for commercial and residential non-permanent structures 5 years for machinery and vehicles, 20 for other vessels etc No provisions on intangibles such as goodwill</td>
</tr>
<tr>
<td>MALAYSIA</td>
<td>Allowed in two parts (1) initial allowance in the year expenditure is incurred and asset is in use and (2) annual allowance calculated on cost for every year the asset is used. Initial allowances include 10% for industrial buildings and 20% for plant, machinery and vehicles while annual allowance varies from 3%-20%. Accelerated capital allowance is available for specified buildings, plant and machinery. Goodwill cannot be deducted or amortized</td>
</tr>
<tr>
<td>PHILIPPINES</td>
<td>Mostly on straight line basis, but any known method that allows depreciation plus salvage value to equal cost is permissible Tax and book depreciation mostly should conform, except when incentives are available for tax Firms in petroleum sector may opt to apply the straight line or declining balance methods over 10 years</td>
</tr>
</tbody>
</table>
Firms in mining may depreciate assets with useful life over 10 years choosing any life period between 5 years and the assets expected life. Cost depletion allowance is available for oil and gas wells based on actual reduction in settled production or regular flow. For mining this is allowed up to the taxable value (for ad valorem mining taxes) of mining output during the year. Goodwill cannot be depreciated.


8. Expenses and Deductions

In the sample, OECD countries considered have varying practices in allowing deduction of startup expenses, most allow deduction for bad debts as incurred, fines and penalties are generally not deductible while the practice of allowing income tax deductions vary, most allow payment to foreign affiliates at arm’s length while withholding taxes (WHT) are applied in most cases. The practices with respect to entertainment expenses vary from country to country with Australia disallowing most such expenditures and Korea allowing employee meals and other remunerations without limit.

The pattern is repeated in the BRICS and Vietnam’s neighbors with most countries allowing startup expenses in some form and bad debts when incurred, mostly disallowing fines and penalties and income taxes deductions and allowing payments to foreign affiliates at reasonable levels subject to WHT, with widely varying practices with respect to entertainment and meals.

<table>
<thead>
<tr>
<th>COUNTRY</th>
<th>REGIME</th>
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<tbody>
<tr>
<td>OECD</td>
<td></td>
</tr>
<tr>
<td>AUSTRALIA</td>
<td>Certain startup expenses such as costs of company incorporation are covered by the so called “black hole” provisions. Bad debt may be written off if previously included in assessable income subject to integrity measures. Most expenditures on entertainment are not deductible. Fines and penalties are generally not deductible. Taxes other than GST and income taxes are deductible. Royalties, management service fees and interest paid to non-residents are deductible subject to reasonable norms and relation to taxable activity. When services are paid for in advance deduction is allowed to be prorated over the life of the service provided up to a maximum of 10 years.</td>
</tr>
<tr>
<td>KOREA</td>
<td>Startup expenses allowed deduction when actually paid. Interest on loans for business purposes are normally deductible except in the case of borrowings from foreign shareholders exceeding their equity contribution by 300%, unknown debenture or bond owners interest on constructions loans before commencement of production.</td>
</tr>
</tbody>
</table>
Most contingent liabilities not deductible except reserves for bad debts (allowed up to 1%-2%), retirement allowances, reserves for non-profits etc
No limit for employee remuneration deductions including meal and housing allowances
Severance allowance up to 5% of annual compensation (subject to overall limit) can also be deducted, as well as pension contributions (separate provisions for defined benefit and defined contribution)
Insurance premiums are deductible form CIT as long as company or its employees are beneficiary; employee beneficiaries are subject to WHT
Fines, penalties not deductible, as are income taxes
Entertainment expenses of more than KRW 10,000 on an event basis must be supported by corporate credit card vouchers, cash receipts, or tax invoices in order to be deductible. The deductible limit for entertainment expenses in a business year is computed as the number of months in the respective business year multiplied by KRW 1 million (1.5 for SMEs) plus the amount calculated by multiplying the amount of gross receipts for a business year by the rates listed below (in the case of receipts from transactions between related parties @ 20% of the amount calculated)

<table>
<thead>
<tr>
<th>Amount of gross receipts (KRW)</th>
<th>Deductible limit</th>
</tr>
</thead>
<tbody>
<tr>
<td>10 billion or less</td>
<td>0.20%</td>
</tr>
<tr>
<td>10 billion to 50 billion</td>
<td>KRW 20 million + 0.1% of the excess over KRW 10 billion</td>
</tr>
<tr>
<td>Greater than 50 billion</td>
<td>KRW 60 million + 0.03% of the excess over KRW 50 billion</td>
</tr>
</tbody>
</table>

Interest, royalty and management fees paid to foreign affiliates are deductible if backed by adequate documentation and meeting specified conditions

SINGAPORE

Generally do not allow startup expenses incurred before start of operations, but from 2012 most businesses can deduct startup expenses incurred 12 months before the first $1 of operational income was earned, if they are of the nature of allowable expenses otherwise
Interest expenses or borrowing costs in lieu thereof allowed deduction if the capital is used to produce income
Expenses on R&D in Singapore deductible @150%, overseas R&D can be deducted subject to conditions, in enhanced deductions for R&D for some tax years like the 400% incentive allowable under the depreciation provisions
Bad debts incurred deductible, and even doubtful debts in some cases, general provisions for bad debts are not deductible
Fines, penalties and income taxes are not deductible
Private automobile expenses not deductible. Tax deduction for
medical expenses confined to 1% of total payroll, unless the employer implements certain specified schemes, in which case 2% of payroll can be deducted
With certain restrictions, employee share based remuneration may also be deductible
Payments to foreign affiliates are deductible if they meet certain restrictions

| UK | R&D expenses deductible, and additional incentives for R&D expenditures may also be available
Non-capital management expenses incurred by holding companies may be set off against own or group income, or carried forward indefinitely
Deductions available for deemed cost of providing shares to employees, including employees of subsidiary companies on formula basis
Fees and interest generally deductible subject to thin capitalization laws with no clear safe harbor provisions, and subject to overall cap based on groups total outside debt
Provisions are generally deductible (including for bad debts) subject to satisfaction of conditions such as the underlying revenue expenditure itself being deductible, compatibility with accounting regulations, accurate estimation etc.
Fines and penalties generally not deductible, except for certain legal costs and compensatory damages that are not punitive in nature; local business taxes are deductible
No separate rules for payments to foreign affiliates, except for transfer pricing regulations requiring arm’s length |

| USA | Startup expenses mostly depreciated over 15 years, with exceptions for some expenses and some taxpayers for immediate expensing in the first year of operation
Section 199 allows qualified production activities a 9% deduction of profits, applicable to AMT as well, but limited to a total of 50% of wages reported on W-2 allocated to those qualified activities, this deduction is not available to those making a loss (including carry forward)
Bad debt deductible form the date it becomes worthless
Contributions by employer to approved employee benefit/pension plans are deductible expenses
No deductions for fines, penalties, bribes etc, while state and municipal taxes are deductible for federal income taxes
Contingent liabilities only deductible when they become fixed and estimable precisely
Limitations on entertainment and business travel expenses, entertainment subject to strict tests and restricted to 50% of the expenses for business meals and entertainment costs |
Royalties, costs of mine exploration and development and other sundry costs of carrying on a business are deductible subject to conditions and limits
R&D expenditures either deductible as incurred, or depreciated over 5 years or more
Payments to foreign affiliates by a US company for royalties, fees and interest on actuals and at arm’s length allowed, WHT may apply

<table>
<thead>
<tr>
<th>BRICS</th>
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</tr>
</thead>
</table>
| BRAZIL | Interest on net equity is payable and deductible to partners and shareholders subject to a maximum rate of 6% and that overall payment are less than 50% of annual or accumulated profits. This payment is subject to a withholding tax on payment, adjustable against further CIT liabilities for corporations and a final tax for individuals. Losses from bad debts other than inter-company transactions are deductible subject to restrictions.
Duly documented and specified travel and medical insurance expenses are deductible.
Fines and penalties are not deductible, but taxes contributions and related costs not being appealed are deductible on accrual basis.
Royalties, technical service fees and interest paid to foreign companies with controlling interest are deductible subject to limits and proper registration of contracts. |
| CHINA | Start-up expenses are deductible completely in the first year of Operation.
For R&D expenses incurred for new technology, new products or new craftsmanship, 150% of the actual expenses incurred are tax-deductible as an incentive.
Asset loss (including bad debt loss) may be deductible in the tax year during which such loss is incurred, with acceptable and approved documentation.
Interest on loans generally tax-deductible. Interest expenses on borrowings from non-financial institutions by a non-financial institution deductible up to the commercial rate. The tax deduction of interest paid to related parties is subject to the thin capitalization rule.
Provisions for asset impairment reserves (e.g., bad debt provisions) and risk reserves generally are not tax-deductible unless otherwise prescribed in the tax rules.
Reasonable wages and salaries of employees incurred by an enterprise are deductible. Directors’ fees are also tax-deductible as are basic social security contributions as prescribed – commercial insurance premium paid for employees are not deductible unless for specified safety insurance.
Staff welfare expenses, labor union fees, and staff education expenses |
<table>
<thead>
<tr>
<th>Country</th>
<th>Description</th>
</tr>
</thead>
<tbody>
<tr>
<td>India</td>
<td>Entertainment expenses are deductible up to the lesser of 60% of the costs actually incurred and 0.5% of the sales or business income of that year, the excess amount lapses. Advertising expenses and business promotion expenses (except for the tobacco industry) are deductible up to 15% of the sales (business) income of that year, excess amounts are carried forward. Fines, penalties, and losses arising from confiscation of property are not deductible, nor are CIT payments and tax surcharges. Management fees for stewardship are not deductible, but services fees paid for genuine services provided by affiliates in China or overseas and charged at arm’s length generally are. Other payments to affiliates, such as royalties, are also tax-deductible provided that the charges are at arm’s length.</td>
</tr>
<tr>
<td>Russia</td>
<td>No specific provisions for startup expenses, and may be lost in some cases. Interest is deductible at a maximum 120% of the average interest rate on similar loans charged by Russian lenders, and if that information is not available then at 80% of the Bank of Russia refinance rate for foreign currency denominated loans and 180% of the Bank of Russia (BoR) refinance rate for domestic currency denominated loans. Bad debts written off are mostly deductible, alternatively a bad debt reserve may be created e.g. an account receivable may be transferred to the reserve 90 after the payment is past due. R&amp;D expenses are deductible within the next one year after completion, and some may be deducted at 150% of actuals and are required to be reported separately – the deductible expenses are specified by the government, and a provision for future R&amp;D expenses may be created.</td>
</tr>
<tr>
<td>India</td>
<td>Startup expenditure for new undertakings and expansion can be deducted at 20% a year over 5 years. Interest expenses are deductible, except interest on loans to acquire capital assets incurred before operation that are added to the cost of the depreciable asset. Written off bad debts are allowable tax write offs. Some expenses (e.g. Employee pension fund contributions, bonuses and interest paid to banks) only deductible on actual payment. Illegal payments are not deductible but business related taxes paid before September 30 (other than income related taxes) are deductible in the same year. Payments to foreign affiliates for royalty, interest and fees for managerial and technical services not capital in nature and related to business can be deducted provided WHT is withheld, or applicable tax is paid into the Treasury.</td>
</tr>
<tr>
<td>Russia</td>
<td>No specific provisions for startup expenses, and may be lost in some cases. Interest is deductible at a maximum 120% of the average interest rate on similar loans charged by Russian lenders, and if that information is not available then at 80% of the Bank of Russia refinance rate for foreign currency denominated loans and 180% of the Bank of Russia (BoR) refinance rate for domestic currency denominated loans. Bad debts written off are mostly deductible, alternatively a bad debt reserve may be created e.g. an account receivable may be transferred to the reserve 90 after the payment is past due. R&amp;D expenses are deductible within the next one year after completion, and some may be deducted at 150% of actuals and are required to be reported separately – the deductible expenses are specified by the government, and a provision for future R&amp;D expenses may be created.</td>
</tr>
<tr>
<td>SOUTH AFRICA</td>
<td>All obligatory insurance expenditure deductible subject to specified tariffs; voluntary expenditures on damages to specified assets and construction activity are also deductible, or if contract liability insurance is required by an international treaty or is accepted international custom. Long term pension and life insurance deductible up to 12% of payroll, and voluntary medial insurance to 6% of payroll. Fines and penalties paid to contractors for contract violations deductible, not other fines and penalties paid to the state. Taxes and social contributions generally deductible. No special provisions for payments to foreign affiliates, may have more stringent documentation requirements.</td>
</tr>
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</tr>
<tr>
<td>SOUTH AFRICA</td>
<td>Normal and reasonable expenses incurred to earn business income allowed. Startup expenses deductible in first year of operation if otherwise deductible and only against related income. Interest income deductible unless incurred for exempt income, and subject to restrictions including thin capitalization provisions. Bad debts deductible subject to conditions, tax allowance available for specifically identified doubtful debts. Fines and penalties not deductible nor are taxes on income, dividends tax and donations tax. Payroll taxes deductible. Payments at arm’s length for royalties, fees and interest paid to foreign affiliates normally deductible, subject to thin capitalization provisions and restrictions on deductions of lump sum interest arrangements.</td>
</tr>
<tr>
<td>NEIGHBORS</td>
<td>Startup expenses allowed full deduction immediately or amortized over 2 years. Interest deduction in any year limited to income from interest plus 50% of net profits excluding interest income and interest expenses. Excess non-deductible interest can be carried forward indefinitely. Bad debts deductible when impossibility of recovery can be proved and the debts are written-off in the books. Fines and penalties are not deductible. Taxes not charged directly to the enterprise (such as withholding) are not deductible. Certain losses on transactions between parties with majority common ownership are not deductible. Expenses payable to foreign affiliates not paid within 180 days of year end is not deductible (does not apply to inventory, capital or depreciable property).</td>
</tr>
<tr>
<td>CAMBODIA</td>
<td>Startup expenses allowed full deduction immediately or amortized over 2 years. Interest deduction in any year limited to income from interest plus 50% of net profits excluding interest income and interest expenses. Excess non-deductible interest can be carried forward indefinitely. Bad debts deductible when impossibility of recovery can be proved and the debts are written-off in the books. Fines and penalties are not deductible. Taxes not charged directly to the enterprise (such as withholding) are not deductible. Certain losses on transactions between parties with majority common ownership are not deductible. Expenses payable to foreign affiliates not paid within 180 days of year end is not deductible (does not apply to inventory, capital or depreciable property).</td>
</tr>
<tr>
<td>INDONESIA</td>
<td>Startup expenses allowed full deduction immediately or amortized over 2 years. Interest deduction in any year limited to income from interest plus 50% of net profits excluding interest income and interest expenses. Excess non-deductible interest can be carried forward indefinitely. Bad debts deductible when impossibility of recovery can be proved and the debts are written-off in the books. Fines and penalties are not deductible. Taxes not charged directly to the enterprise (such as withholding) are not deductible. Certain losses on transactions between parties with majority common ownership are not deductible. Expenses payable to foreign affiliates not paid within 180 days of year end is not deductible (does not apply to inventory, capital or depreciable property).</td>
</tr>
</tbody>
</table>
of net profits excluding interest income and interest expenses. Excess non-deductible interest can be carried forward indefinitely
Bad debts deductible when impossibility of recovery can be proved and the debts are written-off in the books
Fines and penalties are not deductible
Taxes not charged directly to the enterprise (such as withholding) are not deductible
Certain losses on transactions between parties with majority common ownership are not deductible
Expenses payable to foreign affiliates not paid within 180 days of year end is not deductible (does not apply to inventory, capital or depreciable property)

| LAOS          | Accrued expenses deductible, reserves and provisions are not unless utilized
|              | Startup expenses deductible over 2 years
|              | Interest deductible on accrual basis if commercially reasonable, backed by documentation, but not when paid to a shareholder
|              | Bad debts can be deducted when written off but not reserves
|              | Entertainment expenses deductible up to 0.4% of annual revenue
|              | Fines, penalties and CIT not deductible, neither are illegal payments
|              | Pension expenses paid in Laos deductible
|              | Payments to foreign affiliates deductible within ordinary course of business

| MALAYSIA     | Startup incorporation and recruitment expenses may be deductible subject to conditions
|              | Interest incurred to earn business income or buy assets used in business deductible from business income, other interest deductible from non-business income
|              | Bad debts deductible subject to conditions
|              | Fines, penalties and taxes on income not deductible
|              | Payments for royalty, interest and fees paid to foreign affiliates deductible when at arm’s length and WHT paid

| PHILIPPINES  | All corporations may elect to itemize or to deduct standard deduction of 40% of gross income
|              | Startup expenses deductible as incurred
|              | Allowable interest deduction is interest expense less 1/3 of the interest income subject to final tax
|              | Subject to specified conditions bad debts deductible when written off
|              | Entertainment deductible up to 0.5% of sales for those selling goods and properties, and 1% of sales for providers of services
|              | Insurance, petroleum, mining and real estate investment trusts REITs entitled to special deductions
|              | Fines and penalties excluding charges for late payment of taxes are deductible
Resident corporations can deduct most taxes except income, estate and benefit linked taxes, foreign corporations can do so only on taxes connected with Philippines source income.
Payments for royalty, fees and interest to foreign affiliates may be deducted at arm’s length equivalent subject to payment of WHT.
Foreign resident corporations may deduct allocated head office expenses subject to conditions.


9. **Inventory Valuation**
Most countries allow valuation at cost, and most do not allow or severely restrict last in first out (LIFO) while allowing first in first out (FIFO). Unlike in the case of depreciation, most countries expect conformity between tax and book treatment of inventory.

<table>
<thead>
<tr>
<th>COUNTRY</th>
<th>REGIME</th>
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<tbody>
<tr>
<td><strong>OECD</strong></td>
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</tr>
<tr>
<td>AUSTRALIA</td>
<td>LIFO generally not allowed nor is direct costing for manufacturing or work in progress. Full or direct cost, market price or replacement cost is allowable. For tax purposes, inventory may be valued at cost, market selling price or replacement cost regardless of how accounting valuation is done. Small business entities may ignore the change in inventory values if the difference is less than AUD 5000.</td>
</tr>
<tr>
<td>KOREA</td>
<td>Seven methods allowed (1) Lower of cost or market (2) specific identification (3) FIFO (4) LIFO (5) weighted-average (6) moving average (7) retail method. From 2012, due to adoption of Korea -IFRS, LIFO is no longer allowed. Different methods can be chosen for different inventories and locations, method elected has to be consistently applied for a year unless 3 months advance notice of change given</td>
</tr>
<tr>
<td>SINGAPORE</td>
<td>No specified rules, except that LIFO generally not allowed, consistency required from year to year and tax and book treatments are congruent</td>
</tr>
<tr>
<td>UK</td>
<td>Normally expect book and tax treatment to be compatible, usually tax valuation at lower of cost or net realizable value, FIFO permitted where identification not possible, but not LIFO or base-stock methods</td>
</tr>
<tr>
<td>USA</td>
<td>Lower of cost or market, on FIFO basis. LIFO may be applied, but only on cost basis, and tax and book treatment must conform in that case</td>
</tr>
<tr>
<td><strong>BRICS</strong></td>
<td></td>
</tr>
<tr>
<td>BRAZIL</td>
<td>Income tax regulations require inventory valuations at either actual average cost or by the cost of the most recently acquired or produced goods, while LIFO have been deemed unacceptable in some rulings</td>
</tr>
<tr>
<td>CHINA</td>
<td>Inventory values according to costs based on one of 3 methods (1) FIFO (2) weighted average (3) specific identification</td>
</tr>
<tr>
<td>INDIA</td>
<td>Valued at the lower of cost or net realizable value, while FIFO and</td>
</tr>
</tbody>
</table>
average cost are also allowed if applied consistently – generally book and tax treatment are compatible

| RUSSIA | LIFO, FIFO, average cost and individual unit cost methods allowed |
| SOUTH AFRICA | Inventory deducted as soon as acquired, closing balance at end of year added to income, and deducted again next year |

**NEIGHBORS**

| CAMBODIA | Inventory other than work in progress can be valued at weighted average cost, or FIFO or at end period value if it is lower than cost of purchase or production |
| INDONESIA | Consistent and continuous application of valuation at cost using either FIFO or average cost methods required |
| LAOS | Follows same method as used for accounting purposes |
| MALAYSIA | Mostly at the lower of cost or net realizable value, where cost is allowed using either unit cost, average cost or FIFO, applied consistently on annual basis |
| PHILIPPINES | Tax and book valuation should conform in most cases
Either at cost, or lower of cost and market
LIFO not allowed |


### 10. Donations and Charitable Contributions

Most countries allow deduction of charitable donations to approved entities and some impose limits on the total deductions in a year, while many allow carry forward of unutilized deductions. Singapore appears to be the most generous, allowing deduction of 250% of the value of approved donations, while at the other end of the spectrum, Russia generally does not allow deduction of donations and South Africa imposes a 20% WHT on the value of some property donated by residents.

<table>
<thead>
<tr>
<th>COUNTRY</th>
<th>REGIME</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>O E C D</strong></td>
<td></td>
</tr>
<tr>
<td>AUSTRALIA</td>
<td>Donations to charitable organizations mentioned in the tax law or approved by the Commissioner of taxation are deductible up to the limit of positive income that does not generate tax losses</td>
</tr>
<tr>
<td>KOREA</td>
<td>Donations to public interest entities, government R&amp;D etc deductible up to 50% of taxable profit after loss deduction</td>
</tr>
<tr>
<td>SINGAPORE</td>
<td>Qualifying donations deductible @ 250% of the donation if made in cash or other approved forms to approved “charities”</td>
</tr>
<tr>
<td>UK</td>
<td>Charitable donations mostly deductible</td>
</tr>
<tr>
<td>USA</td>
<td>Limited to 10% of taxable income without considering certain deductions (including donations), carried forward if not utilizable for 5 years subject to the annual 10% limitation</td>
</tr>
</tbody>
</table>

**B R I C S**

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129
### COUNTRY | REGIME
--- | ---
**BRAZIL** | Donations are deductible up to certain limits if recipients are registered as charitable institutions
**CHINA** | Charitable donations are deductible – limited to 12% of annual accounting profit – non-charitable donations are not deductible. Donations to other approved public entities deductible up to 10% of taxable profit after deduction of losses and the donations Donations not deducted can be carried over for 3-5 years
**INDIA** | Any charitable contribution made to a “charity” by a company can be deducted at 50%-100% of the contribution made depending on the type of charity and all contributions are restricted to 10% of taxable income
**RUSSIA** | Not deductible
**SOUTH AFRICA** | Donations (gift) tax is payable by a donor at 20% of the value of property donated by South African residents subject to certain exemptions; donations to certain charities (public benefit organizations) are tax deductible up to a maximum of 10% of taxable income
### NEIGHBORS
**CAMBODIA** | Allowable up to 5% of taxable profit backed by proper evidence with the exception of a few notified contributions that are fully deducted
**INDONESIA** | Subject to specified conditions, donations for disasters, education, sports and social infrastructures may be deducted in the year of donation
**LAOS** | Charitable donations deduction limited to the lessor of 0.15% of taxable income or LAK 4 million
**MALAYSIA** | Cash donations to approved institutions allowed to be deducted during the assessment year subject to a maximum of 10% of that company’s total income during the year
**PHILIPPINES** | For certain specified donations, 100% deduction subject to conditions, otherwise total deductions should not exceed 5% of taxable income

*Source: Price Waterhouse Coopers’ Worldwide Tax Summary 2012-13 supplemented by Deloitte’s country tax highlights for 2013 (various).*

### 11. Base Erosion

All the OECD sample and BRICS countries have transfer pricing laws based on arm’s length, while group taxation in normally permitted in most of the OECD sample while these are not permitted in most of the BRICS except Russia, and in the neighborhood of Vietnam(except to a limited extent in Malaysia).

<table>
<thead>
<tr>
<th>COUNTRY</th>
<th>REGIME</th>
</tr>
</thead>
</table>
| **OECD** | Branch income is taxed in normal way under CIT as ordinary income – no withholding of repatriated profits Extensive transfer pricing regime to prevent base erosion and ensure arm’s length pricing
| **AUSTRALIA** | Branch income is taxed in normal way under CIT as ordinary income – no withholding of repatriated profits Extensive transfer pricing regime to prevent base erosion and ensure arm’s length pricing

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The commissioner of taxation is empowered to order transfer pricing adjustments subject to satisfaction of violation of the arms-length principle ALP under domestic law. Legislation is under consideration to allow this retrospectively from 2004 under DTAAs.

**KOREA**

Consolidated group return permitted where there are 2 or more wholly owned subsidiaries. CIT law permits the authorities to adjust prices that are not at arm’s length. Permissible transfer pricing methods are: (1) the comparable uncontrolled price (CUP) method (2) the resale price method (3) the cost-plus method (4) the profit-split method (5) the transactional net margin method (TNMM) and the (6) Berry Ratio method. The method used and the reason for adopting must be disclosed to the tax authorities by a taxpayer in a separate report. Tax authorities may recalculate the taxable income when CIT is unreasonably reduced due to transactions with related parties, mostly for discrepancies between the transaction price and fair market value over 5% of the fair market value or KRW 300 million.

Anti-tax haven rules are intended to regulate a company that has made overseas investments of an abnormal nature and apply to those Korean companies that have invested in a company incorporated in a foreign country with an average effective tax rate of 15% or less on taxable income for the past three years, unless the company has active business operations through an office, shop, or a factory.

**SINGAPORE**

Group transfer of current year losses, depreciation and approved charitable contributions allowed subject to restrictions such as Singapore incorporation and at least 75% ownership relation etc. Provisions for TP exist that impose arm’s length rule and allow authorities to challenge and make adjustments to controlled transactions not at arm’s length, as do guidelines for documentation requirements for all related party transactions including domestic, mutual agreement procedures and advance pricing agreements.

**UK**

Each individual company of a group has to submit own tax return even if several types of group consolidation are allowed subject to anti-avoidance measures. In cases of 75% cross ownership, operating taxable profits and losses can be set off within groups. Intra-group transfers of capital assets, loans, derivative and intangibles normally allowed tax-free. No automatic offset of capital gains or losses between group companies but provision exists for group election to do so on tax-free basis. Detailed transfer pricing provisions exist for both domestic and cross
border transactions, not just for goods and services but also for financing arrangements, no system of safe harbors in thin capitalization rules, also has a debt cap regime
Well defined related party concepts in law, with provisions to exclude SMEs and dormant companies
Arm’s length principle to be substituted to cancel any UK tax advantage, UK companies to self-assess and apply principle before submitting tax returns, implying fines and penalties if the adjustment made is subsequently not permitted
CFC regime exists that allows taxation of undistributed profits in a UK controlled company overseas (nonresident)

| USA                | Affiliated or “includible” group companies with up to 80% ownership relations between parent and subsidiaries can file group return and offset losses, and cannot include foreign incorporated subsidiaries other than Canadian and Mexican or a partnership, but may not be allowed in certain states
|                   | Arm’s length based TP regulations for related party transactions, otherwise Internal Revenue Service (IRS) may raise taxable income, detailed prescriptions for rules and methods
|                   | Advance pricing agreements available

| BRICS      | Brazilian TP rules apply to import and exports of goods, services and rights between related parties using arm’s length
|            | Consolidated tax returns for group companies are not permitted

| BRAZIL     | Group taxation normally not permitted
|            | Arm's length principle applies for related parties, authorities can adjust prices using comparable uncontrolled price method, resale price method, cost plus method, transactional net margin method, profit split method, among others
|            | Disclosure of related party transactions required in the annual tax return. Transfer pricing documentation required if the amount of related parties’ transactions with an enterprise exceeds a certain prescribed threshold
|            | The CIT law also contains transfer pricing provisions relating to cost sharing arrangements and advance pricing arrangements, controlled foreign company (CFC) rule, a thin capitalization rule, and general anti-avoidance rules.
|            | Under the CFC rule, the undistributed profits of CFCs located in low-tax jurisdictions with an effective income tax rate of less than 12.5% may be taxed as a deemed distribution to the TRE shareholders.

| CHINA      | No group taxation permission
|            | All international transactions between associated enterprises at arm’s length
|            | The following methods have been prescribed for TP in India for the
determination of the arm’s-length price:
• Comparable uncontrolled price (CUP) method.
• Resale price method (RPM).
• Cost plus method (CPM).
• Profit split method (PSM).
• Transactional net margin method (TNMM).
• “Other methods” as may be prescribed

The regulations require a taxpayer to determine an arm’s-length price for international transactions or specified domestic transactions. It further provides that where more than one arm’s-length price is determined by applying the most appropriate transfer pricing method, the arithmetic mean (average) of such prices shall be the arm’s-length price of the international transaction or specified domestic transactions. Accordingly, the Indian regulations do not recognize the concept of arm’s-length rule but require the determination of a single arm’s-length price. Taxpayers are required to maintain a set of extensive information and documents relating to international transactions undertaken with approved enterprises AEs or specified domestic transactions, and to submit them with returns.

Indian law prescribes a simplified dispute resolution mechanism as well as “safe harbor” provisions (not yet notified). Taxpayers enjoying tax holidays are also required to comply with TP regulations. Domestic transactions are also covered by TP regulations since 2012. Advance pricing agreements have also been introduced since 2012 under which the authorities may enter into a binding agreement valid for 5 years at most on methods for determining arm’s length prices

| RUSSIA | Group taxation available to large Russian groups since 2012 defined as two or more Russian organizations where one owns at least 90% of the other and all meet minimum size requirements based on tax payments, income and assets
New TP legislation also from 2012, applying arm’s length principle as fundamental basis, puts the onus of proving otherwise on tax authorities, abolishing the allowed 20% variation in market and controlled prices (safe harbor provision), applying transactional net margin and profit split as relevant methods in additions to ones already allowed, introducing advance pricing agreements for large taxpayers and many other changes bringing Russian TP rules closer to OECD guidelines
Plans to introduce controlled foreign company provisions in 2013 |
| SOUTH AFRICA | Group taxation normally not allowed
Arms’ length pricing must be followed by a resident in transactions with a nonresident. After 2012, the onus on correct pricing is on the taxpayer and the discretion with tax authorities to adjust prices no longer exists
Controlled foreign corporation provisions exist, as do general anti avoidance rules |
<table>
<thead>
<tr>
<th>NEIGHBORS</th>
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</table>
| CAMBODIA  | No group taxation provisions  
Tax department can reallocate income and expenses between parties under common ownership (defined at 20% common holding). |
| INDONESIA | No consolidated returns  
Arm’s length prices required otherwise Director General Taxes (DGT) is authorized to recalculate income or cost at arm’s length  
Declaration to be submitted with return requires disclosure of related party transactions, the TP method used and rationale and statement on documentation  
Disputes can be resolved through domestic process or under a mutual agreement procedure in the case of treaty countries  
Advance Pricing Agreements can also be entered into with DGT, normally for 3 years |
| LAOS      | No group taxation or consolidation of returns  
No TP regulations, but intercompany transactions are required to be at arm’s length |
| MALAYSIA | Qualifying companies may get “group relief” by giving up 70% of their adjusted loss in a year to one or more “related” companies; subject to both parties meeting specified conditions such as residency in Malaysia, not being “small” companies, same accounting period, at two years of being related prior to transfer of loss and not enjoying certain specified tax incentives. To prove their “related” nature both companies must satisfy the two tier test specified in the Income Tax Act 1967. The claiming of group relief has to be explicitly and irrevocably filed with the return -surrendering the company’s claim to the loss or claiming the loss as the case may be  
The director general of inland revenue can make adjustments to prices that are not at arm’s length. TP rules apply to defined controlled transactions and specify the methods and circumstances to determine arm’s length prices. Advance pricing arrangement rules also exist but apply only to cross-border transactions |
| PHILIPPINES | No group taxation  
No TP laws, but OECD guidelines are being used  
No CFC rules |

*Source: Price Waterhouse Coopers’ Worldwide Tax Summary 2012-13 supplemented by Deloitte’s country tax highlights for 2013 (various).*

Revenue collected from corporate taxation is an important source of government finance and the case for this tax is particularly strong in developing countries. This is because, unlike in developed countries, not much revenue is raised through personal income taxation and corporate income taxation acts as a partial substitute. Moreover, in developing countries, corporate income tax revenue is especially important because, in many instances, it constitutes the main national benefit to be derived from foreign investment (Bird 96).

At the same time, in a supply-side model, reductions in corporate taxation can raise investment, output and employment (Cotarelli). The classical supply-side growth model, however, is only one of many possibilities to be considered (Bird, 44) and empirical evidence on the ability of lower tax rates to permanently raise investment levels is scarce. On the contrary, some of the countries with the highest tax rates are also the countries with the highest rates of investment, growth as well as those with the lowest rates of poverty (Scandinavia) and poverty-reduction (China) while recent CIT rate reductions in Germany and ECA do not seem to have yielded fruit.

The coming sections will review results from direct flat tax reforms, results of country modeling of indirect tax reforms, incidence analysis of indirect tax systems and reforms, and lessons learned from actual tax systems and tax reforms that can be of use to the Government of Vietnam. It will finish with a concluding section.

1. Impact of Direct Flat Tax Reforms

Beginning in the mid-1990s, a large number of countries in ECA enacted flat tax reforms. Some have implemented a flat rate on the personal income tax (PIT), others have complemented that with changes in rate and exemptions under the corporate income tax (CIT) though at a different rate, while yet others have implemented a flat rate at the same level for both PIT and CIT. The tax rates varied widely across countries, from the 35 percent of Russia or 33 percent of Lithuania for the CIT to the 13 percent of Ukraine and 12 percent of Georgia for the PIT. Such reforms affect revenue collections, tax compliance, administrative costs, economic efficiency and income distribution.

In the short run, the reforms do not seem to have had a significant impact on revenues. The fact that revenues did not decline despite a widespread absence of “supply-side” responses is largely due

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5 “This tax should be seen as a means for taxing personal incomes and an analysis of it should be closely linked to the personal income tax.” (Burgess and Stern).
6 For instance, according to OECDTAX, a detailed general equilibrium model, the German 2000 tax reform reducing tax rates on corporate profits and capital income was to result in an increase in domestic and foreign investment and an associated 0.8 percent of GDP increase in growth. Instead, GDP growth fell by 50 percent whether one compares the 1990-2000 pre-reform decade to the 2001-2010 post-reform decade or the pre-reform decade to the post-reform but pre-global recession 2001-2005 years. Similarly, the investment-to-GDP ratio averaged 22 percent in the 6 years prior to the reform and it declined to 18 percent in the 6 years after the reform. In ECA, similarly, there seems to be no correlation at all between CIT reductions and investment rates.
7 This section is a summary of the findings of Saavedra.
to the fact that most countries designed them to be, in the short term, revenue-neutral. In particular, the countries which set the rate at a relatively low level also decreased allowances and exemptions. In some countries (especially the Ukraine and the Slovak Republic), the reduced reliance on direct taxes was joined to an increase reliance in indirect taxation.

In countries in which there was actually an increase in tax collections, this was not driven by a “supply-side” effect of reduced rates. Rather, it seems to have been driven either by exogenous events which had begun before the tax reforms (increases in investment) or by improved compliance. For instance, in the Slovak Republic in 2005 (the second year of the reform), the PIT and CIT collection increase was driven by factors beyond growth in wages and GDP respectively, most likely an improvement in tax compliance. Subsequently, moreover, the tax-to-GDP ratio in the Slovak Republic declined markedly from 17 percent in the pre-reform year (2003) to just 12 percent by 2010 (World Bank data).

Even the increase in compliance—one of the objectives of the tax reform and in theory one of the benefits of low and flat taxes—did not pan out everywhere. In Ukraine, for instance, there is little evidence of improved compliance in the PIT. In the first year of the reform, PIT collections fell and the increase witnessed during the second year was due to wage growth. This result is common to other countries and could be due to the fact that it is harder to evade PIT to start with for the large majority of taxpayers—those under payroll—while for the self-employed and others, the lower flat rates did not work as an incentive to alter their compliance behavior. The CIT in the Ukraine, on the other hand, did show good performance. Though CIT elasticity to GDP fell during the first year of the reform due to the reduced rate, it increased in the second year to a level above that of the pre-reform year. This, however, may be attributable either to improved compliance or to the continued growth in foreign direct investment which had started before the tax reform. Unlike in the Slovak Republic and Russia, the performance of the Ukrainian tax effort held up, going from 14 percent in the pre-reform year to 18 percent in 2011 (World Bank data).

2. What Tax Structure Do Rich, Democratic Countries with Low Inequality Have?

This section briefly describes the tax systems of Scandinavian countries, as they most closely approximate the vision aimed for by the Government of Vietnam⁹: “a strong, democratic, just and civilized country with rich people.” Results from economic modeling need to be interpreted with caution as their predictive value is limited. Economic policy changes typically have unintended consequences that models are simply unable to capture. Therefore, the ultimate test is reality—what do countries with the desired-for socio-economic characteristics look like institutionally and policy-wise? This is the question this section aims to address.

⁹ Results from economic modeling need to be interpreted with caution as their predictive value is limited. Economic policy changes typically have unintended consequences that models are simply unable to capture. Therefore, the ultimate test is reality—what do countries with the desired-for socio-economic characteristics look like institutionally and policy-wise.
2.1 Scandinavia

Globally, Denmark, Finland, Norway and Sweden are among the richest, most egalitarian, least corrupt countries with the highest quality of democratic governance. They have some of the highest income per capita in the world (all above 30,000 USD per capita as of 2011). They are also among the most egalitarian, with Gini coefficients in the mid-20s\(^{10}\) and poverty having been eradicated. They also have unemployment rates well below the Euro-area average of 11.7 percent–4.8 percent in Denmark, 3.5 percent in Norway, and somewhat higher at 6.9 percent in Finland and 7.8 percent in Sweden. They similarly top the world rankings on good governance. Denmark and Finland are tied at number one (with New Zealand) while Sweden was number 4 and Norway number 7 (tied with Australia) in Transparency International’s 2012 Global Corruption Perception Index. Finally, they also boast some of the best-performing, least captured democracies. On the global quality of democracy index for 2012, Norway, Sweden and Finland ranked first, second and third respectively while Denmark ranked fifth.

As regards socio-economic performance, the Scandinavian countries achieve these results by raising a significant amount of resources through their tax systems. The tax and overall revenue to GDP ratios are 46 and 56 percent in Denmark, 37 and 50 percent in Sweden, 30 and 53 percent in Finland, 40 (non-oil) and 57 (overall) percent in Norway respectively (IMF 2012 data). In addition, these countries have managed to keep their fiscal deficit and debt ratios at very manageable levels compared to other OECD countries. In 2011-2012, the fiscal deficit to GDP ratio was just 0.3 percent in Sweden, 0.8 percent in Finland and 4.2 percent in Denmark while Norway posted a 13 percent of GDP surplus due to oil revenue. The public debt-to-GDP ratios are also low at 37 percent in Sweden, 50 percent in Denmark and Finland, and 60 percent of non-oil GDP in Norway (2012 IMF Article IV Consultation Reports). Longer run fiscal sustainability, however, will need to be addressed due to the rapidly aging populations.

These high levels of public revenues allow the Scandinavian countries to finance large amounts of public expenditure. These high levels of public expenditure finance high quality public education and health systems as well as similarly large fiscal transfer systems –universal pension systems as well as unemployment, disability, child, family and other benefits. The overall amount of redistribution achieved through the fiscal system is very significant. Compared to the primary income (market) Gini, the disposable income (post-fiscal) Gini coefficient is reduced by 46 percent in both Denmark and Sweden.\(^{11}\)

Overall, the largest amount of income re-distribution is carried out through the expenditure side of the budget though the tax system contributes as well. However, unlike in some other countries, tax systems also contribute to re-distribution in the right direction. In 2004 in Denmark, for instance, 79 percent of total fiscal re-distribution (calculated as reduction in primary income Gini) took place through the transfer system and 21 percent through the tax system. In the same year, the equivalent percentages were 84 and 16 percent respectively in Sweden.\(^{12}\) (Wang and Caminada, 2011). These

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\(^{10}\) In 2012, the Gini coefficient in Sweden was 0.23 (IMF Article IV 2012).

\(^{11}\) The equivalent percent reduction is 44 percent in Germany and 27 percent in Canada (Wang and Caminada, 2011).

\(^{12}\) The relative contributions of the transfer and tax systems to income re-distribution are similar in other OECD countries. Also in 2004, they were 68 and 32 percent in Canada and 77 and 23 percent in Germany.
percentages—of roughly three fourths of the re-distribution being carried out through the expenditure side and one fourth through the tax system—are common to most OECD countries (see Table 3).

Table 3: Decomposition of disposable income inequality for 12 countries
(copied from Wang and Caminada, 2011)

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<tr>
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<tbody>
<tr>
<td>Gini primary income</td>
<td>0.412</td>
<td>0.437</td>
<td>0.454</td>
<td>+0.043</td>
</tr>
<tr>
<td>Gini disposable income</td>
<td>0.273</td>
<td>0.281</td>
<td>0.292</td>
<td>+0.018</td>
</tr>
<tr>
<td>Overall redistribution</td>
<td>0.139</td>
<td>0.157</td>
<td>0.163</td>
<td>+0.024</td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th>Transfers</th>
<th></th>
<th></th>
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</tr>
</thead>
<tbody>
<tr>
<td>State old-age and survivors benefits</td>
<td>71%</td>
<td>74%</td>
<td>78%</td>
<td>+7 points</td>
</tr>
<tr>
<td>Social assistance cash benefits</td>
<td>34%</td>
<td>33%</td>
<td>38%</td>
<td>+4 points</td>
</tr>
<tr>
<td>Unemployment compensation benefits</td>
<td>9%</td>
<td>9%</td>
<td>9%</td>
<td>0 point</td>
</tr>
<tr>
<td>Child/family benefits</td>
<td>6%</td>
<td>7%</td>
<td>6%</td>
<td>0 point</td>
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</table>

<table>
<thead>
<tr>
<th>Taxes</th>
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</thead>
<tbody>
<tr>
<td>Mandatory payroll taxes</td>
<td>29%</td>
<td>26%</td>
<td>22%</td>
<td>-7 points</td>
</tr>
<tr>
<td>Income Taxes</td>
<td>1%</td>
<td>1%</td>
<td>0%</td>
<td>-1 point</td>
</tr>
<tr>
<td>Overall Redistributi</td>
<td>28%</td>
<td>25%</td>
<td>22%</td>
<td>-6 points</td>
</tr>
</tbody>
</table>

Note: Countries for which full information is available on the whole trajectory from primary to disposable income, and are included in the analysis are the following: Australia, Belgium, Canada, Denmark, Finland, France, Germany, Ireland, Israel, Italy, Luxembourg, Mexico, Netherlands, Norway, Poland, Spain, Sweden, Switzerland, United Kingdom, USA. Source: Database Wang and Caminada (2011).

Scandinavian countries carry out most of the re-distribution achieved by the tax system through income taxes, particularly highly progressive personal income taxes. As shown in Table 2 below, the top personal income tax rates range from a high of 62 percent in Sweden to a low of 40 percent in Norway (due to oil revenues). As regards capital gains taxation, all four countries introduced flat rates ranging from 28 percent in Norway and Finland to 59 percent in Denmark. As time goes on, if the dual personal income tax system is not reversed, it will be important to follow the evolution of the income of the top decile, top 5 percent and top 1 percent of the population in countries with low capital gains taxation as it is likely to increase substantially.
Table 4: Dual Income Tax Regimes in Nordic Countries (copied from Bird and Zolt, 2011)\(^\text{13}\)

<table>
<thead>
<tr>
<th>Implementation of DIT</th>
<th>Norway</th>
<th>Finland</th>
<th>Sweden</th>
<th>Denmark</th>
</tr>
</thead>
</table>

**Personal Income Tax Rates**

*At Implementation*

<table>
<thead>
<tr>
<th></th>
<th>Norway</th>
<th>Finland</th>
<th>Sweden</th>
<th>Denmark</th>
</tr>
</thead>
<tbody>
<tr>
<td>Capital Income</td>
<td>28</td>
<td>25</td>
<td>30</td>
<td>50-56</td>
</tr>
<tr>
<td>Personal Income</td>
<td>28-41.7</td>
<td>25-57</td>
<td>31-51</td>
<td>50-68</td>
</tr>
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</table>

*2008*

<table>
<thead>
<tr>
<th></th>
<th>Norway</th>
<th>Finland</th>
<th>Sweden</th>
<th>Denmark</th>
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</thead>
<tbody>
<tr>
<td>Capital Income</td>
<td>28</td>
<td>28</td>
<td>30</td>
<td>59</td>
</tr>
<tr>
<td>Personal Income</td>
<td>28-40</td>
<td>16-52.5*</td>
<td>29-62</td>
<td>0-59</td>
</tr>
</tbody>
</table>

**Corporate Tax Rate**

*At Implementation*

<table>
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<th>Norway</th>
<th>Finland</th>
<th>Sweden</th>
<th>Denmark</th>
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</thead>
<tbody>
<tr>
<td>Capital Income</td>
<td>28</td>
<td>25</td>
<td>30</td>
<td>50</td>
</tr>
<tr>
<td>Personal Income</td>
<td>28-60</td>
<td>16-52.5*</td>
<td>29-62</td>
<td>0-59</td>
</tr>
</tbody>
</table>

*2008*

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<tr>
<th></th>
<th>Norway</th>
<th>Finland</th>
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<tr>
<td></td>
<td>28</td>
<td>25</td>
<td>30</td>
<td>50</td>
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*Excludes Church Tax*

Corporate income tax rates are around the mid-20s and have been reduced in the recent past while their bases have been broadened. Following global trends, Scandinavian countries have lowered their corporate income tax rates. However, as in other OECD countries that implemented reforms which simultaneously lowered the rate but broadened the base of the CIT, the percent of GDP collected through the tax has so far remained roughly stable.

2.2 The Tax Systems of Two Successful Middle-Income Countries - Brazil and China

This section presents the tax structure of two middle-income countries that hold useful lessons for Vietnam in both their strengths and their weaknesses. The chosen countries are Brazil and China. These countries have been selected because they have achieved some of the best performance in economic growth (China), reducing income inequality (Brazil) and slashing poverty (both). The tax system has supported these achievements by raising sufficient revenues. At the same time, much room for improvement exists in both countries in terms of simplification as well as in enhancing the progressivity and efficiency of the tax system.

The tax system a middle income country builds greatly contributes to the societal model it creates. It can be argued that tax systems need to be different in developing and developed countries. Their economies are less diversified; economic informality is widespread, trade protection is more prevalent and administrative capacity more limited. Therefore, the tax base is narrower. Moreover, vested interests are often strong, making the collection of personal income tax difficult. This has typically led to greater reliance on trade and corporate income taxation and less reliance on personal income taxation than in developed countries. As a country moves from low to middle-income, however, the range of possibilities open to it in tax policy are larger and the type of tax system it enacts has great influence on the economy and society it builds.

Therefore, it is useful for middle income countries to learn from the tax systems of developed countries they regard as models. This is the case because, in many respects, middle income countries quickly approximate the characteristics of developed countries and are well on their way to

\(^{13}\) The data for this table are from Swensen, From the Global Income Tax, supra note 18, at 59, IBFD, GLOBAL INDIVIDUAL TAX HANDBOOK (2008), and IBFD, GLOBAL CORPORATE TAX HANDBOOK (2008).
building the “model” of developed country they aim at. This is why it is of great use for middle income countries to observe the various models of market democracies in the world and build fiscal systems that will help them get there. Similarly, lower-middle income countries have much to learn from the most successful middle and upper-middle income countries, both in their strengths as well as their weaknesses.

This section presents the tax systems of two middle income countries - Brazil and China - which have had remarkable success in reducing poverty. None of the two countries has done well on all three fronts of growth, poverty and income distribution. China has had stellar GDP growth and poverty reduction, but dramatic increases in inequality. Brazil, on the other hand, has had impressive success in reducing poverty and income inequality, but less success on economic growth. Between 1990 and 2011, the average annual GDP growth rate was 10 percent in China – the highest in Asia (and the world)\(^{14}\) and 3 percent in Brazil. Between 2005 and 2009, growth in Brazil accelerated to average 4 percent. Moreover, between 2000 and 2009, Brazil’s poverty and extreme poverty declined by 50 percent, going from 22 to 11 and from 12 to 6 percent respectively. Similarly, the income share of the top decile has been growing seven times faster than that of the top decile, with a fifty percent contribution coming from market income and the other fifty from the tax-and-transfer system. As a result of this dynamic, the Gini coefficient has declined from 60 to 55 over the past ten years.

Both countries have also made significant progress in other indicators of human welfare. In many human development indicators, such as literacy, infant and maternal mortality and life expectancy Brazil and China now stand well above the levels achieved by the average middle income country (Figure 1). Therefore, on balance, both countries can be considered very strong performers.

![Figure 1: Human Development Indicators (2010)](image)

Neither of the two countries has a tax system that could be considered a model, but they raise significant amounts of resources as public revenues and spend them reasonably well. In 2011, the revenue-to-GDP ratio was 36 percent in Brazil (IMF Article IV) and 23 percent in China. In addition, in China, a large amount of service delivery, particularly in the basic infrastructure area, is carried out by state owned enterprises whose resources are not reflected in general government revenue. Both countries

\(^{14}\) Numbers two to four are Vietnam, Laos and Cambodia respectively (World Development Indicators).
are doing well as regards fiscal sustainability. In 2011, the budget deficit was only 2.6 percent in Brazil and 1.2 percent in China, despite the global recession. Similarly, their public debt-to-GDP ratios were 26 percent in China and 65 percent in Brazil, where it was on a downward trend.

The two sections below will trace the main lines of the tax systems of Brazil and China, which hold useful lessons for middle income countries undertaking tax reform.

i. Brazil

Brazil collects 34 percent of GDP in taxes, but its tax system is overly complex, has an excessive number of taxes and a distortionary cascading effect. The overall number of taxes—at 85—is excessively and unnecessarily large. Moreover, it has a strong cascading effect caused by taxes levied at the federal, state and municipal level which compound each other and are applied to the final sales price of the good including taxes rather than the pre-tax sales price. Because it is a federation, the federal and the regional governments share revenue-raising and spending responsibilities.

Direct taxes account for 55 and indirect taxes for 45 percent of government revenues. Around two thirds of the income tax collection comes from the corporate income tax, which raises around 4.5 percent of GDP while the personal income tax raises 2.6 percent of GDP (IMF Article IV 2012). Social security contributions are also important and yield 6 percent of GDP. Indirect taxation, on the other hand, provides 14.6 percent of GDP.

Corporate income is taxed at a progressive rate of 24 to 34 percent, with a supplementary 6 percent on financial institutions. The corporate income tax rate is 15 percent, with an additional 10 percent on income exceeding BRL 240,000 per year. The presence of the dual rate makes the statutory CIT rates progressive. In addition, there is a social contribution on net profits at a rate of 9 percent. Thus, corporate income taxation is charged at a combined rate of either 24 or 34 percent. As of 2008, the tax rate of the social contribution for financial institutions, private insurance companies and capitalization companies is 15 percent. This higher rate should help compensate for the distortion caused by the fact that the transactions of these institutions are not subject to VAT like other sectors are.

The tax system on its own, on the other hand, is regressive. Direct taxes are strictly progressive, with the first five deciles paying 0, 1, 2, 3 and 4 percent of their income in income taxes while the top decile pays 10 percent. Indirect taxes, on the other hand, are highly regressive with the bottom decile bearing almost three times the burden of the top decile. This incidence, which is much more regressive than in other Latin American and middle income countries, is not mainly due to the tax structure (which includes lower rates for goods consumed by the poor). Rather, it is the result of the extremely high level of inequality of market income and the lower percentage of rural population in Brazil. Because the tax system is dominated by indirect taxes, it is regressive as a whole. On the other hand, because income is so strongly concentrated at the top, the government collects most of its taxes from the upper income groups (See Table 5).

15 The description of the tax system draws heavily from Higgins and Pereira 2013.
16 The percentage of rural population in Brazil is only 15 percent while it is 21 percent in Latin America and the Caribbean region as a whole and 51 percent in middle-income countries. The rural poor are typically much less hard hit by indirect taxes than the urban poor as they have some home-grown production and purchase much of the rest in local agricultural markets which do not pay taxes.
Table 5: Distribution of Tax Payments by Income Group (deciles) (%)

<table>
<thead>
<tr>
<th>% of total taxes paid by each income group</th>
<th>1</th>
<th>2</th>
<th>3</th>
<th>4</th>
<th>5</th>
<th>6</th>
<th>7</th>
<th>8</th>
<th>9</th>
<th>10</th>
</tr>
</thead>
<tbody>
<tr>
<td>Direct Taxes</td>
<td>0</td>
<td>1</td>
<td>1</td>
<td>2</td>
<td>2</td>
<td>3</td>
<td>5</td>
<td>7</td>
<td>13</td>
<td>66</td>
</tr>
<tr>
<td>Personal</td>
<td>0</td>
<td>0</td>
<td>0</td>
<td>0</td>
<td>0</td>
<td>0</td>
<td>0</td>
<td>0</td>
<td>3</td>
<td>97</td>
</tr>
<tr>
<td>Corporate</td>
<td>0</td>
<td>1</td>
<td>2</td>
<td>3</td>
<td>4</td>
<td>6</td>
<td>10</td>
<td>14</td>
<td>22</td>
<td>38</td>
</tr>
<tr>
<td>Indirect Taxes</td>
<td>3</td>
<td>4</td>
<td>5</td>
<td>6</td>
<td>7</td>
<td>7</td>
<td>10</td>
<td>13</td>
<td>16</td>
<td>29</td>
</tr>
<tr>
<td>Total</td>
<td>2</td>
<td>3</td>
<td>4</td>
<td>4</td>
<td>5</td>
<td>6</td>
<td>9</td>
<td>11</td>
<td>16</td>
<td>40</td>
</tr>
</tbody>
</table>

Taxes paid as a % of gross income by income groups (deciles)

| Direct Taxes                              | 0 | 1 | 2 | 3 | 4 | 5 | 5 | 5 | 6  | 10 |
| Indirect Taxes                            | 22| 17| 16| 14| 14| 13| 13| 12| 11 | 8  |

*Source: Rezende and Cunha (2002).*

**ii. China**

China collects 23 percent of GDP in taxes and, through its state-owned enterprises, sustains a level of public investment of 26 percent of GDP. Tax and expenditure responsibilities are split across the various levels of government. Direct and indirect taxes account for 25 and 60 percent of overall government revenues respectively. Personal income tax collections are still very low, amounting to 6 percent of tax revenues in 2006.

China has relatively high tax rates for personal income on labor, moderate rates for corporate and capital income gains and makes extensive use of tax incentives. Personal income tax rates are progressive, with a top rate of 45 percent. Capital gains, on the other hand, are taxed at a flat rate of 20 percent. Corporate income is taxed at 25 percent, since 2007 irrespective of ownership. China has a system of tax incentives designed to subsidize all high-tech companies and companies investing in equipment for environmental protection, water conservation and production safety. The first subsidy is characteristic of industrial policy while the latter two can be justified in terms of correcting for positive externalities generated by these activities. China, however, arguably makes excessive use of tax incentives, eroding the neutrality of the tax system and reducing the tax base sometimes with questionable results.

In 2002, the Chinese central government initiated a reform to phase out all formal state taxes and informal fees by 2006 while increasing central government transfers. In the first stage (up to 2004), the reform can be seen as a “fee-tax swap” in which informal fees were to be replaced with agricultural taxes. In 2004, however, Premier Wen Jiabao promised that all agricultural taxes would be
phased out within 5 years. In fact, by the end of 2005, 28 out of 31 provincial areas had implemented the reform and in 2005, the central government announced the phasing out of all agricultural taxes at the beginning of 2006. Simultaneously, the central government doubled its level of transfers.

The increase in central government transfers, however, did not sufficiently compensate for foregone resources and local governments are having difficulties in funding public services. (Tao and Qin). In 2005, for instance, central government transfers increased by RMB66.4 million while the rural tax reform had a revenue cost of RMB150-160 million (Zhang, 2005). As a result, the financial situation of local governments worsened with budget deficits and public debt increasing in most provinces. Local governments implemented cost cutting measures like reducing the number of public employees and merging school districts. Despite these measures, there has been a significant deterioration in the effectiveness of public service delivery to local populations. Moreover, the absence of a well-functioning social security system providing unemployment and medical insurance and pensions has reduced the margin of maneuver of local governments. This is especially the case in provinces with few private sector opportunities while, in those with a more thriving economy, well-qualified civil servants are leaving the public sector.

3. Conclusions

Fees on public services have increased across the world, reducing access for the poor. A wide and steep increase on fees on education, health, transport, privatized utilities, business licenses and many other public goods and services has weighed heavily on the poor. Public pressure has mounted against these increases in many countries in both the developed and the developing world. Reducing them and supplementing them with tax financing would in many cases be both economically efficient (as it would subsidize areas of positive externalities) as well as equity and positively impact the accumulation of human capital in education and health.

Many ECA transition countries have introduced flat tax rates in both PIT and CIT without clear effects on tax collections, investment or growth. Most countries designed the reforms to be revenue-neutral by enlarging the base of these taxes and reducing deductions and allowances. As a result, in the short run, revenues did not fall markedly. In some countries, there were some positive impact from enhanced compliance, particularly in the CIT, but these results are neither general nor robust. There also do not seem to have been any consistent impact on investment rates across countries. Those benefitting most from these reforms have been the highest income groups whose statutory rates tumbled. In some countries where high thresholds were not instituted, tax rates on lower income groups increased, making the PIT more regressive.

Developed countries with well-functioning democracies and low inequality raise significant resources through the tax system, including a highly progressive personal income tax. Scandinavian countries, some of the closest examples of the market-based social democracy model Vietnam aims at, raise large amounts of revenues through their tax systems. These tax systems carry out roughly one-fourth of the overall re-distributive task of fiscal policy. CIT rates are moderate and the tax is broad-based.
Middle income countries making substantial progress in growth, poverty and inequality reduction also have a strong tax effort. This is the case of China and Brazil. Both countries, however, have features in their tax systems which reduce their efficiency and equity. China implemented a tax reform to reduce the particularly heavy weight of the tax system on rural areas by eliminating agricultural taxation and illegal fees. Brazil has a highly complicated tax system, with an excessive number of taxes and a strong cascading effect.

Globally, there is a need to re-balance tax composition increasing the weight of direct taxes relative to indirect taxation. The case for this rebalancing is particularly strong in developing countries as there is no robust evidence of the impact of tax composition on growth. Moreover, broad-based VATs weigh heavily on lower and lower-middle income groups especially in highly urbanized middle income countries with low informality. Easing the weight on indirect taxes would help improve the distributive impact of tax policy and enhance the legitimacy of the tax system. It would also foster aggregate demand and enhance the working of automatic stabilizers.

On corporate income taxation, the frontier lies in reducing tax incentives and allowances, particularly in developing countries. CIT rates have been reduced across the world, with little evidence of impact on investment rates. On the other hand, investment incentives are pervasive, diminishing the yield of the tax system, reducing its neutrality and often weakening governance. The main task ahead is therefore to simplify CIT regulations, reduce exemptions and maintain rates.

Moving toward homogeneous rates for taxation of income from labor and capital is critical to the credibility of the tax system and may require international cooperation. Globalization has led to the reduction of tax rates on capital gains, which are now significantly below the rates at which income from labor is taxed. This is inequitable, horizontally and vertically, benefitting the wealthiest in every society and undermining the credibility of tax systems across the world. Returning to at least homogeneous rates for both sources of income is highly desirable. International cooperation would facilitate this transition and avoid a further race-to-the bottom in capital gains taxation.
PART 2 - Value Added Tax
Chapter I: Introduction

Value Added Tax (VAT) has been an important source of revenue in Vietnam. It presently contributes about one-third of the total tax revenues, which is the largest share of all taxes to total tax revenue matched only by the tax on Enterprise Profits (CIT). Together, the VAT and CIT account for almost two-thirds of the tax revenues of the Government of Vietnam. Except for a few years in the past, it has been generally a buoyant tax, the revenues growing at a rate greater than the growth rate of the GDP.

Prior to the introduction of a VAT, Vietnam had adopted a turnover tax in October 1990 in its first round of tax reform. In an effort to mitigate the shortcomings of this tax, several rounds of amendments have been carried out since then. Finally, the turnover tax was replaced by a VAT in 1999. Subsequently, several amendments have been made with some major changes adopted in 2003, 2006, and the VAT Law revision conducted in 2008. Several major changes have also been approved by the National Assembly in 2013 and are due for implementation soon.

1. Overall Structure of VAT

The VAT law introduced in 1999 was consumption-based, following the destination principle, and applied to both goods and services. Exports were zero-rated while 26 categories of goods and services were exempt. A special feature of this tax was the exemption of goods and services subject to Special Consumption Tax (SCT) or excises.

A rate of 5 percent applied to 13 categories of items, a rate of 20 percent applied to 5 groups of goods and services including gold, silver, gems, hotel tourism and catering services, lotteries of all kinds, shipping agents and brokerage services, while the rate of 10 percent applied to all remaining goods and services. The rate of 20% was subsequently removed and the maximum rate applicable presently is 10%.

A number of articles of the original VAT have been subsequently amended. The main characteristics of the current VAT system (applied since January 2009) are discussed next. The present VAT law mandates three tax rates. A tax rate of zero (0) percent is for the export of goods and services, and international transportation. A tax rate of five (5) percent is applied to a select group of about 15 categories of goods and services. This group includes clean water; fertilizers and pesticides; medical equipment and medicines; teaching and learning aids; children’s toys and books; unprocessed products of cultivation, husbandry, forestry and fresh foodstuffs; sugar and by-products; products made from jute and bamboo; semi processed cotton; feed for cattle and poultry; technical and scientific services; special purpose machinery and equipment for agricultural production and newsprint; cultural exhibits and sports activities. The only change proposed in this category is to remove ores used in fertilizer production from the list of goods and services taxed at 5%, and to charge 5% VAT on selling, renting and leasing of social residential houses.

Finally, a tax rate of ten (10) percent is applied to the remaining items under VAT.
A major change compared to the earlier VAT law has been that VAT now applies to all goods and services subject to the Special Consumption Tax (SCT) which, in fact, is the Excise Tax. It is an important change and ensures that Vietnam law conforms to the international practice.

Twenty five categories of goods and services are VAT exempt under the new law.

2. Exclusions

A number of items are excluded (not exempted) from the VAT laws of Vietnam. They are regulated by Decree No 121/ND - CP and Circular 06/TT - BTC, which came into effect from March 01, 2012. These include- goods and services provided outside Vietnam by Vietnam-based taxpayers except international transportation with overseas places of departure and arrival; revenues from compensation, bonus, support, transfer of emission rights and other financial revenues; Vietnam-based production and business organizations and individuals that purchase from foreign organizations without permanent establishments in Vietnam or overseas individuals not residing in Vietnam services such as repair of vehicles, machinery or equipment (including supplies and spare parts); advertising and marketing; investment and trade promotion; goods sale and service provision brokerage; training; or share of charges for international post or telecommunications services provided outside Vietnam between Vietnamese and foreign partners.

Non-business organizations and individuals that are not value-added tax payers are not required to declare and calculate value-added tax when selling their assets, including assets they are using to secure loans at banks or credit institutions. Further details of this category are discussed in the chapter on exemptions.

3. Exemptions

The list of exempt categories of goods and services is long and broadly includes: (a) products of cultivation, husbandry, animal breeds and plant varieties; (b) financial/credit services and insurance (including engagement in stock exchange); (c) state owned dwelling houses sold to tenants; (d) healthcare and animal health services; (e) renovation, and construction of cultural, physical and sports infrastructure; (f) radio and TV broadcasting funded through state budget, newspapers and magazines publications; (g) public services of sanitation, water drainage, and irrigation in agricultural production; (h) public transportation by bus and tramcar; (i) weapons and military equipment for defense; (j) humanitarian aid and nonrefundable aid; (k) transfer of technology; (l) post, telecommunication and internet services; (m) machinery, equipment and supplies which cannot be produced domestically and need to be imported for direct use in scientific research and technological development activities; machinery, equipment, spare parts, special purpose means of transport and supplies which cannot be produced domestically and need to be imported for prospecting, exploring and developing oil and gas; (n) goods and services of business individuals with monthly incomes below the common minimum salary level applicable to domestic organizations and enterprises; (o) salt products; (p) transfer of land use rights; (q) teaching and vocational training, (r) goods transited through Vietnam territory; (s) Export of unprocessed mined resources; (t) Gold imported in the form of bars or ingots etc.
The current draft law approved by the NA makes minor changes to this list including extending the VAT exempt categories of insurance and financial services.

4. Tax Exempt Threshold for Small Traders

Presently, every small producer and trader is subject to VAT unless their income falls below the level comparable to the official minimum wage. In Vietnam, there is no threshold based on turnover exempting small producers and traders from the VAT net. A provision, though, has been made to apply the subtraction method of VAT calculation for those small businesses that cannot maintain records. This method calculates value added as the selling price of goods or services minus the purchase price of such goods and services. Records need not be maintained for purchase of inputs and these are generally estimated on the basis of the type of business and the turnover. The combination of zero thresholds and application of the subtraction method increases administrative costs without a commensurate increase in revenues.

The law recently approved by the national assembly introduces a threshold based VAT system for the first time in Vietnam. Under the present system, business with annual turnover below VND 100 million a year would not be subject to the VAT, while businesses with turnover below 1000 million VND a year would pay a presumptive tax based on turnover. Businesses that fall below the second threshold of 1000 million VND could opt for payment of VAT through the credit invoice system if they maintain prescribed records, and some household businesses as well as firms in the gold, gems and jewelry businesses are allowed to operate under the subtraction method of calculating VAT.

5. VAT Computation Methods

Both the credit method, called the value added tax credit method (deduction method), and the subtraction method, referred to as the calculation of tax based on added value method (direct method), have been adopted for calculating the VAT liability in Vietnam. At present Vietnam has virtually no turnover based threshold for VAT. All registered Enterprises and co-operatives are supposed to pay VAT through the credit invoice method and those individual and household businesses that can meet accounting requirements could also register under the credit invoice or deduction method. It has been found through audit and inspections that most individual and household businesses do not in fact maintain proper accounts.

The proposed new law approved by the NA introduces VAT thresholds and requires all Enterprises and co-operatives above the 1 billion VND thresholds to register and pay VAT according to the deduction method. It requires individual and business households to apply the direct or subtraction method, and thus provides them an incentive to incorporate if they cross the threshold, since only Enterprises (registered) can pay VAT by the invoice-credit method. The subtraction method is presently applied to those enterprises and small traders doing business who fail to fully implement regulations on accounting, invoices, and vouchers to serve as the bases for tax calculation under the credit invoice method and to businesses involved in gold, silver and gems trading activities and to household and individual businesses.
Under the new regime, all individual and household businesses, certain foreign contractors and the gold, gems and jewelry sector will operate under the direct or subtraction method. All Enterprises and co-operatives over the 1 billion thresholds will register and pay under the credit-invoice system and those Enterprises and co-operatives under the 1 billion thresholds who maintain prescribed accounts may also voluntarily register and pay under the deduction or invoice credit system.

The proposed new law approved by the NA has also changed the method of computation of the subtraction or direct method, from using ratios of value added to turnover to determine the taxable base, to a direct tax on turnover with the exception of gold and precious stones sector. It has specified that enterprises and cooperatives with turnover under 1 billion except those that can voluntarily register under the deduction method, and all household and individual business regardless of size, business entities, and foreign business individuals and organizations that are not permanent residents of Vietnam, but have incomes incurred in Vietnam and have not fully complied to the required regime of accounting, with a few exception shall pay VAT based on turnover at the following rates:

- Commercial (distribution and supply of goods): 1%;
- Product related production, transportation and services, construction combined with input material supply: 3%;
- Service and construction (with exception of construction services combined with input material supply): 5%;
- Other business operations: 2%.

An exception has been made for gold, silver, precious stones, where the value added tax payable according to the subtraction method for computing value added tax is calculated by the direct added value of the sold goods and services times the value added tax rate, applied for gold, silver and precious stone trading and product making. The added value of gold, silver, and precious stones is determined by the selling prices of the gold, silver, precious stones minus the input prices of the gold, silver, precious stones correspondingly.

6. Real Estate

In Vietnam, the price of the transfer of the right to use land is not taxable under VAT. This has been discussed at length in a later chapter. Almost all the issues in this category arise because the sale of real estate is taxable, but land is exempted as is the sale of state owned dwelling houses to current tenants. The problem of allocation of land value to real estate is further complicated in the case of sale of high rise apartment buildings, leading to loss of revenue on account of non-inclusion of land value and giving rise to numerous disputes about the proper transaction price for levying VAT.

7. VAT Policies for Gems and Jewelry

At the importation stage, Article 5 of the Law on VAT of 2008 defines "Gold imported in bar and foil which has not yet been processed into fine art articles, jewelry and other products" is not subject to VAT, while Gold jewelry, other products made by imported gold are charged 10% VAT.
In the domestic market, according to the current regulation the purchase, sale, and manipulation of gold are taxed by the subtraction method or direct method for VAT, and the VAT liability is the difference between the selling prices minus (-) the cost of goods sold times (x) the rate of 10%.

The exemption given to imported gold while taxing domestically purchased gold under VAT provides negative protection to the domestic gold industry. In the proposed draft VAT law approved by the national assembly, the government has retained both the exemption to imported gold as well as the method of subtraction for calculating VAT for gold, silver and precious stones industry.

8. VAT Taxable Value (Taxable Price)

Article 7 of the VAT law regulates the price on which the output VAT is levied. In general, the transaction value is used and the attempt is to use the actual selling price exclusive of VAT and interest, but including other levies (such as special consumption tax), in domestic currency as the basis for calculating VAT. The current set of amendments approved by the national assembly also includes the value of another excise type tax – the environmental tax in the taxable value. The article 7 separately specifies the price in cases of imported goods, goods and services sold by production and trading entities, goods and services used for internal exchanges or consumption, donation and gifts, asset leasing, installment payment methods, out-sourcing of goods, construction and installment, real estate businesses, trading agents and brokers and invoices with the value added tax inclusive prices.

9. VAT Refunds

The present rules on VAT refund in Vietnam are complicated and vary with the nature and activity of a particular business.

i. For businesses operating under the deduction method excess tax on inputs is not refunded unless it is carried forward for three months.

ii. For exporting businesses, cumulative total excess input tax refund in excess of 200 million dongs is permitted at present.

iii. In case of businesses that have undertaken investment for more than a year but have not been able to deduct input credits completely, cumulative excess input tax is refunded annually unless it exceeds 200 million dongs in which case it is refunded quarterly. If, however, the business investment is new, refunds are made on a quarterly basis in case the cumulative excess input tax is less than 200 million dongs, and immediately if over 200 million. Thus a different set of rules is applicable in case of VAT refund on different companies.

Under the new draft law approved by the NA, the default period for availing refund of unutilized input credit has been increased to 12 months and the threshold amounts for refund of accumulated credits have been raised to 500 million VND.

10. VAT Deductions

The present VAT law allows deduction of taxes paid on inputs from VAT payable subject to certain restrictions for units operating under the credit invoice system. The present system discriminates somewhat between investment inputs and other inputs in that it allows for investment input credit for all
capital goods even in cases where some goods produced are taxable and some are not while other input credit for raw materials is allowable only in the same proportion as taxable turnover. For payments above VND 20 million, supporting bank documents are required, while for payments under the limit payment through a bank is not mandatory.

The recently approved draft law has incorporated a number of changes in these provisions that are discussed in detail in chapter 8, the most important one being the treatment of investment input and other input credit on an equal footing.

11. VAT on Exports

In general, the VAT treatment of exports in Vietnam is in line with international practice, which is to zero rate exports. However, certain categories of exports are kept outside the purview of zero rating such as cases of transfer of technologies or intellectual property rights abroad; offshore reinsurance services; credit provision, capital transfer and derivative financial services; post and telecommunications services; and exported products that are unprocessed mined resources and minerals.

At present, Vietnam does not have comprehensive laws to govern the “point of taxation” in the case of services. Normally it is recommended that all exports of goods and services be zero rated to keep them competitive in international markets as well as to properly apply the destination principle. This is not an issue in the case of goods where the decision to exempt or zero rate is largely a matter of policy. It is more of an issue with services as it can be very difficult to define whether services were actually exported or not. This matter is discussed in detail in the chapter on exports under VAT.
Chapter II: VAT Rates

At present, Vietnam has the following VAT rates:

(1). **Tax Rate of Zero (0) Percent for Export Goods and Services**, including export goods and services exempted from value added tax when they are exported and international transportation; except:

   a) Transfer of technologies or intellectual property rights abroad;
   b) Offshore reinsurance services;
   c) Credit provision;
   d) Capital transfer;
   e) Derivative financial services;
   f) Post and telecommunications services; and
   g) exported unprocessed minerals stipulated in detail by the Government

The government proposes to add the category “Exported goods and services that are consumed outside Vietnam, in the non-tariff zones, and in some cases provided to foreign customers in accordance with the Government’s regulations.”

This is not an unusual provision, as Vietnamese goods consumed outside Vietnam and in non-tariff areas should not be subject to VAT as VAT is for goods in “home use”. Care needs to be taken, however, to prevent diversion and re-entry of these goods into Vietnam (domestic tariff area) without payment of tax. However, there may be a need for further elaborating the proposed definition to both clearly define “point of sale” for exported services, to limit leakage of benefits to non-entitled persons, to extend legitimate services to foreigners and at the same time to prevent unnecessary extension of benefits to foreigners as well. The general principle is to zero-rate all exports of goods and services and the law should be elaborate enough to ensure this, if necessary with supplementary rules. These issues are discussed further in the chapter on export treatment of VAT.

(2). **Tax Rate of Five (5) Percent for the Following Goods and Services:**

   a) Clean water for production and daily life;
   b) Fertilizers; ores for fertilizer production; insecticides, pesticides and plant and animal growth stimulators;
   c) Feeds for cattle, poultry and other domestic animals;
   d) Services of digging, embanking and dredging canals, ditches, ponds and lakes for agricultural production; growing, tending, and preventing pests and insects for, plants; preliminary processing and preservation of agricultural products;
   e) Unprocessed cultivation, husbandry and fishery products, except products specified in the Law;
   f) Preliminarily processed rubber latex; preliminarily processed turpentine; nets, main ropes and fibers for making fishing-nets;
   g) Fresh and live food; unprocessed forest products, except timber, bamboo shoots and products specified in the Law;

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h) Sugar; by-products in sugar production, including molasses, bagasse and sludge;

i) Products made of jute, rush, bamboo, leaf, straw, coconut husks and shells and Eichhornia crassipes, and other handicrafts made of agricultural raw materials; preliminarily processed cotton; paper for newspaper printing;

j) Special-purpose machinery and equipment for agricultural production, including ploughing machines, harrowing machines, rice-planting machines, seeding machines, rice-plucking machines, reaping machines, combine harvesters, agricultural product harvesters, insecticide or pesticide pumps or sprayers;

k) Medical equipment and instruments; medical cotton and bandage; preventive and curative medicines; pharmaco-chemistry products and pharmaceuticals used as raw materials for the production of curative and preventive medicines;

l) Teaching and learning aids, including models, figures, boards, chalk, rulers, compasses, and equipment and tools exclusively used for teaching, research and scientific experiments;

m) Cultural, exhibition, physical training and sports activities; art performances; film production; film import, distribution and screening;

n) Children toys; books of all kinds, except books specified in Clause 15, Article 5 of this Law;

o) Scientific and technological services under the Law on Science and Technology.

The government plans to delete the category “ores for fertilizer production” from this list, raising the VAT to 10% for these products.

The government also plans to add the category selling, renting or leasing of social residential homes to the 5% category. We have commented on the use of VAT on new property and residential construction in a later chapter so no further comments are made here.

To benefit agriculture, metal ores used for fertilizer production are charged 5% VAT as applied to fertilizer whereas ores in other cases are charged 10%. It is very difficult to tax any good at different rates based on end-use. VAT is normally charged at the time of clearance from the factory gate (or mine) and end-use is not certain at that stage. This invariably leads to disputes and extra administrative and compliance cost to monitor end-use. The government proposes to delete the category “ores for fertilizer production” from the 5% category which is a good idea.

(3). The Tax Rate of 10% applies to Goods and Services not listed under 0% and 5%.

The international experience is varied. The standard VAT rates in some countries like Denmark, Poland, and UK are as high as 25, 22, and 20% percent respectively. Some countries like Australia and New Zealand have moderate rates of 10 and 12.5 percent respectively. On the other hand, countries like Switzerland and Japan have comparatively low tax rates at 7.6 and 5 percent respectively. In Canada, provincial governments charge an additional VAT or sales tax rate on top of the federal rate of 5 percent. The standard tax rates in most Asian countries are more moderate and range from 10 to 17 percent.

Currently about 145 countries have adopted VAT out of which 54 per cent countries have a single rate in addition to a zero rate. In the chapter on international experience of the VAT it may be seen that
while the VAT system in Vietnam may look very different from most of the OECD countries, it compares well with the neighboring countries. The rationale for multiple rates is rooted primarily in a two-way equity concern. First, that the poor should not be taxed heavily and therefore some goods and services that are mainly consumed by them should be lightly taxed. The list of goods and services with a 5 percent VAT rate in Vietnam therefore mostly include items related to agriculture and animal husbandry, education, medicine, science and technology. The second consideration probably has been that the rich should not get off lightly and therefore those goods and services that are mainly consumed by the rich should be taxed at a higher rate.

The issue of multiple VAT rates may be analyzed on the dual principles of efficiency and equity. Efficiency gains could be realized by following the inverse elasticity rule according to which goods/services with low elasticity of demand should be taxed at a higher rate and goods/services with high demand elasticity should be taxed at a lower rate. This would justify higher VAT rate for the so called “sin” goods like alcohol and tobacco products. It could also be argued that some other goods such as gasoline and some luxury items have low elasticity of demand so far as the rich were concerned. A higher level of taxation for all such goods, however, can be easily ensured by imposing excises on those items in addition to the normal VAT. Another aspect of the efficiency point could be made on the ground that higher rates would result in higher tax revenues. There is, however, no strong evidence to support this hypothesis. On the other hand, it is a well-known fact among tax administrators that higher tax rates are more likely to encourage tax evasion.

As regards the equity or distributional considerations for tax differentiation, income taxes and expenditure policies which may be thought of as subsidy for the poor or a negative income tax are preferred policy instruments compared to the use of different rates of indirect taxation on different commodities. For instance, food items are often taxed lightly on the ground that the poor spend a greater share of their earnings on food in comparison to the rich. Studies of tax systems where rate differentiation has been implemented, however, tend to show that in majority of such cases, the tax benefits largely go to the rich who are likely to spend larger sums on those items compared to the poor. Even if it is accepted that distributional gains may be realized by rate differentiation in VAT, such gains are likely to be quite modest. Also, there are very few items that can be differentiated clearly on the basis of consumption by different income groups.

While there may be some marginal benefits of rate differentiation in VAT, several costs imposed by this kind of policy are well known and would outweigh such benefits, if any.

Some of these costs are outlined below.

i. A single positive rate lowers cost of compliance by simplifying the requirements of keeping records and invoices. It also simplifies tax forms which goes a long way in promoting self-assessment.

ii. Rate differentiation creates opportunities for misclassification of items, thereby raising the cost of administration. On the other hand, a single positive rate removes the confusion that might arise in the treatment of border line cases and thus lowers the cost of administration. For example:
- Printing activities are charged 10% VAT but books (except non-taxable books) are charged 5%.

- Science and technology services, which are regulated in the Law on Science and Technology, are charged 5% VAT. Science and technology services have a lot of similarity with other services such as inspection, legality inspection, storage etc.; charged at 10%.

- As regulated in the Law on VAT, products of cultivation, husbandry, aquaculture, seafood and fisheries which have only been subject to conventional preliminary treatment (semi-processed) in the stages of sale are charged 5% VAT; products that have been subject to finished processing are charged 10% VAT.

- Whether massage machines should be taxed 5% or 10% VAT? In the businesses’ opinion, massage machines are used for health treatment purposes thus should be charged 5% (patient’s’ treatment); in the tax authority’s opinion, the massage machines are not distinctly used for health treatment purpose and should be charged 10%.

- Teaching aids are charged 5% VAT and there are a lot of products that can be both teaching aids and normal goods such as white board, equipment tables, etc.

- Sugar and by-products are charged 5% like agriculture products in the sale stage. But then, should sweetener and chemical sugar be taxed at 5% or 10%?

iii. The use of a single rate helps limit the numbers of refunds. If there is a low tax rate along with a zero rate some taxpayers, particularly exporters and importers of capital goods, could be in a sustained credit position vis-à-vis the tax department. This would result in additional refund claims.

In the case of Vietnam, a lower VAT rate on several input items is sometimes justified on the ground that it will reduce the cash flow burden of the VAT taxpayers. The VAT payers, however, typically enjoy a cash flow benefit from collecting higher VAT on their outputs so this cannot be a serious problem.

Thus, there is hardly any justification for maintaining multiple rates on a long term basis. Vietnam should therefore consider moving to a rate structure with zero and one positive VAT rate and a few, well defined exemptions.

Also, when a single VAT rate is adopted, all the categories of goods/services to which that rate will apply need not be listed. The new law should spell out the zero-rated goods, exempt goods and then the single rate should apply to all the remaining goods and services being produced and consumed in the economy.

The introduction of a single rate should be part of an overall VAT reform rather than implemented in isolation. It may have to be synchronized with the reform in excises where some luxury items are brought in the tax net so that the elimination of the lower VAT rate is not seen as a step unfavorable to the poor.
The question is if the government decides to adopt a single VAT rate, what should that rate be? If
the 5 per cent rate is abolished, should the country maintain the 10 per cent rate or it should explore
the possibility of enhancing the rate. There are several reasons for thinking of a higher tax rate for the future.

i. If the 5 per cent rate is abolished, what remains is the rate of 10 per cent. But this is
comparatively a low rate of taxation under VAT in the international context. Out of the 112
countries in the world with a VAT for which we have data, 88 countries impose a VAT with
their rate in a range of 12%-25% out of which 20 countries impose the rates from 20%-25%,
36 countries impose the rates from 17%-20%, 32 countries impose the rates from 12%-17%,
the other 24 countries impose 12% rate or below. Countries in the region having common
economic characteristics to Vietnam such as Laos, Indonesia, and Cambodia impose 10%
rate. China imposes a general rate of 17% and preferential VAT rate of 13%. Singapore
imposes 5% GST rate.

ii. With the gradual reduction of trade taxes under the provisions of WTO, the question of
recouping the loss of revenue will certainly arise for Vietnam in not too distant a future. The
revenue from the corporate income tax is currently at the level of over 5 per cent of GDP and
it will be unrealistic to expect a phenomenal increase in this. The scope of additional revenue
from property and land related taxes are limited not only in Vietnam but generally in most
countries. While some of the requisite increase in revenues can come from the restructuring
of income taxes, the VAT has to play a dominant role in increase of revenues in the future.

iii. The choice of the higher than 10% rate can be made more palatable by exempting some of the
goods currently taxed at 5% such as equipment and machinery for agricultural production,
clean water and medical equipment. Under a VAT even exempted goods pay some VAT on
inputs, so this may meet the considerations of equity while largely preserving revenues.
Goods that need not be taxed at a concessional rate and can be moved to the higher rate,
currently enjoying 5% tax rate are:

- Books of all kinds (except non-taxable books) because it is difficult to make a distinction
  between them and other goods charged 10% for printing.
- Science and Technology services (ST) because there are no grounds to distinguish
  between them and other common services such as: evaluation, legality inspection,
  storage, etc.
- Metal ore for fertilizer production because there is no way to distinguish such metal ores
  from other ores. This is proposed in new law.
- Teaching aids because many of them are normal goods (such as board, equipment table).
- Sugar and by-products because it will be more fair to sweetener and chemical sugar
  industries.
- Cultural activities; exhibitions; physical training and sports activities; artistic
  performances; film production; and importation, distribution and screening of films
  should be charged 10% VAT or higher because these are supplied for profit.
- Growth Stimulators for animals and plants should be charged the 10% VAT or higher
  because there are many types and are difficult to distinguish. Also, there is some
  uncertainty about whether they are goods for animals and plants or not.
iv. The government budget deficit has been widening over the years, forcing the government to borrow more. Since 2009 Vietnam has continuously reduced its tax rate; therefore another reduction in tax rate even 1% or 2% will create difficulties in balancing the government’s budget in the next several years, especially when import tax is lowered due to international commitments and Vietnam’s economic prospects as well as the world economic prospects are yet to improve. Unbalanced budget over a long period leads to serious repercussions. Vietnam’s credit rating is still low thus borrowing cost in the international market is going to be high.

v. According to international experience, other countries do not reduce VAT rate on “merit” goods but give aid directly to consumers (normally low-income people) in cash or give “merit” goods and products to consumers or vouchers. For instances, in the situation of long and serious imbalance of government budget and recession, decreased spending and deflation, the Japanese government is trying to convince Japanese Congress to increase the VAT rate from 5 percent to 10 percent.

It is therefore suggested that in the course of its tax reform, Vietnam should consider enhancing the VAT rate. Of course, before deciding upon a higher rate, a sensitivity analysis will be necessary in terms of rate versus tax revenue trade off using a revenue forecasting model. Even with a modest increase in rate, the VAT rate should remain at an acceptable level. Elimination of the 5% rate will also have to coincide with streamlining the current list of exemptions, which is discussed in the next chapter.
Chapter III: VAT Exemptions and Exclusions

1. Exclusions

A number of items are excluded (not exempted) from the VAT laws of Vietnam. They are regulated by Decree No 121/ND - CP and Circular 06/TT - BTC, which came into effect from March 01, 2012 as “3. Cases not requiring declaration and payment of value-added tax:

a) Goods and services provided outside Vietnam by Vietnam-based taxpayers, except international transportation with overseas places of departure and arrival.

In case service provision activities are carried out both in Vietnam and overseas, while service provision contracts are signed between two enterprises paying tax in Vietnam or having permanent establishments in Vietnam, such services are subject to value-added tax for the contract value performed in Vietnam, except the provision of insurance services for imported goods;

b) Revenues from compensation, bonus, support, transfer of emission rights and other financial revenues;

c) Vietnam-based production and business organizations and individuals that purchase such services from foreign organizations without permanent establishments in Vietnam or overseas individuals not residing in Vietnam as repair of vehicles, machinery or equipment (including supplies and spare parts); advertising and marketing; investment and trade promotion; goods sale and service provision brokerage; training; or share of charges for international post or telecommunications services provided outside Vietnam between Vietnamese and foreign partners;

d) Non-business organizations and individuals that are not value-added tax payers are not required to declare and calculate value-added tax when selling their assets, including assets they are using to secure loans at banks or credit institutions.”

Circular No. 06/2012/TT-BTC of January 11, 2012, guiding the implementation of a number of articles of the Value-Added Tax Law and guiding the implementation of the Decree No. 123/2008/ND-CP of December 8, 2008 and the Decree No. 121/2011/ND-CP of December 27, 2011 of the government mandates in Article 5 as follows.

Besides the 5 cases listed in Clause 3, Article 2 of Decree 121/ ND-CP, it adds another category:

“6. Other cases:

Business establishments are not required to declare and pay tax in the following cases:

a) Contributing assets as capital for establishing enterprises. Contributed assets must be enclosed with: written record on contributions as capital for production and business, joint-venture, affiliation contract, written assets valuation record by the Council of delivery and
receipt of contributed capital from contributing parties (or written valuation by valuating organizations as prescribed by law) enclosed with the dossier on asset origin.

b) Asset transfer among dependent cost-accounting member units of the enterprise; asset transfer upon division, splitting, consolidation, merging, and enterprise transformation. Transferred assets among dependent cost-accounting member units of the business establishment; for assets transferred upon division, splitting, consolidation, merging and transformation, business establishments with transferred assets must have asset transfer orders enclosed with a set of asset origin dossiers and are not required to issue invoices.

For asset transfer among independent cost-accounting units or among member units with full legal entities in the same business establishment, business establishments with transferred assets must issue VAT invoice, declare and pay VAT as prescribed except for the cases guided in clause 5 of this Article.

c) Payment claiming from third parties in insurance activities.

d) Amounts collected on other’s behalf not relating to the sale of goods and services of business establishments.

d) Revenues from goods, services of agent sale and commissions from agent sale at prices prescribed by agent-appointing parties for commission on services such as: post, telecommunication, lotteries, air/car/train/ship ticket sale; international transport agents, agents of aviation, maritime services thereon applied 0% VAT rates; insurance agents.

e) Revenues from goods, sales and agent commissions received from agent sale of goods, services not subject to VAT.”

2. Exemptions

The following category of goods is currently VAT exempt.

1. Cultivation and husbandry products, and reared and fished aquatic products which have not yet been processed into other products or have been just preliminarily processed and sold by producing and fishing organizations and individuals, and products at the stage of importation.

2. Products which are animal breeds and plant varieties, including breeding eggs, breeding animals, seedlings, seeds, sperms, embryos and genetic materials.

3. Irrigation and drainage; soil ploughing and harrowing; dredging of intra-field canals and ditches for agricultural production; services of harvesting farm produce.

4. Salt products made of seawater, natural rock salt, refined salt and iodized salt.

5. State-owned residential houses sold by the State to current tenants.

6. Transfer of land use right.
7. Life insurance, student insurance, insurance on domestic animals, insurance on plants and reinsurance.

8. Credit provision services; securities trading; capital transfer; derivative financial services, including interest-rate swap contracts, forward contracts, futures contracts, call or put options, foreign currency sales, and other derivative financial services as prescribed by law.

9. Healthcare and animal health services, including medical examination and treatment and preventive services for humans and domestic animals.

10. Public post and telecommunications and universal Internet services under the Government’s programs.

11. Public services on sanitation and water drainage in streets and residential areas; maintenance of zoos, flower gardens, parks, street greeneries and public lighting; funeral services.

12. Renovation, repair and construction of cultural, artistic, public service and infrastructure works and residential houses for social policy beneficiaries, which are funded with people's contributions or humanitarian aid.

13. Teaching and vocational training as provided for by law.


15. Publication, import and distribution of newspapers, journals, specialized bulletins, political books, textbooks, teaching materials, law books, scientific-technical books, books printed in ethnic minority languages as well as propaganda postcards, pictures and posters, including those in the form of audio or visual tapes or discs or electronic data; money printing.


17. Machinery, equipment and supplies which cannot be manufactured at home and need to be imported for direct use in scientific research and technological development activities; machinery, equipment, spare parts, special-purpose means of transport and supplies which cannot be manufactured at home and need to be imported for prospecting, exploring and developing oil and gas fields; aircraft, drilling platforms and ships which cannot be manufactured at home and need to be imported for the formation of enterprises’ fixed assets or which are hired from foreign parties for production and business activities or for lease.

18. Special-purpose weapons and military equipment for security and defense purposes.

19. Goods imported as humanitarian aid or non-refundable aid; gifts for state agencies, political organizations, socio-political organizations, socio-political-professional organizations, social organizations, socio-professional organizations or people’s armed forces units; donations or gifts for Vietnam-based individuals within the Government-prescribed quotas; belongings of foreign
organizations and individuals within diplomatic immunity quotas; and personal effects within
duty-free luggage quotas.

Goods and services sold to foreign organizations or individuals or international organizations for
use as humanitarian aid, and non-refundable aid to Vietnam.

20. Goods transferred out of border gate or transited via the Vietnamese territory; goods
temporarily imported for re-export; goods temporarily exported for re-import; raw materials
imported for the production or processing of goods for export under contracts signed with foreign
parties; goods and services traded between foreign countries and non-tariff areas and between
non-tariff areas.

21. Technology transfer under the Law on Technology Transfer; transfer of intellectual property
rights under the Law on Intellectual Property; computer software.

22. Gold imported in the form of bars or ingots which have not yet been processed into fine-art
articles, jewelries or other products.

23. Exported products which are unprocessed mined resources or minerals as prescribed by the
Government.

24. Artificial products used for the substitution of diseased people’s organs; crutches,
wheelchairs and other tools used exclusively for the disabled.

25. Goods and services of business individuals who have a monthly income lower than the
common minimum salary level applicable to domestic organizations and enterprises.

This is obviously a long list of exemptions and needs to be examined carefully. But first, a brief
note on the rationale of exemptions is presented below.

Why Exemption?

First of all, why exempt any goods and services? One possible reason could be if output were
hard to identify and measure or if it were administratively hard to tax. For instance, financial services and
small traders are exempted on these grounds. In the first case, it is not easy to measure the output of
financial services in addition to the fact that these services are internationally mobile. In the second case,
the administrative cost of taxing traders below a certain threshold is comparatively higher than the
revenue gains from taxing them. Therefore, there is some justification for exempting these sectors.

Another reason for exemption could be that it is a less costly and administratively convenient way
of applying a reduced VAT rate. It may be argued that a lower rate may be preferable to exempting a set
of goods and services. The issue of rate differentiation has already been discussed in the preceding
section with the conclusion that it is not a desirable feature of a VAT system. Thus exemption of goods
and services cannot be justified on this ground.

Revenue Implications of Exemption
Second, what would be the implication of exemptions for tax revenue? Effectively, exemptions break the VAT chain and may result in an increase of VAT revenues if there is a cascading of taxes. If, however, exemptions are applied at the last stage, revenues will fall. So the overall impact of VAT exemption is indeterminate and there is no clear cut evidence that it is a revenue enhancing measure. In any case, cascading is not a desirable feature and one reason for moving away from turnover taxes was that it causes cascading.

**Anomalies Created by Exemption**

There are several anomalies created by exemption.

(i) Exemption distorts the input choices because of an element of tax that remains in the chain of production. This aberration does not remain confined to a single sector but would pervade all those sectors where the products made from the exempt input are further used as production inputs.

(ii) By introducing an element of cascading, exemption will create an incentive for vertical integration of units giving rise to artificial groupings of activities and organizational forms that are not necessary from commercial viewpoint.

(iii) It would create a major problem if the final product is exported because zero rating will not be able to eliminate the cascading created by exemption at an intermediate stage. Similarly, it creates incentive to import inputs that domestically have an exemption in their production chain because the import price does not have an element of tax in it since exports from other country would be zero-rated.

(iv) Exemptions also create administrative and compliance problems for traders who sell both taxed and exempt items. Their input tax payments must be allocated between the two kinds of sale.

**Some Goods and Services Commonly Exempted**

Looking at the international practice of exemptions, the following broad categories of goods and services seem to be generally included in the category of exempt goods and services.

(i) Agricultural products and key agricultural inputs
(ii) Passenger transport
(iii) Cultural and other merit goods
(iv) Aid financed activities
(v) Services provided by the public sector, health and education in particular
(vi) Financial services
(vii) Real estate and construction
The rationale behind exempting the first two categories of goods and services is some sort of distributional or equity consideration in the sense that by exempting these sectors, the low income consumers and agricultural farmers will benefit. This concern is, however, partially addressed since small farmers and transporters will normally fall in the category of small exempt traders below the prescribed threshold limit. The third category reflects the sensitivity of taxing certain goods and services in a particular country while the fourth group might arise because of conditions imposed by the donors. The extent to which exemption may have to be granted to these two categories of goods and services would be country specific and somewhat item specific.

Goods and services supplied by the public sector in competition with the private sector should be fully taxed except where these are purely non-commercial services given free of charge. Defense, other not-for-profit public services, some categories of health and education services fall in this category. It is hard to tax a service that is given away free except by taxation of inputs. In fact, public sector may be regarded as the final consumer of non-commercial services that it produces and gives away free of charge. This is the practice currently adopted in EU countries.

As regards health and education, the standard advice and practice is to exempt basic services – primary education, basic healthcare - and tax the specialized services at normal tax rate.

One relevant question is: does it make a difference whether such public sector services that are provided free of cost are taxed or exempt? Since the final price is zero, taxation or exemption apparently does not make any difference. As regards tax revenue on inputs, that also is a washout because that will increase the budgetary costs to the government for providing those services. The only difference is that exemption would break the chain with its accompanying implications.

Some countries (Canada, some EU countries) have therefore adopted the practice of taxing these services and then rebating the VAT to public bodies engaged in this kind of activities. This virtually converts the exemption to zero-rating. The problem of assessing the sales value for such services is often solved by looking at the user fee collection if there is a user fee or by the amount of budgetary subsidy provided to the agency in question. In any case, the overall revenue implication for the government would be zero.

Financial services such as banking and insurance are typically VAT exempt for reasons discussed earlier. The main reason is that they are extremely hard to tax and are fairly mobile.

The ideal treatment of real estate and construction would be to tax the services that flow from them. Credit may, of course, be given if services are used as business input. The leasing of real estate for commercial purposes can be easily subject to VAT but this would be hard in case of owner occupied houses. To avoid distorting choice between renting and house ownership, the commercial leasing of residential property is also generally exempt. One way to tax residential property under the VAT would be to tax at the time of purchase of house. Taxing the subsequent resale does not make a lot of sense as the tax revenues paid by buyer and the refund claimed by seller would cancel out. The construction activities should be taxed in the normal way and credit given for construction as a business activity. This practice would ensure that those who construct houses for own occupation and are therefore VAT exempt on the final value of the house, at least pay VAT on their inputs.
In Vietnam, the Law on VAT defines that transferring the use of land is non-taxable for VAT. Therefore, when determining the tax rates for the transfer of land (including the rights to use land, buildings and works on land), tax calculators have to exclude the value of transferring the use of land which is not subject to VAT. Actually, there is not sufficient evidence to determine what the value of transferring the use of land will be while deducting this item in determining the taxable value in the land transfer transactions. If the contract price is used in calculation, the buyers and sellers will agree to put high price for the value of transferring land and low price for the value of buildings and works on land in their contracts to avoid tax, especially in the case of sale to final consumers.

The taxing authorities (Government’s authorities on tax, audit and inspection) have no basis to distinguish the agreed price from the market price leading to different decisions. Business and buyers in many cases suffer from prolonged, inconsistent processes along with incomplete and complicated procedures. If the provincial-level People's Committee’s land price is used, the tax deduction from land is low leading to complaints about high tax burden from the real estate businesses and customers. In this case, the best way is to include the total transaction value including land to avoid these disputes, a “Homestead exemption” as a percentage of the total transaction value may be given for non-commercial properties to reduce the total tax payable while maintaining the single rate and making the process simple and transparent.

**Some Guiding Principles for Vietnam on Exemptions**

The above discussion provides some useful guidelines for reexamining the existing list of exemptions in Vietnam. Similarly, imports of some machinery and equipment that cannot be produced domestically are VAT exempt. On the category of machinery and equipment, there is no need for tax exemption unless the VAT refund system is very slow or dysfunctional.

Goods and services provided by the public sector free of cost on a noncommercial basis are good candidates for exemption. This includes primary education and basic health. Cultural and other merit goods, aid financed activities; financial services may be considered for exemption because of their unusual situation. Residential rentals are a good candidate for tax exemption while new residential properties can be taxed. Other items in the list in section 4 of the act need a close scrutiny and should be excluded unless there are some strong reasons to keep them tax exempt.

**A Cautionary Note on Taxing Health and Education Services**

When bringing anything under the tax net from an exempt list, one has to make sure the sale price of the output is commercial price and not below market or subsidized price. Otherwise, the tax department may end up paying more tax on the input than collecting tax on the output. This kind of problem may arise in cases such as secondary education where the output price may not be market determined and has some hidden element of subsidy. Many countries (Botswana, South Africa) ended up losing revenues by not exercising caution. If there is an element of subsidy in sales price, it should be grossed up before applying VAT to avoid this problem.
Some of the issues raised are examined below and some general comments provided on specific exemptions. It may be noted that the comments have to be read with observations made in chapter 2 on rates and chapter 4 on threshold.

Comments on Specific Exemptions in Vietnam

a. Products of cultivation and husbandry; cultured and fished aquatic and marine products, which have not yet been processed into other products.

b. Products being animal breeds or plant varieties, including eggs, breeds, saplings, seeds, sperms, germs and genetic materials at the stages of culture.

Comment: Normally it is advisable to exempt small farmers from VAT but not all farmers. In fact, producers over a certain turnover find it in their interest to remain part of the VAT system so that they can claim refund of taxes paid on their input and the price of their output is not higher than other producers.

When a threshold is introduced for VAT exemption, small farmers may become automatically exempted while bigger producers remain part of the VAT and thus there may not be any need for this category of exemption. An issue has also been raised about “Products of cultivation, husbandry, aquaculture, seafood and fisheries which have not yet been processed into other products or which have only been subject to conventional preliminary treatment by organizations and individuals in the stages of production, catching, sale and import.”

Several authorities, businesses, especially the Vietnamese Customs and domestic agricultural producers complain about the difficulties in determining “preliminary treatment”. For example: cooked fish vs raw fish, spiced fish vs un-spiced fish; frozen cut chicken; etc. The provision leads to complexity and difficulties due to inconsistency in implementation between companies and tax authorities as well as between different authorities (tax offices, customs offices).

The solution to this problem is to remove the exemption and rely on the threshold. However, given that the middle rate of 5% should also be eliminated as we recommend, this category then becomes taxable at the rate of 10%. The second best solution to restrict the exemption to a few specific items can work in two circumstances: (1) Once we have a single positive rate and a good threshold and (2) A clearly defined VAT tariff nomenclature aligned to the HSN on the Customs side (relying on the accompanying explanatory notes). Disputes of this kind can be minimized, even if not completely eliminated even if the exemption continues or is limited to a few items. The general principle is that all exemptions are to be interpreted strictly; normally the onus of proving that they are entitled to a reduction in duty is on the assessee, not revenue authorities. This issue has been discussed in detail in the chapter on treatment of agriculture.

c. Irrigation and drainage; soil ploughing and harrowing; dredging of intra-field canals and ditches for agricultural production; services of harvesting farm produce.

Comment: The question is who distributes irrigation water and provides drainage facilities. If it is public sector agency, exemption is okay otherwise it should be subject to normal VAT. VAT Law
defines that dredging inland canal activities are not subject to VAT. However, according to several tax departments, agricultural technical services for "dredging inland canals" are difficult to determine because the Irrigation Law only classifies inland canals by their levels (level 1 to level 4 or 5, depending on each period) or the main canal, sub-canals etc.; the Irrigation Law does not define the term "inland". Therefore, it is difficult to determine whether to collect or not to collect VAT on canal dredging activities. Again, if the government provides the service it can be exempted, there is no real benefit to exempt a private provider.

d. Salt products made from seawater, natural rock salt, refined salt, iodized salt. Here the government intends to insert a qualifier in the new VAT law that restricts the exemption to salt products whose main component is the chemical formula NaCl.

Comment: It is important to know the nature of the industry: is it organized and formal or small and totally informal? If it is organized, there is no particular need for exemption. If it is small and informal, the introduction of exemption threshold should solve the problem. The restriction (NaCl) is useful if there are many classification disputes over the use of the word “salt” and will limit loss of revenue in this category, this restriction already exists at the decree level.

e. State-owned dwelling houses sold by the State to current tenants.

Comment: State owned dwellings sold to private individuals should be treated the same way as sale of other buildings. If, however, the sale to current tenants is part of a privatization move and VAT exemption is a sort of incentive to promote that policy, the current practice may continue as long as the government wishes to provide a temporary boost to a slumped real estate market. The selling, renting and leasing of social residential houses has now been placed at the 5% rate. It is recommended again that all new construction be treated evenly as discussed below.

f. Transfer of land use right.

Comment: Land use is subject to “Land Use Right Transfer Tax” but the rates are quite low and vary between 2 to 4 percent. Either that rate should be revised or normal VAT may apply to this transfer. This issue has been discussed in more detail above in this chapter as well as in the chapter on treatment of special entities.

g. Credit services and investment funds, including capital lending activities; loan guarantee; discount of negotiable instruments and valuable papers. Here the government proposes to add a provision to charge VAT on sales of defaulters assets used as security and forfeited by lenders and several other financial transactions involving foreign exchange and debt.

h. Life insurance; insurance for school pupils; insurance for domestic animals and cultivation plants, and non-commercial insurance. Here the government proposes to add to the scope of insurance by including “insurance of ships and boats and other equipment and tools directly used in fishery and re-insurance.”

Comment: These two belong to the normal category of financial services and should remain VAT exempt. The forfeiture of pledged assets is meant to help creditors recover their loans and help the credit market function smoothly. There should be independent regulations to prevent profit-making by lenders
when they sell assets to recover money lent. The VAT can be charged on the amounts of sale in excess of the recoverable amount (and regulations should determine what should be done with the remaining surplus) but to charge VAT on amounts below the amount owed to the lender will only raise the lending margin and quantum of lending in the long run by imposing a further cost on the lender.

Regarding the addition made for fisherman insurance, it is acceptable in order to encourage working in the sea. As long as it is confined to exempting the insurance only that is fine, and the exemption should not be extended to recreational boats and luxury/leisure craft. Rather, the government can follow the approach to exempt all insurance and reinsurance activities rather than list them individually as this will reduce disputes and minimize costs.

i. Medical examination and treatment, healthcare services, and veterinary services.

**Comment:** This exemption is quite open ended and technically even cosmetic surgery would be VAT exempt. A line has to be drawn somewhere clearly specifying which categories of health and veterinary services will remain exempt (limited exemption of health and education services has been discussed above). It may be a better approach to exempt specific categories of medicines rather than for profit medical services by doctors and nursing homes.

j. Post, telecommunication and Internet services universalized by Government programs.

**Comment:** If it is publicly funded it is okay but not if the private sector is involved.

k. Public services of sanitation and water drainage; maintenance of zoos, flower gardens, parks, street greenery and public lighting; funeral services. The government proposes to remove the category of Public services of sanitation and water drainage in streets and residential areas from this category in the new VAT law.

**Comment:** This category may remain VAT exempt if all the activities are strictly non-commercial in nature. An issue has arisen recently since many businesses have been involved in providing public services on sanitation, lighting or services having similar characteristics such as house cleaning, office cleaning, there is no basis to distinguish them and it is difficult to identify the concept of “public”, leading to problems due to different interpretations of the concept of "public". It may be better to stick to the principle of “commercial” rather than public – is the service provider undertaking an activity for commercial profit based on the fee charged? If yes, they should be taxed regardless of whether the service is meant for the public or privately provided.

l. Maintenance, repair and construction of cultural, art and public welfare works infrastructure and houses of gratitude.

**Comment:** Purely artistic, cultural and charitable services may remain VAT exempt but why exempt maintenance of these services? Who will be exempt? – The contractor? If so then one has to split inputs that go into these services versus other maintenance activities. It is better to make all these taxable, and include a provision that really non-commercial forms of artistic activities may be tax exempt, not maintenance.
m. Teaching and job-training activities.

   **Comment:** Commercial and job training should be subject to VAT, only Public Education should be VAT exempt.

n. Radio and television broadcasting under programs financed by the State budget.

   **Comment:** This is again quite open ended. Advertising services should be taxed both in public and commercial radio and TV.

o. Publication, import and distribution of newspapers, magazines, textbooks, course books, political, scientific and technical books, legal documents, propaganda materials in any media, money printing. Here the government proposes to add the category “money” in the new VAT law.

   **Comment:** Any distinction between domestic production and imports ends up providing negative protection to domestic industries. So this may be dropped. However, if some categories of books are deemed important, they may be considered for zero-rating. The addition of “money” is made to clarify that money (notes and coins) is not subject to value added tax levy to remove obstacles in the importing and exporting processes, and this is a good idea.

p. Public transportation by bus or tramcar.

   **Comment:** At present, there is no public transportation by tram. Also public transportation by bus is no longer a field of no profit, or low profit, or in need of Government’s subsidies to encourage people to use. People choose their public transportations by convenience and ticket prices. Currently, many companies participate in public transportation by bus by forming business cooperatives for profit purpose. In some provinces, there has been the phenomenon that inter-provincial, inter-district transportation businesses take advantage of bus transportation which is not subject to VAT to gain profit. Also taxi associations have suggested listing taxi activities under public transport operations because they are transporting millions of people each year and have petitioned the Government for taxi association’s equality under tax law like other forms of transportation. Again, the same principles apply. Subject to the threshold, any for-profit activity that charges a commercial price should be taxed, especially luxury services such as air-conditioned limousines etc.

q. Equipment, machinery, supplies and transport means which cannot be produced at home and needs to be imported for direct use in scientific research and technological development activities; aircraft, drilling platforms and ships hired from foreign countries used in production and trading, which cannot be produced at home; equipment, machinery, spare parts, special-use transport means and supplies, which cannot be produced at home and need to be imported for activities of prospecting and developing oil and gas fields.

   **Comment:** Instead of exempting such imports, a policy of deferment may be a preferred option where VAT payment on capital imports is deferred until VAT input deductions are claimed. Thus these capital inputs become subject to the normal VAT and subsequent refund or reimbursement without affecting the VAT chain in any way.
r. Special-purpose weapons and military equipment for security and defense purposes.

Comment: The question is what is VAT exempt – production of all such weapons or production/purchase by military or for military use only? The purchase by military should be VAT exempt but if production and sale is being done by the private sector they should pay VAT on their input purchases.

s. Goods imported in the following cases: humanitarian aid and non-refundable aid goods; gifts for State agencies, political organizations, socio-political organizations. Goods sold to international organizations and foreigners for humanitarian and non-refundable aid to Vietnam.

Comment: These two categories are okay. The administrative issue is that these items should not find their way to the private markets.

t. Goods which are transshipped; transited or transported through Vietnam.

Comment: This category is redundant because VAT only applies if imported for home use.

u. Technology transfer under the Law on Technology Transfer; transfer of intellectual property rights under the Law on Intellectual Property; computer software.

Comment: Some more information is needed on this category. It is not clear what is exempt – royalty paid for these transfers, some form of fees, or something else?

v. Gold imported in the form of bars or ingots which have not yet been processed into fine-art articles, jewelries or other products.

Comment: question is why special treatment to gold? The exemption of this category is not justified, particularly exempting only imported gold creates negative protection for the domestic industry. This is also discussed further in the chapter on treatment of special sectors.

w. Artificial products used for substitution of diseased people’s organs; crutches, wheelchairs and other tools used exclusively for the disabled;

Comment: This being for medical, functional purposes is okay. There are several opinions on determining the replacement parts such as time, function, and purpose. Recently, cosmetic surgery is becoming more popular along with the use of materials such as breast implant. If tax authorities only consider the criteria on replacement function and not on medical materials, the breast implant will be considered non-taxable artificial products; but if they do consider the medical materials criteria, breast implant will be taxable. Or kidney purifier, although only used once in a very short time the majority opinion among the public as well as tax authorities is that this product is an artificial product. However, there are also some opinions that in terms of time a kidney purifier only operates for a few hours and cannot meet the replacement requirement, thus is subject to VAT.
x. Exported products which are unprocessed mined resources or minerals as prescribed by the Government. Here the government proposes to substitute “into other products” in place of “as prescribed by the government” in the new law.

Comment: There is no need for this category of exemption because this should be covered by normal zero-rating of all exports. Is this provision somehow supposed to override normal zero-rating provision?

Clause 23, Article 5 of the Law on VAT defines: “Export products being exploited natural resources and mined minerals which have not yet been processed as stipulated in regulations of the Government” non-taxable for VAT to limit their exportation because their export value is low, and their exportation businesses do not create many domestic jobs, and create social and or environmental tensions. Actually, it is very hard to determine what unprocessed natural resources are, leading to complexity, inconvenience, and inconsistency between businesses and tax authorities as well as between different authorities. A typical example is some types of stone (cut or split, crushed or otherwise) or some types of enriched ore such as copper; iron; gold etc.

Products that are unprocessed natural resources are unique products, being regulated under the Minerals Law. The Law on VAT does not define specifically that issue but does give the Government authority to guide, leading to inconvenience on implementation, causing a delay in the application of law, and affecting the rights of the tax payers under VAT. On the other hand, this is also an export and should be subject to 0% VAT like other goods; and other regulatory issues should not be included in the VAT Law but be included in others legal documents, policies, or in the Law on Export. This issue is also somewhat spurious. If the government’s policy is to encourage all exports, the government can remove this item from the exempted list and place it under the zero-rated list, as it should all exports of goods and services. if the government does not want to promote exports of raw and unprocessed materials, it can keep it under the exempted category, transferring the onus on the exporter to prove that the item is adequately processed to claim export refund. This is an effective way to discourage exports of low value added raw materials.

y. Goods and services of business individuals who have a monthly income lower than the common minimum salary level applicable to domestic organizations and enterprises. The government proposes to replace the income criterion by “the monthly turnovers at or under 100 million dongs”.

Comment: The determining criteria for an individual business that does not have to pay VAT is based on the minimum wage applicable to businesses and not based on business revenue; thus the criteria is inconsistent with the nature of VAT that is an indirect taxes imposed on goods and services and also making the implementation difficult and complicated for both the taxpayers and the tax authority. When added to the fact that there are two different methods for charging VAT as well, it makes the system unnecessarily complicated. The idea of using a turnover threshold is a good one. This issue is discussed in detail in the next chapter and recommendations provided.
Chapter IV: VAT Threshold

1. Tax Exempt Threshold for Small Traders

Currently, there is no threshold based on turnover for exempting small producers and traders from the VAT net. That means everyone is subject to VAT with the exception of exemptions granted. To deal with the problem of small businesses that cannot maintain records, provision has been made to apply the subtraction method of VAT calculation. This has also been extended to Gold, Silver and Gems trading activities and specified foreign organizations and individuals conducting business without a resident establishment. Those businesses that can keep sales invoices but not input invoices and for those who cannot keep either of those two sets of invoices, the subtraction method of computation is used based on sales invoices or declared sales turnover and deemed markup as a proxy for input costs. The only exemption provided is based on the income for those small businesses whose monthly income is below the minimum public sector wage.

This practice of keeping zero thresholds and applying subtraction method on small traders clearly increases the cost of administration without commensurate yield in revenues. A common characteristic of VAT in most countries is that the bulk of revenues – 80 per cent to 90 per cent - come from relatively small proportion – 10 per cent to 20 per cent - of VAT payers. Thus the situation is more skewed towards very small number of VAT payers paying almost the entire tax revenues while the tax administration has to spend substantial resources to collect very small amount of revenues from large number of small VAT traders.

There are about 550,000 business entities declaring and paying VAT by the tax credit method in Vietnam. One third of them are small and very small businesses making less than 1 billion VND in sales/turnover a year contributing about 0.3% of total VAT revenue. For most small and very small businesses, their accounting is not organized well enough to ensure compliance with the Law on Accounting, and a lot of these businesses lack the ability and willingness to comply with the regulations of law for the declaration and payment of VAT. A few businesses even take advantage of the favorable conditions for the company establishment process to establish businesses to trade VAT invoices or issue fake VAT invoices for other businesses to deduct input VAT, leading to deterioration of the business environment as well as losses to the Government’s revenues. The tax management has been costly and inefficient due to the absence of a threshold. About 70% -80% of the management costs is for 20 % of VAT revenue whereas only 20% -30% of the administrative costs is for 80% of VAT revenue.

Household businesses currently are allowed to select the tax credit method if they comply accurately with regulations for accounting books, invoices, and receipts. The result of tax inspection reveals that nearly all of household businesses cannot meet the above requirements. Therefore, the regulation on allowing businesses to select the tax computation method has not been effective in ensuring compliance with accounting procedures.

This, therefore, calls for introduction of a tax exempt threshold in order to lower the burden on the tax department and also on the small VAT payers. This will clearly break the VAT chain and create
some degree of cascading. Thus it may place those small VAT payers at a disadvantage who transact with bigger taxable enterprises. To mitigate this adverse impact, the option for voluntary registration should be available to the exempt VAT payers as well.

What would be the desirable threshold for Vietnam? Universally there is a great variation in the threshold level across countries. The exemption levels vary considerably in the neighborhood of Vietnam as well. For instance, the threshold in Philippines is US$14,100 while the threshold in Singapore is US$709,200. Cambodia has a threshold of US$62,652 for services and US$125,304 for goods, Indonesia has a threshold of US$15,300 and Thailand US$56,250.

The level of threshold for Vietnam should be chosen so that it eliminates bulk of those small VAT payers who do not make substantial contribution to revenues while imposing a large administrative cost. This requires a revenue estimation exercise to determine the most suitable threshold level.

Most countries start with a high threshold and gradually lower it. In case of Vietnam, the threshold has been virtually zero and this approach cannot be applied in the future. It is, however possible to examine, with the help of econometric modeling, several alternative thresholds in terms of their revenue implications and the resulting number of taxpayers. The one which is found to be most appropriate and cost effective should be selected.

2. Taxing The “Below Threshold Traders”

Vietnam is currently considering two thresholds. The first or “lower” threshold of 100 million VND of annual turnover will serve as a minimum turnover level below which businesses will not have to pay any VAT. The “upper” threshold of 1000 million VND will serve as the cut-off for implementing the credit invoice method. Firms between the two thresholds will be required to pay VAT using the subtraction method or simply on turnover, including all individual and household enterprises.

The taxpayers below the “upper” threshold would be VAT exempt in terms of applying the credit invoice system but some sort of taxation can be provided for them. Many countries have opted for a turnover tax of 2-3 per cent which is then tax deductible by the next registered buyer. It may be mentioned that there will still be a category of very small businesses that cannot be subjected to even this turnover tax because the revenues from them may not be adequate to cover even the costs of administering them. It may also be mentioned that no distinction should be made between types of VAT entities in applying the threshold if a single threshold is chosen. It should not matter if the taxpayer is an Enterprise or a household business, only turnover is considered.

If a business below the threshold wants to register under the credit-invoice VAT, it has to comply with the VAT documentation and accounting regulations. Any firms and household units regardless of size should be allowed to register and operate under the credit-invoice system if they want to, subject to maintenance of proper records and following applicable laws and procedures. The proposed VAT law has deleted the clause “and register to pay tax according to the tax credit method” under the paragraph that regulates who should avail of the credit-invoice method. Under the proposed law, corporate businesses that fully satisfy accounting and book-keeping regulations and have turnover above 1 billion VND and others who voluntarily register and meet the accounting criterion can use the credit invoice
system, except households who use the turnover method, while gold, gems etc. use the subtraction method. Other businesses who are above the 100 million VND limit but do not qualify/opt for the credit method would pay tax on the percentage (%) of turnover.

At present, the VAT law provides two options for payment of VAT for firms that do not avail the credit-invoice method.

**Option 1: Collect on The Income Ratio (%) Added Value on Turnover**

This option has the advantage of being consistent with the current Law on VAT and consistent with the current method applied by household businesses and small and very small business. However, the drawback of this method is the determination of the added value can be very complex because the value added depends on the characteristics of each sector and business area. The current rate schedule by % of added value applied on turnover by the Ministry of Finance (The General Department of Taxation) is divided into 5 regions and 19 industry groups (making up 95 division of the percentage rates in the schedule), and the rate is specified by Tax Department for each division of schedule. Therefore, to simplify the procedures and meet the requirements for modernization of tax administration, there is a need to eliminate this method of calculating VAT, which is used very rarely around the world mostly to tax sectors like banking and finance which we have recommended to keep out of the VAT net anyway. There is no real need to retain this method for just one sector.

**Option 2: Collect on The Percentage (%) of Turnover.**

The second option has the advantage of being simple, clear, and easy to implement for the tax authorities and taxpayers. Compared to the first option, the second option does not require taxpayers to calculate the added value; which is in line with international practice that has been adopted by many countries in the world. At the same time, following the second option may cause some uncertainty about the tax obligations for a number of taxpayers, especially for the taxpayers who are currently paying taxes on the added value. Therefore the answer is to introduce this method for all firms between 100 million and 1000 million annual turnover (with the option for firms to choose the credit invoice method and comply with accounting regulations), and eliminate the subtraction (or direct) method, while ensuring that turnover is the only criteria for selection, not the type of business. The draft law has proposed to do this, while unfortunately retaining the heading for the section consistent with the old subtraction method for gold and precious stones.

At present Vietnam is considering a threshold of 100 Million Dong for absolute exemption from VAT, and a range of 100 million Dongs (approximately US$ 5000) to 1000 million Dongs (approximately US $ 50,000) to keep traders and businesses out of the credit-invoice system. In our opinion, the absolute threshold should be chosen first, below which there is no taxation. The absolute and intermediate thresholds should be chosen subject to the revenue forecasting exercise and for firms within the two thresholds, a simple turnover tax of 2-3% on sales should be applied. Whether the turnover tax is to be made creditable or not depends on the rate chosen and the overall revenue implications that will emerge from the revenue estimation. When below threshold sellers sell to final consumers or other exempt sellers the credit of presumptive tax paid cannot be used, but it may well make a difference when small sellers sell inputs to large purchasers registered under the credit invoice system. Unlike what is
being proposed, a flat rate should be used rather than multiple rates for different activities which will give rise to classification disputes and raise administrative costs. Since we are simultaneously proposing a single positive VAT rate for the credit invoice system, the choice of a single rate for the presumptive tax will minimize distortions.

This “presumptive” tax should not be linked to PIT or CIT since all enterprises are required to pay CIT regardless of size while household enterprises are not required to pay CIT. All income earners regardless of whether income is from dividends, corporate capital gains or household businesses are normally required to pay income tax in most countries. Thus, a turnover based “presumptive tax” has no connection with CIT which is a tax based on choice of business structure. We can think of it as an extra tax for limited liability due to incorporation. The issue of CIT plus PIT on the same income can be sorted out through tax integration measures. The presumptive tax can be thought of as a substitute for PIT and VAT for any small business unit, regardless of whether household or enterprise, but it then becomes possible for the shareholder of a small enterprise to be taxed thrice: for PIT through turnover, for CIT, and then again through PIT on dividends and capital gains!

3. VAT Calculation Methods

Both the credit - invoice method (called the method of tax deduction), and the subtraction method (referred to as the direct calculation method) have been adopted for calculating the VAT liability under the present law. As explained above, the subtraction or direct calculation method is applied to those individuals and small traders doing business who fail to fully implement regulations on accounting, invoices, and vouchers to serve as bases for tax calculation under this method and is proposed to include gold, silver and precious stones and some foreign agents.

Once a suitable threshold for exempting small traders is chosen and implemented, the dual computing system may be abolished and only the credit or tax deduction method should remain applicable. All businesses above 1000 million VND in turnover should be forced to comply with the accounting and bookkeeping regulations regardless of whether they are enterprises or household businesses and use the credit-invoice system. Businesses below 100 million VND need not pay VAT. The rest can either pay the presumptive tax, or voluntarily register for the credit-invoice system subject to approval after they comply with accounting regulations.

With the implementation of the threshold, taxpayers whose turnover for a year or 12 consecutive months is higher than the upper threshold will file and pay tax by the tax credit method, and taxpayers whose turnover is below the upper threshold but above the lower threshold will pay VAT according to the percentage of sales. The regulation and the classification will help taxpayers, especially small taxpayers (including small businesses, very small businesses, household businesses, and individuals), saving time on tax procedures and reducing expenses for small taxpayers and the tax administration.

In Vietnam the number of businesses with a turnover of 0.5 billion / year or less accounted for 27.7% of the number of firms and contributed 0.1% of total value added tax; businesses with turnover below 1 billion / year accounting for about 30% of firms contributed 0.3% of total VAT revenue.
Around 30% of businesses and 80% of household businesses have turnover under 1 billion VND/year, around 35% of businesses and 85% household businesses have turnover under 2 billion VND/year. If all these businesses are simply exempted, the GDT would potentially not lose more than 0.3% revenue at current rates and the savings on administrative and compliance costs would be huge, even if no presumptive tax is imposed. In fact, if the rates are rationalized to one single rate around 10-12% on the remaining firms, a lot of these below threshold firms would pay final VAT on their inputs and would not be able to issue VAT invoices, so total revenue could go up with all changes in place and total costs would go down substantially! The control of the GDT over the remaining firms would go up considerably since they will be able to free up more resources for effective audit.

In case that business turnover is volatile, to ensure stability, businesses will be required to apply a stable tax calculation method (the tax credit method or the presumptive method for VAT) in the next fiscal year or 12 months.

In case that a business has both taxable and excluded or exempt goods and services then only the turnover from the sales of taxable goods and services is used to determine the business turnover for the threshold purpose.

For the newly established businesses, the taxpayers choose one of the two options on taxation or can voluntarily register for the tax credit method. If, at any time during the year, any business exceeds any of the two thresholds, they must register immediately in the appropriate category, maintain prescribed records and start collecting and paying the appropriate VAT.
Chapter V: VAT Treatment of Agriculture

The treatment of agriculture under the VAT is quite varied around the world ranging from full taxation to outright zero-rating or exemption. In Vietnam, different agricultural products are subject to different types of tax treatment.

1. VAT Law 2008

Article 5.- Non-Taxable Objects

1. Cultivation and husbandry products, and reared and fished aquatic products which have not yet been processed into other products or have been just preliminarily processed and sold by producing and fishing organizations and individuals, and products at the stage of importation.

Article 8.- Tax Rates

2. The tax rate of 5% applies to the following goods and services:

   e/ Unprocessed cultivation, husbandry and fishery products, except products specified in Clause 1, Article 5 of this Law;

   g/ Fresh and live food; unprocessed forest products, except timber, bamboo shoots and products specified in Clause 1, Article 5 of this Law;

2. Issues

   In many cases, it is very hard to determine whether agricultural products have been processed into other products or have just been preliminarily processed (such as in the cases of rubber, rubber latex, marinated and spiced seafood, husbandry products, raw lumber for making paper, etc.), leading to difficulties for businesses, tax authorities, auditing authorities, and inspection authorities. Sometimes tax authorities and businesses judge the appropriate classification based more on opinion than on rational criteria. In some cases, policy makers have hard time determining whether the products have been completely processed. There have been many cases where businesses have been denied their tax refunds and charged fees although they have completely complied with the accounting principles and correctly declared their tax liability as well as consulting relevant authorities in advance and not intending to violate any tax rule.

   This can be dealt with by linking the exemptions to a VAT tariff aligned to the HSN. The HSN and explanatory notes considerably reduce uncertainty of classification. Similarly, if the suggestion to impose customs duty on these products at importation is followed, the HSN is used directly. Alignment of the VAT tariff with HSN reduces disputes between different authorities. In general, exemptions and other duty reliefs are always interpreted strictly to protect revenue. This means that for charging duty, the
onus is on the tax authority to demonstrate that duty is due, but for any reduction in duty or refund, the onus is on the person claiming the relief to demonstrate that they are eligible for the relief.

The Law on VAT defines that unprocessed agricultural products sold directly by domestic producers and at the import stage are non-taxable under VAT. This ensures equality between imported goods and domestic goods, and conforms to WTO regulations. The fact that tax authorities do not charge and collect VAT on unprocessed agricultural products or preliminarily processed products at the import stage creates favorable conditions for the importation of agricultural products. Recently, low labor productivity along with high input prices has led to higher domestic production cost. The price of agricultural products imported into the Vietnamese territory does not include VAT (foreign companies selling agricultural products in Vietnam not only pay 0% VAT on exports but also receive a full refund of creditable VAT input in most countries).

On the other hand, domestic producers of agricultural products cannot deduct VAT input; thus their price will include VAT on inputs for the reason that agricultural products are not subject to VAT. Therefore the price of agricultural products sold by domestic producers may be higher than the price of imported agricultural products (assuming that both products bear the same costs and profits).

The Law on VAT defines that unprocessed or preliminarily processed agricultural products are not subject to VAT at the import stage and are subject to a VAT rate of 5% at the trade stage. In fact, there are frauds created by a number of importation businesses dealing with agricultural products by (1) creating businesses to import agricultural products and then dissolving these businesses and (2) continuing that methodology in other provinces, (3) making purchases among these businesses, and not legally declaring and paying VAT at the stage of importation for unprocessed agricultural products. Tax authorities have not had any effective solution to investigate these cases, resulting in big losses to the Government’s revenues. This is similar in some respects to “carousel” fraud cases that have been found in the EU as well.

3. Recommendations

**Recommendation 1:** Remove the regulation that agricultural products are not subject to VAT at the stage of direct sales of domestic production and importation. This brings imports and domestic producers under the VAT net and they can claim input credit as well.

Therefore, there is a need to amend the Law on VAT by removing the Clause 1 Article 5.

Implementing this solution helps to fix the loophole in management policies and limits tax evasion that affects the domestic agricultural sector. However, there is a need for a careful consideration of impacts before implementing this solution for the following reasons:

a. The household producers (currently there are more than 11 million households) would have to declare and pay VAT on their agricultural products sold as well. In the current socio-economic conditions and even for later years, the policy may not be feasible because: (i) it directly impacts the lives of farmers and (ii) the tax authorities do not have enough infrastructure and manpower to manage these household producers.
b. Most domestic agricultural products that have not been processed into other products are basic consumer goods for majority of the population, are sold through street markets and vendors. The collection of VAT whether in the form of deduction method or direct method will affect food prices and income for the majority of these low-income earners if they are brought into the tax net.

To limit the effects mentioned above, there is a need to consider another provision to ensure that not only farmers and small businesses do not have to declare and pay VAT but also the non-discrimination principle of the World Trade Organization is not violated. A threshold is required for domestic VAT.

Clause 25 Article 5 the Law on VAT defines objects not subject to VAT “Goods and services of business individuals being people with an average monthly income lower than the minimum wage applicable to domestic organizations and enterprises.”

Under the above regulation, the majority of farmers and small businesses still fall under VAT and the major producers including the farms will have to declare and pay tax if direct sales are not exempted.

However, the government is proposing to implement a threshold system in place of the above provision that should exclude most such small farmers and street vendors or have them liable to a simplified presumptive tax on turnover. So that issue does not arise in the proposed law.

There will still be large farmers and traders who will fall under the tax regime in this system and thus there will be a need to train the large producers so they can comply with accounting principles, keep invoices and receipts for VAT payment. Taxing the big producers actually does not affect the market much because theoretically the prices of goods of these major producers and farms are generally lower than that of small household businesses due to their higher productivity; and if they are large enough they will get credit of input taxes.

However, that will still mean that large farmers will be brought under the VAT net and so will food in general when sold through large establishments and when imported, and this might be unpopular politically. Since it is also being recommended that the 5% rate be eliminated this makes exemption all the more valuable; otherwise the tax rate jumps from tax only on inputs or 5% on value added to 10% on value added. If the exemption is removed and the 5% rate eliminated, all food domestic or imported, produced or sold is taxable at the single rate.

**Recommendation 2:** Put a limitation on the number of agricultural products that have not been processed into other products or preliminarily processed and is not subject to VAT at the stage of production or importation and tax the rest.

The principle limits the basic exempted agricultural products for consumption to those that need not be imported or imported in very small volume, including goods that Vietnam has trade surplus such as: rice, coffee, soybeans, seafood, etc.

There will be some difficulties in the implementation of the policy as listed below:
a. The policy cannot cover all farmers and household businesses (small ones will be exempt anyway under the threshold, but imports will not be, but some large farmers and traders will now be taxable) thus some of them will have to pay VAT on their goods sold, creating an issue with respect to equity.

b. There is also a risk that this may violate WTO principles of non-discrimination.

This policy is not recommended on grounds of horizontal equity. Further, with elimination of the 5% category, items that are taxed will be taxable at 10% and not 5%, while many are exempt due to the exempted category and the threshold. This obviously has the potential to increase inequity.

**Recommendation 3:** Impose a Customs duty (not VAT) at WTO approved rates on imported food that is not creditable in the VAT chain. This would cancel the benefit to importers of not having to bear input VAT duty on the imported goods, while domestic farmers still continue to be out of the tax net. The customs duty is collected at the border, so it also solves the problem of disappearing firms and gives some protection to small farmers with higher costs of production. Since there is no threshold for customs duty, all imports regardless of size have to pay the duty.

However, for domestic traders of imported or domestically produced food, there is a plan to introduce a threshold, and this will give VAT relief to small businesses. Direct sellers of domestic produce (farmers etc.) continue to be exempt. There is also no violation of equal treatment under the VAT if a customs duty is imposed. However, with the elimination of the 5% category, traders above the threshold will now pay 10%.

Currently, the value of importation of imported agricultural products by household businesses and individuals is not high and most of these imported agricultural products are imported from countries having common borders with Vietnam. These can be dealt with through border trade rules and land customs stations.

For exported agricultural products, the current law extends zero rating to all exported products, including exempted ones. So any exporter regardless of size can claim refund of input credit on export. In case small exporters find it difficult to comply with accounting rules to claim input credit, duty drawback rates based on value and volume can be considered to reimburse input duties. Further issues regarding exports are dealt with in the chapter on export treatment under VAT.

In general, the regulation on not collecting VAT on the “products that have not yet been processed into other products or which have only been subject to conventional preliminary treatment/semi-processed by organizations and individuals in the stages of production, catching, sale and import” has some shortcomings. There is a need to correct these anomalies and make the provision consistent with Vietnam’s commitment to its WTO obligations and its desire to keep small farmers and sellers of basic agricultural produce out of the VAT net.

We have recommended that the list of exemptions be limited as far as possible. The elimination of the middle VAT rate, the introduction of generous thresholds and strictly restricting the exemptions to food and agriculture are all connected with this issue. Our first recommendation is to eliminate the exemption as well as the 5% rate. We then rely on the threshold for equity and there is no discrimination
between domestic agriculture and imports, and between domestic producers and traders. The second best solution, recognizing the political nature of food is to severely limit the exemption to basic food items only relying on HSN style tariff headings, or imposing a customs duty on all imports of food etc, while maintaining the current exemption, and allowing the 5% rate to be eliminated and the threshold to be introduced.
Chapter VI: VAT Refunds

The present rules on VAT refund in Vietnam are complicated and vary with the nature and activity of a particular business.

(i) For businesses operating under the deduction method excess tax on inputs is not refunded unless it is carried forward for three months.

(ii) For exporting businesses, cumulative total excess input tax refund in excess of 200 million dongs is refundable in the current period.

(iii) In case of businesses that have undertaken investment for more than a year but have not been able to deduct input credits completely, cumulative excess input tax is refunded annually unless it exceeds 200 million dongs in which case it is refunded quarterly. If, however, the business investment is new, refunds are made on a quarterly basis in case the cumulative excess input tax is less than 200 million dongs, and immediately if over 200 million. Thus a different set of rules is applicable in case of VAT refund on different companies.

I. The Draft Law Proposes The Following Changes to Article 13 Governing Refunds:

1. Substitutes the phrase “If having the input value added tax not fully deducted for the month or quarter in case of quarterly declaration, the amount will be deducted in the following period; in case of tax credit accumulation after at least twelve months from the first month or after at least four quarter from the first quarter of having un-deducted input value added tax, the remaining amount of un-deducted input value added tax can be refunded” in place of “shall be able to claim value added tax refunds if in three continuous months, the input value added tax exceeds the output value added tax.”

   The only sensible interpretation of this change is that it increases the time for claiming refund from 3 months to 1 year on inputs!

2. Raising the threshold for claiming refund in case of new investment and exports to 500 million VND from 200 million VND.

3. Inserts the terms quarter after month to bring it in line with existing legislation that allows SMEs to choose to file quarterly.

4. Non-residents have been allowed refunds of VAT when carrying duty paid goods out of the country; diplomats have been allowed this facility within the country.

5. Projects carried out using ODA, grants and humanitarian aid have been extended the benefits of refund in varying degrees which is already provided for in regulations and decrees.

As mentioned above, excess input tax should be preferably refunded fully after each tax period which happens to be quarterly in case of Vietnam. This is, however, not feasible in many developing countries with limited administrative capacity. The carry forward system is mainly advocated as a
safeguard against fraud but that can be really caught only with a quick and effective audit system. Thus one main area of weakness in refunds could be the lack of effective and prompt auditing capacity. So the long term solution is strengthening administration and acquisition of audit capacity.

In case of Vietnam, however, some other complications related to VAT refund need to be remedied. There is no justification for distinguishing between the VAT refunds on capital goods versus VAT refund on other inputs. A carry forward period of three months may be applied to every business and a threshold for obtaining the current period refunds may also be fixed but it should not be excessive and should remain uniform across different businesses. This would render the system simpler and more transparent.

All new businesses must be audited for a couple of years before getting refund to make sure it is a genuine unit and not a scam. Otherwise, a new unit may come up and claim a lot of refund based on false invoices and then disappear. Old and well established units are less likely to commit fraud.

To deal with the concerns of investors about late refund, some countries have adopted the practice of allowing deferment of VAT payments on specific capital imports until VAT input deductions are claimed. This approach requires effective customs control and coordination between customs and domestic VAT administration. Vietnam exempts import of capital goods which cannot be produced domestically. This clause may be replaced by a deferment provision. In case such capital goods are also produced at home, however, this may place the domestic capital equipment producers at a disadvantage. Sometimes, zero-rating of capital equipment items has been tried in some countries but this may result in a net revenue loss to the extent that capital equipment is used by unregistered businesses as well.

II. Justification Given for The Proposed Changes

1. The limit of 200 Mil VND for creditable input VAT for investment projects and exports has been constant since 2000 in the VAT regulations. After 12 years of inflation the CPI Index in 2011 is 253.5 compared to the base in 2000 at 100. The purchasing power of 200 Mil VND value in 2000 equals that of 500 Mil VND in 2011. Because of inflation, the purchasing power of 200 Mil VND value has gone down drastically and the number of tax return filers has gone up leading to higher administration costs.

2. Business establishments paying tax under the tax deduction method are eligible for VAT refund if their input VAT is not completely deducted in 3 consecutive months or more. This regulation has led to an increase in VAT refunds, putting a strain on the VAT Refund Fund. Due to the short waiting time of three months, the time available to the authorities for inspection and audit is not enough and some tax payers are taking advantage of the situation to establish businesses where it is easy to accumulate claims for tax refund. The capacity of the tax authorities for inspection and audit is limited, leading to losses in tax revenue.

3. Tax refund for tourists:

Clause 1, Article 8, the Law on VAT No 13/2008/QH12: The tax rate of zero (0) percent shall apply to exported goods and services, international transportation, and to goods and services which are not subject to VAT regulated in Article 5 of this Law which are exported...”.

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In order to stimulate tourism and exports, the Prime Minister issued the Decision No 05/2012/QD-TTg dated 19/01/2012 on the pilot implementation of a scheme of refunding VAT on goods bought in Vietnam by foreign tourists when the tourists leave the country. The policy has been adopted and implemented by a number of countries such as Singapore, Thailand, etc. in order to attract tourists to buy more goods in-country. The policy has been effective since 01/7/2012 to 30/6/2014. To date, there are 43 businesses in Hanoi and Ho Chi Minh City registered to sell goods and products to foreign tourists.

Article 13 of the Law on VAT has not yet regulated specifically refunds for foreign tourists.

4. Tax refund for ODA-funded projects and Beneficiaries of diplomatic privileges or immunities: Article 13 of the Law on VAT does not contain provisions for refunds for ODA-funded projects and beneficiaries of diplomatic privileges or immunities, but these regulations already exist in decrees.

III. Comments

1. Raise the threshold for refund to 500 million VND from 200 million VND except for exporters and large investors to take care of inflation.

2. Add the regulations proposed for VAT refunds to foreign tourists and non-residents and diplomats.

3. Add the regulations for VAT refund to ODA-funded projects etc.

4. Allow exporters and investment projects shorter time periods to claim refunds. A waiting period of 1 year is too long. The standard default period for refund claims should be at most 3 months if the refund amount is below 500 million VND. Allow all exporters who export more than a certain percentage of their output to claim refunds monthly based on their return filing frequency even if it is below the threshold of 500 million, and extend a similar benefit to large investors based on a transparent ratio criterion. There should be no distinction between input and investment credit as recommended above. To prevent fraud based on input claims by disappearing companies, such new companies that claim large refunds from new investment should be audited to make sure they are genuine. The solution lies in increasing audit and enforcement capacity, not to delay refunds by a year by default which imposes a real cost of capital on businesses and is not likely to encourage exporters or investors.
Chapter VII: VAT Treatment of Exports

VAT using the destination principle requires taxation at the place of consumption or use, rather than at point of origin or production. This is implemented by applying the same VAT at the border to imports as is applied to goods manufactured domestically, and zero rating exports. Vietnam strives to do so in most cases and is conscious of its obligation under WTO to treat imports and domestically produced goods fairly under the VAT. This issue has also been discussed in the context of agricultural products in the relevant chapter. An exception to this rule is the exemption to the import of gold that is exclusively imported by the government agencies.

The regulations governing imports and exports in the VAT Law 2008 are as follows.

**Article 8. Tax Rates**

The tax rate of 0% applies to exported goods and services, international transportation and goods and services not liable to value-added tax specified in Article 5 of this Law upon exportation, except cases of transfer of technologies or intellectual property rights abroad; offshore reinsurance services; credit provision, capital transfer and derivative financial services; post and telecommunications services; and exported products which are unprocessed mined resources and minerals specified in Clause 23, Article 5 of this Law.

**Comment:** Some confusion exists with respect to the exemptions in this clause of some services and unprocessed mineral resources from the application of zero rating on export. These items are otherwise non-taxable under article 5 or exempt as discussed in the chapter on exemptions. The same article 8 says in clause 3 that goods not zero rated or subject to the 5% rate are to be taxed at 10%, leading to the conclusion that they may be considered taxable at 10% when exported (since they are denied zero rating) unless they are treated as exempt. However, in practice, notwithstanding this minor legal point that may potentially be misinterpreted; these goods are treated as exempt goods on export as well as domestic consumption. This also means that they are in effect being taxed to the extent that input and/or investment input VAT is not being refunded on export.

The issue regarding exports of exhaustible natural resources has been discussed in the relevant chapter on exemptions, while the issue of exemption to services involves a few more points that we shall discuss below. Notwithstanding those points discussed individually, in general it is recommended that all exports be zero-rated. There is no need to list the specific goods and services granted zero rating, it is better to zero rate all goods and services and explicitly deny zero-rating to or tax the chosen few. If the government wants to discourage export of low value added natural resources, it can continue to deny zero rating to these items and for services. Some additional regulations are recommended below.

Further, Circular No. 06 /2012/TT-BTC of January 11, 2012, guiding the implementation of a number of articles of the Value-Added Tax Law and guiding the implementation of the Decree No. 123/2008/ND-CP of December 8, 2008 and the Decree No. 121/2011/ND-CP of December 27, 2011, lists a few more provisions that regulate zero rating and exports. They include need for written service
contracts and bank payment in specified cases as well as adherence to import and export procedures in others. This circular also increases the list of items denied zero rating on export by including the face value of mobile phone cards including calling cards, services of certain kinds provided in non-tariff zones etc.

Next, an amendment is proposed to amend article 8(1) to clarify that exported goods to which the 0% rate applies consist of “Exported goods and services that are consumed outside Vietnam, in the non-tariff zones, and in some cases provided to foreign customers in accordance with the Government’s regulations.” It also ensures that non-residents and tourists can claim refund of VAT when they leave the country with duty-paid VAT purchased in Vietnam (as is the practice in many developed countries such as the UK). Further, the proposed amendment leaves it to the government to decide what items may be provided to “foreign customers” at zero rate. When coupled with the idea discussed above of the implicit taxation of exported services, it seems that the definition of exports subject to zero rating needs to be refined further.

There is no real problem with the definition of export of goods, and denial of zero rating to any goods is a matter of government policy. As stated earlier, the normal policy is to extend zero rating to goods exported out of the domestic tariff area. The issue of zero rating exports of services is however an area that is still a “work in progress” and can be debated further.

To apply the destination principle, we should be zero rating services when exported. However, this gives rise to a host of issues, especially when the service can be delivered over the internet. For example, the determining criterion of whether the services claiming the zero rates are consumed in foreign countries or not is satisfied; but the criterion of whether these services’ buyers are foreigners without permanent establishment in Vietnam cannot be satisfied. With economic development and international integration, more and more Vietnamese businesses are getting involved in the provision of goods and services beyond Vietnam. For example:

(a) Vietnamese businesses buy and sell goods that do not transit through Vietnamese territory. Piaggio Vietnam trades in the Asia region (buying bikes from Italy for distribution to other Asian countries); the services of trading are rendered entirely abroad, to foreign consumers by a Vietnamese entity.

(b) Vietnamese taxpayers provide services in foreign countries or in both international and domestic market for Vietnamese customers, including survey, design, construction supervision and the performing arts. Services provided to a Vietnamese taxpayer abroad would not qualify for zero rating.

(c) Vietnamese businesses engage in construction internationally and perform installation for Vietnamese businesses or for foreign organizations and individuals, such as construction projects in Laos, Cambodia, Congo, Burma etc. They could be hit by either the Vietnamese entity restriction or the permanent establishment in Vietnam restriction.

VAT (in theory, especially if intended to be a destination based, consumption type VAT) is a tax on the consumption of goods and services in Vietnam. The determination of the place where these services are consumed can be based on general criteria such as location (the headquarters of the supplier),
the location of the property (for real estate), place of residence of the consumer, and place where service is consumed (eg. for fine arts performances).

Different types of services have different specific criteria to determine the point of sale of the service. For example, for services such as performing arts, sports, entertainment, education, food, the determination based on the service suppliers’ headquarters location will be inconsistent with the principle of VAT destination rule, therefore these services need to be taxed by their actual consumption location (inside or outside the Vietnamese territory) for tax liability calculation. For services related to real estate (such as repair, construction, supervision, valuing of real estate, leasing hotels, halls), their place of supply should be based on the real estate’s location. For intangible services such as consultants, brokers, etc. the criteria for determining consumer location services should be based on residence of the buyers.

In some countries, the concept of export of services is determined only by the customers’ location at the time of issuing the VAT invoice. For instance: according to regulation No 9 of the European Commission: “exported service are determined if the buyers are in a foreign country.” This regulation does not mention whether and where these services are consumed and the reason for their consumption.

According to international practice, exported services are defined by whether the consumption is located in a foreign country, including the domestically produced services consumed in a foreign country, such as cross-border services (TV, network service). China applies a VAT rate of 0% for research and development and design activities provided to overseas entities; Indonesia imposes tax rate of 0% on repair and maintenance services related to the goods other than real estate not consumed in the “customs territory” of Indonesia and for construction activities (including planning, design, construction, supervision and counseling services) if the services are tied to real estate inside the “customs territory” of Indonesia. Services on repair and maintenance of aircraft, ships, machinery, and equipment for overseas customers are also subjected to 0% VAT rate by a number of countries (Indonesia, Thailand, Russia, etc.).

To summarize, it is increasingly conventional to have a set of rules and regulations to define the “point of sale” of services or the place of supply. The present EU regulations adopt the destination principle for services within the EU, but apply the origin principle to sales of service to entities outside the EU. While the general principle of zero rating exports of goods and services is re-iterated, it is also recommended to have a clear set of rules to define the conditions for zero rating of services based on the place of supply or the ‘point of sale”. Rather than excluding specific services from zero rating, and taxing them as exempt services on export, it may be a better idea to zero rate all services that are exported in accordance with a set of rules and regulations defining the place of service. Countries in the region have already issued such rules (Singapore and India) and the OECD is in the process of preparing a set of guidelines that the government may like to consider.
Chapter VIII: VAT Treatment of Special Sectors, Taxable Value and Deductions

1. VAT Policies for Real Estate (Transfers of Land or Transfers of Land Use Rights and Structure on or Associated with the Land)

VAT Law 2008 has the following provisions in this regard.

*Article 5.* Non-taxable objects

5. State-owned residential houses sold by the State to current tenants;

6. Transfer of land use rights;

*Article 7.*

Taxable price for real estate trading, the taxable price is the real estate-selling price exclusive of value-added tax, excluding the charge for transferring land use rights or the land rent remittable into the state budget.

In Circular No. 06 /2012/TT-BTC of January 11, 2012, guiding the implementation of a number of articles of the Value-Added Tax Law and guiding the implementation of the Decree No. 123/2008/ND-CP of December 8, 2008 and the Decree No. 121/2011/ND-CP of December 27, 2011 of the government:

Taxable prices for real estate business, taxable prices are real estate transfer prices minus (-) land prices deducted for VAT calculation.

a) Land prices deducted for VAT calculation are prescribed as follows:

a.1) For land allocated by the State to invest in infrastructure of houses for sales, land prices deducted for VAT calculation includes land levies payable to the State budget (not including exempted or reduced land levies) and compensations for land clearance as prescribed by law.

a.2) For State-owned land use right auctions, land prices deducted for VAT calculation are auction winning prices;

a.3) For land lease to construct infrastructure, houses for sale, land prices deducted for VAT calculation are the land rents payable to the State budget (not including the exempted/reduced land rents) and the compensations for land clearance as prescribed by law.
a.4) For business establishments receiving land use right transfer from organizations, individuals, land prices deducted for VAT calculation are land prices at the time of land use right transfer including the value of infrastructure (if any); business establishments are not eligible for deductions of input VAT of the infrastructure calculated in the deducted VAT-exclusive value of rights to use land. If it is not able to determine land prices at the time of transfer, land prices deducted for VAT calculation are land prices prescribed by People's Committees of central-affiliated cities and provinces at the time of signing the transfer contract.

a.5) For real estate establishments conducting business in the form of build-transfer (BT) and exchanging works for lands, land prices deducted for VAT calculation are prices at the time of signing the BT contract as prescribed by law.

b) For construction and trade of infrastructure, building houses for sale, for transfer or for lease, prices for VAT calculation are the collected amounts by the progress of the project or the progress of money collection specified in the contracts.

Article 21.- Effect

2. For real estate transfer contracts signed from January 1, 2009 until March 01, 2012, the first payment date is January 1, 2009 and made before March 01, 2012, if the collected amount is not lower than 20% of the total contract value, the deductible land prices are still applied in accordance with the Circular No. 129/2008/TT-BTC of December 26, 2008 and guiding documents of the Ministry of Finance.

For real estate transfer contracts signed before March 01, 2009, but the first payment is after March 1, 2012 or the collected amount before March 01, 2012 is lower than 20% of the total contract value, the deductible land prices are applied in accordance with the Government’s Decree No. 121/2011/ND-CP and the guidance in this Circular.

Issues

These have been discussed at length in the chapter on exemptions. Almost all the issues arise because the sale etc. of real estate is taxable, but land is exempted as is the sale of state owned dwelling houses to current tenants. The problem of allocation of land value to real estate is further complicated in the case of sale of high rise apartment buildings. The main points discussed in chapter 3 on exemptions are summarized below:

1. Tax real estate at the point of first sale – new residential or business construction at market price.
2. Allow credit of input VAT both to the seller (if he is registered to pay VAT under credit invoice) and to buyers of new construction for business use if they are also registered large taxpayers under credit invoice. Exempt buyers like households would either bear the tax on purchase of a new home, or bear at least the tax on inputs.
3. Allow a “homestead exemption” (to borrow a term from property taxation) – a fixed percentage of total sale value of the property as a consideration for the current exemption of land.
4. Since we plan to have only one positive VAT rate, this allows us to avoid having a special rate for real estate, and will end all disputes about what proportion of the real estate sale price is due to land.

5. Avoid taxing subsequent resale of real estate.

6. Avoid taxing rentals and leasing.

7. Bring sales of government housing to existing private tenants under the VAT unless this is a privatization or welfare related move that is temporarily needed to boost a flagging real estate market. If there is a real estate bubble, the real estate VAT acts as an “automatic stabilizer” and yields substantial revenue to the government.

2. VAT Policies for Gems and Jewelry

- At the importation stage: Article 5 the Law on VAT of 2008 defines "Gold imported in bar and foil which has not yet been processed into fine art articles, jewelry and other products" is not subject to VAT.

- Gold jewelry, other products made of imported gold are charged 10% VAT.

In domestic market: According to the current regulation the purchase, sale, and manipulation of gold are taxed by the direct method for VAT, and the VAT liability is the difference between the selling price minus (-) the cost of goods sold times (x) the rate of 10%.

The exemption given to imported gold while gold purchased domestically remains subject to taxation provides negative protection to the domestic gold industry. In the proposed draft VAT law, the government plans to retain both the exemption to imported gold as well as the method of subtraction for calculating VAT for gold, silver and precious stones industry.

**Comment:** The exemption for gold imports is justified by pointing out that it is a monopoly of the central bank. If that is really the case, it makes no difference if it is taxed on import or not. Presumably, VAT is applied whenever imported gold is re-sold to any private person since the central bank obviously is not part of the industry that uses gold in bar or foils form to produce any other goods (except perhaps as content in coins) for sale. If VAT is applicable whenever imported or any other gold is sold within the country by any taxable entity above the threshold (under the proposed VAT law); gold becomes similar to any other commodity that can be taxed using the credit-invoice system. However, the fact that gold is exempted on import and untaxed small private sellers of gold do not generate VAT input credit for buyers is given as the rationale for retaining the subtraction method for the gold and gems industry.

This does not appear to be a tenable reason to keep the third method of calculating the VAT (the subtraction method) in the law just for one industry. The real reason appears to be that under a credit invoice system, many businesses will have input credit invoices while some will not, hence the tax liability will be different for different businesses with the same net of tax input and output prices. Hence the subtraction method avoids the problem of missing input tax invoices. This is again no different from any other commodity that has exempt sellers. That is insufficient ground to retain the third method of calculating VAT for just this sector.
3. VAT Taxable Value (Taxable Price)

Article 7 of the VAT law regulates the price on which the output VAT is levied. In general, the transaction value is used and the attempt is to use the actual selling price exclusive of VAT and interest, but including other levies (such as special consumption tax which is an excise tax), in domestic currency as the basis for calculating VAT. The article separately specifies the price in cases of imported goods, goods and services sold by production and trading entities, goods and services used for internal exchanges or consumption, donation and gifts, asset leasing, installment payment methods, out-sourcing of goods, construction and installment, real estate businesses, trading agents and brokers and invoices with the value added tax inclusive prices.

There are two types of amendments proposed to this article (1) to include the “environmental protection tax” in the base for VAT and (2) to delete a section deducting the lease prices paid to the foreign partners in the case where imported machinery that could not be produced at home was leased.

**Comment:** Since import duties are included in taxable value for imported goods as is the special consumption tax (an excise) where applicable, another excise – type tax like the environmental tax should also be included.

Regarding the removal of the a section deducting the lease prices paid to the foreign partners in the case where imported machinery that could not be produced at home was leased – this provision obviously has no place in the law since there is no similar deduction of the price paid in full in the case of import on full payment. If this provision stays it would give a clear incentive to lease rather than purchase such machinery.

4. VAT Deductions

**Issues**

The current Law on VAT defines the general principles on deducting input VAT. However, these principles are quite loose and abused in VAT deduction process. Many businesses purchase items and incur expenses such as telephones for executives and entertainment that benefit employees rather than serve as inputs in production. When these taxable expenditures are incurred in the company’s name, they are able to then avail the input credit through the VAT invoice.

One general principle of input value-added tax credit stated in VAT Law is: “Input value-added tax on goods or services used for the production or trading of goods or services subject to value-added tax may be wholly credited”.

But there is also special regulation stated in the VAT Law: The input value-added tax on fixed assets used for the production and trading of goods or services both subject and not subject to value-added tax may be wholly credited. There is a difference in the treatment of input credit and investment input VAT. The VAT Law has also not specified how to determine creditable input value-added tax amounts in the case when taxpayers have input value-added tax used for the production and trading of goods or services both subject to value added tax and not subject to value-added tax and cannot account for them separately. However such a proviso exists in decrees.
About the time for deduction of input VAT, point d, Clause 1, Article 12 of the Law on VAT defines: Upon determination of the tax payable for a month, input VAT arising during such month shall be declared and credited. Any business establishment which discovers that an amount of input VAT declared and credited was erroneous shall be permitted to conduct a supplementary declaration and amend the declaration within a time-limit of a maximum of six months after the date of discovery of the error.

The current law has a provision that allows taxpayers up to 6 months to file a revised declaration supplementing or correcting the monthly input VAT claim otherwise required. While under claiming input VAT deduction is obviously detrimental to the taxpayer (since the government has already received the input VAT), erroneous over or incorrect claims benefit the taxpayer.

Therefore, the 6 months provision hurts genuine claimants who cannot claim input VAT for any reason within 6 months, while it benefits taxpayers who erroneously claim input credit refunds not due if the mistake is detected by audit within 6 months. In the latter case, they may be able to claim that they would have filed a revised declaration within 6 months and escape penalties.

Recently, there have been many businesses that cannot declare and deduct their input VAT within six months of discovering missing claims or erroneous under-claims that they have due to the following reasons: newly established businesses whose accounting departments are still not well versed in accounting for VAT, changes in personnel, lost records due to relocation, sellers have not issued VAT invoices because they have not collected their payments, etc.

For business goods and services that have been lost without compensation: In the production process, there are risks of losses due to unavoidable reasons such as natural disasters, fires, accidents and destruction of goods for quality reasons (especially food). For these losses, the Law on VAT of 2008 has not specified what can be done about the deduction of input VAT on goods and services that are lost without compensation. Thus, if the input VAT of these lost goods and services is not deductible, business will be in a position where they are unable to recover the VAT paid on lost or destroyed goods. Currently, the Decree 121/ND-CP permits businesses to avail of the input VAT credit on taxable goods and services (inputs) lost or destroyed.

Regarding the phrase “payment via a bank or banking payment”: The Law on VAT 2008 requires a bank payment receipt to deduct input VAT on individual payments over 20 million VND. However, there are many methods of payment through a third party that does not involve a bank or payment in cash, for example payment through credit cards.

To resolve these issues, the following amendments are proposed to article 12 in the draft VAT law:

✓ Including the input value added tax on uncompensated losses of value added taxable goods in deductible input credit.

This is a good idea; to ensure that this provision is not misused by unscrupulous taxpayers by regularly claiming deduction on lost goods without proper evidence (perhaps by buying/forging
VAT invoices), the tax authorities may insist on time bound audit in these cases and maintenance of proper evidence (e.g. insurance documents in case of accidents).

✓ Deleting the provision allowing investment input credit for all capital goods even in cases where some goods produced are taxable and some are not and adding a provision to apportion input credit based on separate accounting for such classes of goods, failing which the input credit is to be apportioned by percentage of turnover of taxable and non-taxable output. These provisions already existed in decrees outside the law.

This is also recommended. It has been stressed in the chapter on refunds that there is no basis for treating VAT on inputs differently from VAT on investment goods. It is also a good idea to introduce a clear and simple rule to apportion credit in cases of taxable and non-taxable goods. The onus is now on the taxpayer to account for input use properly if he feels the ratio is detrimental to him.

✓ Inserts a provision to fully deduct the input value added tax of the goods and services used for oil and gas field exploration and development.

This provision already exists in decrees outside the law. Presumably, this provision means to provide some sort of benefit (a parallel to immediate expensing in the CIT to such companies), and in any case should be allowed.

✓ Replacing the time limit of 6 months to file supplementary declarations in cases of missing or erroneous claims of input VAT credit with the phrase “before the tax authorities make decisions on tax inspection and audit at the headquarters of the taxpayers.” This brings the provision in line with Item 1, Article 38 of the Tax Administration Law. It also allows genuine payments of input credit to be recovered even after 6 months and should also allow erroneous claims discovered during an audit before 6 months to be penalized.

✓ Replaces the term “bank transaction” with “non-cash” where it occurs in this section, thus turning “bank transaction payment” into “non-cash payment”.

This is also recommended since payments can be both non-cash and not made through a bank in modern commerce. The basic purpose of this measure however should be remembered for VAT purposes: to ensure that there is independent third party evidence that the VAT invoice (thus the initial taxable event and payment for input VAT, and subsequently the validity of the input tax credit claim) is genuine. This has actually been done by other, more effective means in some countries such as Korea, where all VAT invoices are issued by the government through software installed on all the registered taxpayers’ cash machines.
Chapter IX: VAT - Revenue

1. Introduction

The value-added tax has increasingly been adopted by countries around the world. Governments in developing countries have replaced turnover taxes, sales taxes, and some excise taxes as well as import duties with the consumption-type VAT. The main argument for doing so is based on the fact that VAT is a stable source of revenue. It allows an efficient tax collection at multiple stages of production and distribution of goods and services, and minimizes the cascading effect from taxes on inputs of businesses which also pay taxes on sales.

There is a considerable uncertainty and concern regarding the impact of a VAT and changes to its structure on revenue collection. Particularly, the input tax credit under the VAT system, while necessary to avoid the tax cascading effect, makes the estimation of the tax base rather complicated. Thus, the estimation of VAT base and potential revenue is of significant importance to policy makers.

The most prevalent VAT system is a consumption-type multi-stage sales tax based on the destination principle. The VAT is typically assessed using the credit-invoice method where each firm charges tax on its sales and receives credits for tax paid on its inputs. The VAT based on the destination principle aims at taxing sales of goods and services for the domestic market, regardless of whether they are produced domestically or abroad. This type of VAT is essentially equivalent to the single-stage domestic retail sales tax on final consumption, but administered differently.

The potential VAT revenue depends on whether it is origin- or destination-based, the method of assessment (credit-invoice or subtraction), the scope of exemptions and zero-rating, the level of tax rates, and the degree of tax compliance. Exemption means no VAT on sales and no credit is provided for the taxes paid on inputs. No VAT also applies on zero rating, but the business receives full credit for the taxes on inputs.

Vietnam has a destination type; consumption based VAT using the credit invoice method for enterprises and has proposed the turnover based presumptive tax on household businesses.

2. Different Methods of Estimating VAT Revenue

Generally, there are three methods that can be used to estimate the VAT base and its corresponding revenues. These methods assume a consumption-type multi-stage VAT based on the destination principle. They also assume a credit-invoice mechanism for assessing the VAT.

✓ Aggregate (National Accounts) Method. The aggregate method follows one of two alternative approaches: (i) production and (ii) consumption. The production method starts with the GDP. To arrive at the value-added included in the VAT base, the GDP needs to be adjusted for imports, zero rating, exemptions, and turnover threshold. Since the VAT is
ultimately paid by consumers, the consumption method starts with final consumption and adjusts for zero-rated and exempt goods and services to estimate the VAT base.

- **Disaggregate Method.** The disaggregate method also could follow production or consumption approach. This method requires detailed breakdown of the National Accounts and Input-Output (I-O) Tables, and also information from other sources, such as household expenditure and industrial surveys to estimate the impact of exemptions and zero rating. The production approach computes the tax base by adding up the value added of each industrial sector in the economy to provide the tax base by sector. The consumption approach uses the final selling price of all goods and services purchased by final consumers and exempt sectors in the economy. This approach would automatically capture the destination principle of the VAT since the value purchased by final consumers excludes exports and includes imports. Moreover, it allows for an analysis of the incidence and price impact of the VAT on consumers.

- **Microsimulation (Tax Returns) Method - VAT returns databases ideally provide detailed information on accrued domestic and import VAT liabilities and credits, as well as actual collections, refund payments, and assessment adjustments. Detailed information on imports, and the duty and VAT charged on these imports, provide a strong starting point for estimating VAT revenues.

For VAT revenue estimation in Vietnam, we have used the production approach and used the aggregate model supplemented partly with available data from the I-O table. Due to incompleteness of data made available to us, the use of the consumption approach was not feasible. Data required for microsimulation models (consolidated VAT returns in electronic format—either a stratified sample or all returns for any recent year) are not available. The I-O table also aggregates categories of government consumption spending and aggregates all capital formation (private, government and change in inventories). This rules out the use of the full disaggregated model as we would require isolation of government expenditure on different goods and services, separation of capital formation into private, government and change in inventories for each sector separately to the extent possible. A brief description of the methodology of the production approach we actually use is as follows.

3. **Production Approach**

For the production approach, the value added of all exempt goods and services and exempt imports must be subtracted from the GDP, while exempt investment expenditures and exempt exports as well as intermediate sales of exempt goods to taxed sectors must be added back to the estimation of the VAT base.

We start with the definition of Gross Domestic Product (GDP) = Consumption (C) + Investment (I) + Government expenditure (G) + Exports (X) – Imports (M), and recognize the both consumption (C) and Investment (I) can be either private or by government. Using subscript (p) for private, we can rewrite GDP = C\_p + I\_p + G + X – M recognizing that G covers all government expenditure including current as well as capital expenditure. In the case of a consumption-type VAT, the base (B) can be estimated by subtracting exports and adding imports to reflect the domestic consumption following the destination principle. The base should also be reduced by the amount of gross fixed capital formation since businesses receive input tax credit for their capital investment. If sales of new houses are subject to VAT,
residential constructions ($I_h$), which is part of the gross fixed capital formation, must be added back to the tax base as consumers cannot claim input tax credits. Since residential construction in the national accounts does not include the land value and Vietnam also does not tax land value under VAT, $I_h$ need not be adjusted.

The total government expenditures ($G$) is equal to expenditures on wages and salaries ($G_w$) plus consumption of final goods and services ($G_c$) purchased from the private sector. $G_w$ is not a part of the base since VAT is not imposed on wages, but the $G_c$ is potentially includable as long as it is not exempt or zero rated. Thus we arrive at the VAT base using the production approach:

$$Base^p = GDP - G_w - VA_{exempt} - I_p + I_h + I_{p, exempt} - X_{exempt} + X - M - M_{exempt} + IS_{exempt, taxed}$$

Where $VA_{exempt}$, $I_{p, exempt}$, $X_{exempt}$, and $M_{exempt}$ denote exempt domestic production (including exempt exports and retail traders), taxed capital formation in exempt sectors, exempt exports, and exempt imports purchased directly by households, government or exempt traders, respectively. $X_{exempt}$ could be exports of exempt goods or exports done by unregistered traders. Investment expenditure of exempt sectors must be added to the VAT base since these sectors do not receive input tax credits. $IS_{exempt, taxed}$ is the total sales value - not the value added - of intermediate sales of exempt goods to the taxed sectors.

The table below provides a detailed framework for making necessary adjustments to GDP to arrive at a tax base of a destination-based, consumption-type VAT implemented with a credit-invoice method using the production approach.

<table>
<thead>
<tr>
<th>Remarks</th>
<th>Likely Data Source</th>
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<tbody>
<tr>
<td><strong>VAT Base</strong></td>
<td></td>
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<tr>
<td>$= GDP$</td>
<td></td>
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<tr>
<td><strong>Adjustment A: Government Expenditure</strong></td>
<td></td>
</tr>
<tr>
<td>Expenditures on Wages and Salaries</td>
<td>Non-taxable expenditure component in NIA.</td>
</tr>
<tr>
<td><strong>Adjustment B: Exempt Sectors</strong></td>
<td></td>
</tr>
<tr>
<td>Value Added of Exempt Domestic Production (at Factor Costs)</td>
<td>E.g., financial services and farmers are typically exempt from VAT; imputed rents of owner-occupied dwellings are not feasible for taxation. Adjustment B does not include exemption threshold adjustment, which is done in Adjustment G.</td>
</tr>
<tr>
<td>Indirect Taxes in Exempt Sectors</td>
<td>This is needed if the national accounts are in producers’ prices.</td>
</tr>
<tr>
<td><strong>Adjustment C: Private Capital Formation</strong></td>
<td></td>
</tr>
<tr>
<td>Gross Domestic Capital Formation</td>
<td>For consumption-type VAT, investments are not subject to tax.</td>
</tr>
<tr>
<td>New Residential Construction, including Land Value (if taxed under VAT)</td>
<td>Sales of new houses, including the land price, are typically subject of VAT. Gross capital formation includes new residential construction, but excludes the land value.</td>
</tr>
<tr>
<td>+ Gross Capital Formation in Exempt Sectors</td>
<td>Input tax on investments in exempt sectors is not creditable.</td>
</tr>
<tr>
<td>− Change in Inventories</td>
<td>VAT is not charged to unsold inventories.</td>
</tr>
</tbody>
</table>

**Adjustment D: Border Tax**
- Exports
- Exports are zero-rated.
- Exports
- No input tax credit is given to exports of exempt commodities.
+ Exports
+ Exports

**Adjustment E: Intermediate Sales (Cascading)**
+ Output of Exempt Sectors Sold to Taxed Sectors
+ Including consumption plus investment goods sales and outputs from businesses below exemption threshold.

**Adjustment F: Final Private Consumption Expenditure**
- Expenditures on Exempt Goods & Services
- E.g., basic food items, health and education services, rents.
+ Taxed Inputs in Exempt Goods & Services
+ Due to cascading.
+ Alternatively the value-added of final traders is removed as exempt sector under B and/or G
+ Foreign Expenditures in Local Markets
- Expenditures Abroad by Residents
- These consumption expenditures should not in the VAT base.

**Adjustment G: Exemption Threshold**
- Value Added of Businesses below Turnover Threshold
- For reducing administrative and compliance costs.

### 4. VAT System Proposed for Vietnam and Parameters for Modeling

In the current study, we have outlined a proposed system for Vietnam in the previous chapters. The salient features of this system are summarized below and contrasted with the system accepted by the National Assembly (NA) after recent amendments. Since the models are based on the proposed system, it is useful to contrast the two approaches before we discuss the impact on revenue.

- A credit invoice based consumption type VAT has been proposed for all enterprises except household businesses (HHBs), with a turnover based threshold. The optimal threshold is normally suggested based on a model for determining that threshold which balances the loss of revenue with the savings in compliance and administrative costs. This exercise is presented at the end of this chapter, while the NA has accepted two thresholds already – (1) 100 million VND below which there will be no requirement to pay VAT (2) 1000 million VND above which there
will be a requirement for all enterprises to maintain accounts, register for an invoice credit system and collect and pay VAT based on the difference between input VAT paid and output VAT liability. Household businesses, it is understood will pay taxes through the presumptive tax unless they register as Enterprises. Since they will then also be liable to pay CIT, it is assumed that they are unlikely to do so unless they lose a lot of VAT input credit. We have thus presented 2 models – one in which our suggestion of a uniform threshold for all businesses is followed and presumptive tax is charged on all businesses between 100 and 1000 million VND and the second where it is assumed that all household businesses pay presumptive tax. We had also recommended a flat presumptive tax on sales at 2-3% while the proposed system retains separate rates for categories of taxpayers. Land value is still not included in the value of the VAT base for construction sales, but is taxed separately under a different tax at a lower rate.

✓ We have proposed a single positive VAT rate of 10% (up to 12% if necessary), on all taxable goods and services not otherwise exempted or zero rated. However, the 5% rate has been retained in the new law. We had also proposed this VAT rate (10%) should be extended to new sales of construction including land value which was not accepted.

✓ We had proposed that all exports should be zero rated and the only exemptions should be on clean water and financial services and all goods and services provided publicly on non-commercial basis. This has been partially done since most financial services are exempted (including on export) and most exports are zero-rated other than some exempt exports. We have taken the category “real estate” to be completely exempt. There are already two categories of “civil construction” and “other construction” and we have taken part of the value of civil construction to be new residential construction taxable under the VAT at 10% excluding land value since land value is not included in the proposed law. A separate category called “real estate services and business” also exists and it has been taken as taxable at 10%. Therefore, since we are not recommending taxation of rents of any kind (as imputed rent of owners is not taxable), in the absence of information on what constitutes “real estate” or “real estate services” which is either consumed by households or is exported, we have treated it as an exempt sector.

✓ Therefore for modeling purposes we have started with the base case of a uniform 10% VAT imposed on credit invoice basis for all activity with turnover above 1000 million VND, a 2.5% turnover tax on all turnover between 100 and 1000 million VND, complete exemption for water and financial services (domestic sales as well as exports) and 50% exemption for sectors such as:

- Health medicine
- Health instrument and apparatus
- Products of printing activities
- Products of publishing house
- Science and technology
- Education and training
- Health care, social relief
- Culture and sport
- Association
- Other services

Association and other services are undefined. For the others it is expected that the government is the producer of at least half of the value. These assumptions can of course be refined when more accurate information is available than at present. The ratio of exemption and the choice of fully or partially exempt sectors can be varied in the model.

To take care of the taxation of HHBs under the presumptive system the next variation we have introduced is to model the same system as in the baseline case with 90% of the base where the 10% represents household businesses that are taxed on turnover. The 10% was arbitrarily chosen due to lack of information on the output of these firms and could also be modified. A sensitivity analysis can be done on this presumed share of household businesses once we have more information. We separately model the output under thresholds as enterprises between the upper and lower thresholds in both the baseline model as well as the model with HHBs removed.

5. Modeling Steps

The basis for the model was the last available Input Output table of 2005 that was available. This model listed GDP by production approach as VND million 839,310,059 and GDP by expenditure approach as 839,310,061 million VND at producers prices in 2005. An estimate for the 2010 figure for GDP was found to be 1,980,914,000 million VND and was used to age the table to 2010. Further, for the presumptive tax model we needed to subtract the output of the 5 largest firms in each sector to estimate the output above and below the proposed thresholds. Since this data (extracted from 2010 enterprise survey) was available to us with a modified set of sectors (based on industrial classification 2007 codes), we had to further collapse the aged I-O table to match the output data for large enterprises from the 2010 enterprise survey. This inflated and collapsed I-O table for 2010 served as the basis for simulations. The results for the baseline case where all output is taxed at 10% except zero rated exports and exemptions listed above are reported in the table next page.

Since change in inventories is not available, only positive GFCF of 3,624,203 is added as GFCF in exempt sectors and the negative figure of 8,094,097 is not used. The VAT/GDP ratio in 2011 is around 7.8% for Vietnam. Given that there are 2 rates of 5% and 10% (and the total rate is a weighted average of the two) the C-efficiency ratio for Vietnam in the same year has been calculated at 1.09 (IMF 2012). This implies that Vietnam raises at least 10% more revenue than is implied by applying the weighted average tax rate to all consumption. Normally, the difference between the tax rate applied to the calculated base and actual revenues is taken as a measure of the compliance rate. In this case, adding 10% of the calculated VAT to the estimate (as implied by a C-efficiency ratio of almost 110%) would also give us the actual revenue in 2010. This can be explained in two ways: (1) the I-O table figures are not reliable and are a serious underestimate of GDP; (2) due to the numerous exemptions, collection of VAT by the subtraction method and turnover taxes etc., Vietnam collects more VAT than is warranted by the level of consumption. The answer is that both are probably true, and has also been suggested in an earlier report (Haughton, 2012).
### Base Line Case

<table>
<thead>
<tr>
<th>Remarks</th>
<th>Value Added of Domestic Production (at Factor Costs)</th>
<th>Commodity produced</th>
<th>Remarks</th>
</tr>
</thead>
<tbody>
<tr>
<td>Remarks</td>
<td>Expenditures on Wages and Salaries</td>
<td>Non-taxable expenditure component in NIA</td>
<td>(58,511,087)</td>
</tr>
<tr>
<td>Remarks</td>
<td>Value Added of Exempt Domestic Production</td>
<td>E.g., financial services and farmers are typically exempt from VAT, imputed rents of owner-occupied dwellings are not feasible for taxation. Adjustment B does not include exemption threshold adjustment, which is done in Adjustment G.</td>
<td>(159,013,726)</td>
</tr>
<tr>
<td>Remarks</td>
<td>Indirect Taxes in Exempt Sectors</td>
<td>This is needed if the national accounts are in producers' prices.</td>
<td></td>
</tr>
<tr>
<td>Remarks</td>
<td>Gross Domestic Capital Formation</td>
<td>For consumption-type VAT, investments are not subject to tax.</td>
<td>(697,820,170)</td>
</tr>
<tr>
<td>Remarks</td>
<td>New Residential Construction, EXCLUDING Land Value</td>
<td>Sales of new houses, including the land price, are typically subject of VAT. Gross capital formation includes new residential construction, but excludes the land value.</td>
<td>155,469,146</td>
</tr>
<tr>
<td>Remarks</td>
<td>Gross Capital Formation in Exempt Sectors</td>
<td>Input tax on investments in exempt sectors is not creditable.</td>
<td>(8,094,947)</td>
</tr>
<tr>
<td>Remarks</td>
<td>Change in Inventories</td>
<td>VAT is not charged to unsold inventories.</td>
<td>3,624,203</td>
</tr>
<tr>
<td>Remarks</td>
<td>Expenditures on Exempt Goods &amp; Services</td>
<td>E.g., basic food items, health and education services, rents.</td>
<td></td>
</tr>
<tr>
<td>Remarks</td>
<td>Exports</td>
<td>No input tax credit is given to exports of exempt commodities.</td>
<td>(1,351,090,940)</td>
</tr>
<tr>
<td>Remarks</td>
<td>Exempt Exports</td>
<td>Exempt imports are not taxed at the border. Exempt imports by VAT registered traders have no impact on final VAT base</td>
<td>(48,553,413)</td>
</tr>
<tr>
<td>Remarks</td>
<td>Imports</td>
<td></td>
<td>1,498,341,484</td>
</tr>
<tr>
<td>Remarks</td>
<td>Exempt Imports by households, government or exempt traders</td>
<td></td>
<td>(7,491,074)</td>
</tr>
<tr>
<td>Remarks</td>
<td>Output of Exempt Sectors Sold to Taxed Sectors</td>
<td>Including consumption plus investment goods sales and outputs from businesses below exemption threshold.</td>
<td>61,858,123</td>
</tr>
<tr>
<td>Remarks</td>
<td>Expenditures on Exempt Goods &amp; Services</td>
<td>Alternatively the value-added of final traders is removed as exempt sector under B and/or G. This only applies if foreigners are not allowed to claim tax refunds.</td>
<td></td>
</tr>
<tr>
<td>Remarks</td>
<td>Expenditures Abroad by Residents</td>
<td>These consumption expenditures should not be in the VAT base.</td>
<td></td>
</tr>
<tr>
<td>Remarks</td>
<td>Value Added of Businesses below Turnover Threshold</td>
<td>For reducing administrative and compliance costs.</td>
<td>(5996190)</td>
</tr>
</tbody>
</table>

**BASE**

<table>
<thead>
<tr>
<th>Remarks</th>
<th>Value Added of Domestic Production (at Factor Costs)</th>
<th>Commodity produced</th>
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<td>Remarks</td>
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</tr>
</tbody>
</table>

**EXCLUDING TURNOVER TAX**

<table>
<thead>
<tr>
<th>Remarks</th>
<th>Value Added of Domestic Production (at Factor Costs)</th>
<th>Commodity produced</th>
<th>Remarks</th>
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<td></td>
</tr>
<tr>
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</tr>
<tr>
<td>Remarks</td>
<td>Imports</td>
<td></td>
<td>1,498,341,484</td>
</tr>
<tr>
<td>Remarks</td>
<td>Exempt Imports by households, government or exempt traders</td>
<td></td>
<td>(7,491,074)</td>
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</tr>
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<td>Remarks</td>
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<td></td>
</tr>
<tr>
<td>Remarks</td>
<td>Expenditures Abroad by Residents</td>
<td>These consumption expenditures should not be in the VAT base.</td>
<td></td>
</tr>
<tr>
<td>Remarks</td>
<td>Value Added of Businesses below Turnover Threshold</td>
<td>For reducing administrative and compliance costs.</td>
<td>(5996190)</td>
</tr>
</tbody>
</table>
The next form of simulation is to try and incorporate the choice made by the NA to keep household businesses regardless of size out of the purview of the invoice credit system and tax them on a presumptive basis on turnover. This poses two sets of issues: (1) what is the total turnover of these units for the purpose of the presumptive tax; and (2) how does removal of these firms from the invoice credit system affect the I-O table itself – in terms of both inputs and outputs. It is obvious that this requires sector by sector information on both the outputs of household businesses as well as their inputs. Such information was not available and we had to proceed on the basis of an overall assumption. To continue the modeling process we assumed that 10% of all value added was accounted for by household enterprises that will remain out of the credit invoice system and be taxed on turnover. This ratio was also assumed to be uniform across all sectors to begin with in the absence of any other information. The I-O table was then reduced on both the input as well as the output side by a uniform 10%. These assumptions can of course be modified with better information – not only can the 10% ratio be changed; we can also change the uniform 10% assumption. A sensitivity analysis on this model can provide VAT revenues for different assumptions.

Next, the reduced I-O table with 90% was used to repeat the estimation procedure above. The difference in the total output of the two I-O tables for each column was added to the turnover to be taxed on a presumptive basis. This provides an estimate of what would happen if we continue with the ideal system proposed and then introduce modifications proposed by the NA. To repeat, the rate of adjustment for the output of HHBs, the exempt sectors, proportions for partially exempt sectors, and the rates of presumptive taxation can all be varied in this model with better information. The results presented here are valid for the assumptions we have made at present.

A further note of caution is warranted about the threshold modeling that determines the value added of output below the threshold (deducted from the base in adjustment of $G$). The data used for this adjustment is from the Enterprise survey and does not include HHBs. This means that the number of firms is undercounted and that average output of firms is overstated after the top 5 enterprises are removed. This reduced the value added below the threshold and thus overstates the VAT base in the baseline case. It however does not do so in the simulation case since HHBs are not included. To maintain consistency the first two tables - the baseline case and first simulation with no HHBs have been calculated using the threshold model and the Enterprise data for the baseline case only, and the simulation takes value added under threshold at 90% of the baseline case and calculates the presumptive tax using a similar procedure for turnover in addition to the difference in gross output from the two models. Another table is presented (the second simulation) that uses the threshold model in the reduced I-O table since it is correct to use number of enterprises when we have removed the output attributed to HHBs.
### Simulation 1 - Below Threshold Taken as 90% of Baseline Case and Reduced I-O Table

#### VAT Base

<table>
<thead>
<tr>
<th>Remarks</th>
<th>Value</th>
</tr>
</thead>
<tbody>
<tr>
<td>Sum of all value added of domestic production.</td>
<td>1,782,822,595</td>
</tr>
</tbody>
</table>

#### Adjustment A: Government Expenditure

<table>
<thead>
<tr>
<th>Remarks</th>
<th>Value</th>
</tr>
</thead>
<tbody>
<tr>
<td>Non-taxable expenditure component in NIA.</td>
<td>(43,658,691)</td>
</tr>
</tbody>
</table>

#### Adjustment B: Exempt Sectors

<table>
<thead>
<tr>
<th>Remarks</th>
<th>Value</th>
</tr>
</thead>
<tbody>
<tr>
<td>E.g., financial services and farmers are typically exempt from VAT; imputed rents of owner-occupied dwellings are not feasible for taxation. Adjustment B does not include exemption-threshold adjustment, which is done in Adjustment G.</td>
<td>(143,112,353)</td>
</tr>
</tbody>
</table>

#### Adjustment C: Private Capital Formation

<table>
<thead>
<tr>
<th>Remarks</th>
<th>Value</th>
</tr>
</thead>
<tbody>
<tr>
<td>For consumption-type VAT, investments are not subject to tax.</td>
<td>(628,038,153)</td>
</tr>
<tr>
<td>Input tax on investments in exempt sectors is not creditable.</td>
<td>(7,285,452)</td>
</tr>
</tbody>
</table>

#### Adjustment D: Border Tax

<table>
<thead>
<tr>
<th>Remarks</th>
<th>Value</th>
</tr>
</thead>
<tbody>
<tr>
<td>For destination-based VAT.</td>
<td>(1,215,981,846)</td>
</tr>
</tbody>
</table>

#### Adjustment E: Intermediate Sales (Cascading)

<table>
<thead>
<tr>
<th>Remarks</th>
<th>Value</th>
</tr>
</thead>
<tbody>
<tr>
<td>Including consumption plus investment goods sales and outputs from businesses below exemption threshold.</td>
<td>55,672,311</td>
</tr>
</tbody>
</table>

#### Adjustment F: Final Private Consumption Expenditure

<table>
<thead>
<tr>
<th>Remarks</th>
<th>Value</th>
</tr>
</thead>
<tbody>
<tr>
<td>E.g., basic food items, health and education services, etc. Due to cascading.</td>
<td>(1,125,981,846)</td>
</tr>
<tr>
<td>Alternatively the value-added of final traders is removed as exempt sector under B and/or G.</td>
<td>134,850,733</td>
</tr>
</tbody>
</table>

#### Adjustment G: Exemption Threshold

<table>
<thead>
<tr>
<th>Remarks</th>
<th>Value</th>
</tr>
</thead>
<tbody>
<tr>
<td>For reducing administrative and compliance costs.</td>
<td>(5,396,571)</td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th>Remarks</th>
<th>Value</th>
</tr>
</thead>
<tbody>
<tr>
<td>BASE</td>
<td>1,270,271,345</td>
</tr>
<tr>
<td>VAT @ 10%</td>
<td>127,027,134</td>
</tr>
<tr>
<td>TURNOVER TAX</td>
<td>10,691,531</td>
</tr>
<tr>
<td>ACTUAL VAT IN 2010</td>
<td>155,022,000</td>
</tr>
</tbody>
</table>

| TOTAL PREDICTED VAT | 137,718,665 |
Another note of caution is posed with respect to producers prices. The I-O table of 2005 is available at producer’s prices and these do not include wholesale and retail margins that are normally taxable. Had we been estimating the base from the consumption side directly using the actual I-O table of 2010 we would have had to make an adjustment for wholesale and retail margins. We have not done so for two reasons in the inflated table:

(1) The GDP figure used to inflate the 2005 I-O table is not assumed to be at producer prices and thus would have taken care of this adjustment since the adjustment factor would be higher than in the case 2010 GDP was at producer’s prices as well.

(2) It is not clear whether the category “trade” includes undistributed wholesale and retail margins. Since we are using gross value added to estimate the base, and the Gross Value Added (GVA) of the sector “trade” is also included, adding trade margins again would be double counting if this category already includes undistributed retail and wholesale margins. However this is unspecified and if the I-O table is at producer’s prices, pure wholesale and retail margins should not have been included in other columns since the trade column is not zero. When the trade column is at zero, the table is taken to be at purchaser’s prices. Moreover, under the household consumption column, the 2010 table shows household consumption of “trade” of 66,890,846 VND and this should indeed be the relevant trade margins that are undistributed, but recorded as a separate activity.

The last simulation model is presented on the next page that differs in only one way from the first simulation model on the previous page. The threshold model is applied to the reduced I-O table to determine the presumptive tax as well as value added of below threshold business. Since the reduced I-O table already excludes the output of HHBs, it is correct to estimate turnover above threshold by using the number of firms from the enterprise survey since only enterprises should be left. This second simulation repeats the procedure in the baseline case for estimating both the presumptive tax as well as the value added of firms below the threshold. Since the number of firms is underestimated in the baseline case (as HHBs are not recorded) the average output in the baseline case is inflated using this procedure. This is corrected in the second simulation and the average turnover falls, and the value added below threshold as well as the presumptive tax increases. However, the differences in total revenue between the three tables are negligible and so are the differences between the two simulations.
Simulation 2 – Below Threshold Calculated Using Threshold Model as in The Baseline Case

<table>
<thead>
<tr>
<th>Remarks</th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>VAT Base</strong></td>
<td>Sum of all value added of domestic production.</td>
</tr>
<tr>
<td>= GDP</td>
<td>1,782,822,595</td>
</tr>
<tr>
<td><strong>Adjustment A: Government Expenditure</strong></td>
<td></td>
</tr>
<tr>
<td>− Expenditures on Wages and Salaries</td>
<td>Non-taxable expenditure component in NIA.</td>
</tr>
<tr>
<td></td>
<td>(43,658,691)</td>
</tr>
<tr>
<td><strong>Adjustment B: Exempt Sectors</strong></td>
<td></td>
</tr>
<tr>
<td>− Value Added of Exempt Domestic Production (at Factor Costs)</td>
<td>E.g., financial services and farmers are typically exempt from VAT. Imputed rents of owner-occupied dwellings are not taxable for taxation. Adjustment B does not include exemption threshold adjustment, which is done in Adjustment G.</td>
</tr>
<tr>
<td></td>
<td>(143,112,353)</td>
</tr>
<tr>
<td>− Indirect Taxes in Exempt Sectors</td>
<td>This is needed if the national accounts are in producers’ prices.</td>
</tr>
<tr>
<td><strong>Adjustment C: Private Capital Formation</strong></td>
<td></td>
</tr>
<tr>
<td>− Gross Domestic Capital Formation</td>
<td>For consumption-type VAT, investments are not subject to tax.</td>
</tr>
<tr>
<td>+ New Residential Construction, EXCLUDING Land Value</td>
<td>Sales of new houses, including the land price, are typically subject to VAT. Gross capital formation includes new residential construction, but excludes the land value.</td>
</tr>
<tr>
<td></td>
<td>139,922,231</td>
</tr>
<tr>
<td>+ Gross Capital Formation in Exempt Sectors</td>
<td>Input tax on investments in exempt sectors is not creditable.</td>
</tr>
<tr>
<td></td>
<td>(7,285,452)</td>
</tr>
<tr>
<td>− Change in Inventories</td>
<td>VAT is not charged to unsold inventories.</td>
</tr>
<tr>
<td></td>
<td>3,261,783</td>
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<tr>
<td><strong>Adjustment D: Border Tax</strong></td>
<td>For destination-based VAT.</td>
</tr>
<tr>
<td>− Exports</td>
<td>Exports are zero-rated.</td>
</tr>
<tr>
<td>+ Exempt Exports</td>
<td>No input tax credit is given to exports of exempt commodities.</td>
</tr>
<tr>
<td>+ Imports</td>
<td>Exempt imports by VAT registered traders have no impact on final VAT base.</td>
</tr>
<tr>
<td>− Exempt Imports by households, government or exempt traders</td>
<td>(67,425,367)</td>
</tr>
<tr>
<td><strong>Adjustment E: Intermediate Sales (Cascading)</strong></td>
<td>Including consumption of investment goods sales and outputs from businesses below exemption threshold.</td>
</tr>
<tr>
<td>+ Output of Exempt Sectors Sold to Taxed Sectors</td>
<td>55,672,311</td>
</tr>
<tr>
<td><strong>Adjustment F: Final Private Consumption Expenditure</strong></td>
<td>E.g., basic food items, health and education services, rents.</td>
</tr>
<tr>
<td>− Expenditures on Exempt Goods &amp; Services</td>
<td>Due to cascading.</td>
</tr>
<tr>
<td>+ Taxed Inputs in Exempt Goods &amp; Services</td>
<td>Alternatively, the value-added of final traders is removed as exempt sector under B and/or G.</td>
</tr>
<tr>
<td>+ Foreign Expenditures in Local Markets</td>
<td>This adjustment only applies if foreigners are not allowed to claim tax refunds.</td>
</tr>
<tr>
<td>− Expenditures Abroad by Residents</td>
<td>Those consumption expenditures should not be in the VAT base.</td>
</tr>
<tr>
<td><strong>Adjustment G: Exemption Threshold</strong></td>
<td>For reducing administrative and compliance costs.</td>
</tr>
<tr>
<td>− Value Added of Businesses below Turnover Threshold</td>
<td>(7,234,246)</td>
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<th>Remarks</th>
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<tr>
<td>BASE</td>
<td>1,268,433,670</td>
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<tr>
<td>VAT @ 10%</td>
<td>126,843,367</td>
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<tr>
<td>TURNOVER TAX</td>
<td>10,784,717</td>
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<td>ACTUAL VAT IN 2010</td>
<td>155,022,000</td>
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<tr>
<td>TOTAL PREDICTED VAT</td>
<td>137,628,084</td>
</tr>
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6. Comparative Results and Some Issues

Comparing the two sets of results (the baseline case with HHBs included with the same models but excluding HHBs) shows that the effect on revenue is negligible, a small fall from 140.3 million VND to approximately 137.7 to 137.6 trillion VND in both simulations. This is achieved using a uniform rate of turnover taxation at 2.5% and can be easily varied, as can the proportion of value added of HHBs and other details in the estimation based on more accurate information.

One other issue that requires highlighting is that the turnover information from the 2010 Enterprise survey does not match the I-O table in many cases. This is to be expected in some cases since the 2005 table was aged using a uniform rate in the absence of information on sector by sector changes and some sectors may have actually grown faster than others. However a bigger issue is that for several sectors the turnover of the top 5 enterprises was actually larger than total output from the aged table. This implies negative output for remaining firms and those sectors have to be dropped from the analysis. This further implies that the presumptive tax base is underestimated in the base case and the proportion of value added deductible from the base attributable to small firms and potentially in the simulations as well. This cannot be corrected unless we have an I-O table for 2010 that is consistent with the Enterprise survey data of the same year.

Another issue is the choice of threshold. At present, we have taken the thresholds approved by the NA in the draft law. As we have highlighted in previous chapters, this is not the optimal procedure. The threshold should be chosen to balance the losses and gains from introducing a turnover based threshold and we shall examine this issue in more detail in the next section.

7. Choice of Threshold

Generally the optimal threshold $Z$ is calculated as:

$$
Z = \frac{\delta A + C}{\nu \tau (\delta - 1)}
$$

Where:

- Administrative cost per year = $A$
- Compliance cost per year = $C$
- Marginal economic cost of revenues or public funds = $\delta$
- "Value added" (taxed output value-taxed input value) as a share of turnover = $\nu$; Tax rate = $\tau$
- Threshold annual turnover = $z$

We have the following information:

$$
V = (1-0.467105269)
$$
\[ \tau = 10\% \]

\[ C = 1030 \text{ hours of staff time per year} \text{ (Coolidge, 2012)} \]

\[ A = \text{taken at 2 million VND per SME based on GDT salaries on SME staff (2010) divided by estimated 800,000 SMEs including household enterprises} \]

\[ \delta = 1.25 \text{ (range 1.33) as recommended by White House for US projects} \]

The compliance cost is an assumption, as are some aspects of administrative costs. The compliance cost could be accurate for large firms but is unlikely to be accurate for small and medium enterprises. Assuming that the wage for accountants and those who can manage taxes is at least 2 times the official minimum wage (2,350,000/month) on an hourly basis (divided by 160 hours for a month gives around 14,687 an hour), the total compliance cost (1030*14687*2) is over 30 million VND which small and medium enterprises (SMEs) obviously cannot spend on just complying with taxes. Using administrative costs equal to compliance costs and a wage rate higher than minimum wage that still gives a reasonable total spending on compliance to account for non-labor costs would need to adjust downward the number of hours required for SMEs to comply with taxes.

Without more accurate information on compliance costs and administrative costs we cannot get more accurate results. For simulation purposes, it is possible to forecast the revenue under various different threshold scenarios by substituting the different thresholds in both models above. This exercise is not attempted here until a more firm range of possibilities for thresholds is decided based on complete information; otherwise it would amount to little more than an academic exercise.

Taking a more reasonable assumption of average compliance cost at 10 million VND and administrative cost at 2 million VND each for SMEs (which is still quite high for micro businesses) we get an optimal threshold at \[ Z = (1.25*2000000 + 1000000)/(0.533*0.1*0.25) = 938,086,304 \text{ VND} \] which is just a little lower than the 1000 million accepted by the NA. Therefore, no adjustment is proposed to the thresholds proposed by the NA at present in the absence of more firm information on compliance and administrative costs for SMEs.
Chapter X: International Experience on Value Added Tax

1. Overall Assessment of VAT Design and Revenue Performance from International Perspective

A comparative picture of VAT regimes in the OECD and selected Asian countries is presented in Tables 11.1, 11.2, 11.3 and 11.4 below. The picture in OECD countries emerging from tables 11.2-11.4 is quite diverse. The standard VAT rates in some countries like Denmark, Poland, Hungary, and the U.K. are as high as 25, 23, 27 and 20 percent respectively. Other countries like Australia and New Zealand have moderate rates of 10 and 15 percent respectively. On the other hand, countries like Canada and Japan have comparatively low tax rates at 5 percent. It may be noted, however, that the rate in Canada is low because the country has a dual VAT and provinces apply their own General Sales Tax and VAT. Similarly the threshold varies from a low of US$6,339 in Denmark to a high of US$93,566 in Japan. The contribution of VAT revenue also varies considerably from as low as 2.6 percent of GDP in Japan to as high as 10.1 percent in Denmark.

It is clear from table 6 that the standard tax rates in Asian countries are more moderate at around 10 percent. While the Philippines has a low threshold of US$34,407, Indonesia has a comparatively high threshold of US$64,018. In 2011, the contribution of VAT to revenues is around 3 to 4 percent of GDP in most of these countries with the exception of Vietnam (7.7%) and China (9.4% in 2010). While the VAT system and its performance in Vietnam may look very different from most of the OECD countries, it compares well with the Asian countries.

In order to assess the VAT efficiency, two efficiency ratios are generally used: production efficiency ratio and consumption efficiency or C-efficiency ratio. The production efficiency ratio of VAT is measured by the ratio of VAT revenues to GDP divided by the standard VAT rate expressed as a percentage. A low ratio indicates erosion of the tax base due to poor tax policy such as zero-rating and reduced rates or poor enforcement of the law. Consumption efficiency or C-efficiency ratio is a similar measure where the share of VAT revenue as a percentage of consumption divided by the standard rate is estimated. If a uniform consumption tax is imposed on all consumption, its efficiency will be 100 percent. Zero-rating of some items will reduce the ratio below 100 and taxation of investment goods will raise it to more than 100 percent. Alternatively, a high C-efficiency could be an indicator of multiple breaks in the VAT chain due to excessive exemptions resulting in taxation of both the final consumption and some of the constituent intermediate goods. Both these ratios show the same thing but one is normalized with reference to an income-type VAT while the other is to a consumption-type VAT.

Clearly the three factors that would determine the revenue productivity of VAT in a country are: (a) The rules that prescribe the rates, the base, the threshold and other issues related to tax structure; (b) The scale of taxable consumption in the economy that is, the final expenditure made by the consumers on taxable items; and (c) The effectiveness of the tax administration and the level of compliance. Since VAT on tradable goods are collected by the customs department, the third factor related to tax administration would also depend to some extent on the share of trade in the economy that is, the trade/GDP ratio, because it is easy to collect VAT on the imports.
Table 6: VAT, Corporate, and Individual Income Tax Rates for Selected Asia and Pacific Countries, 2012

(In percent)

<table>
<thead>
<tr>
<th>Country</th>
<th>GDP per Capita 2012 (US dollars)</th>
<th>VAT Thresholds (US dollars)</th>
<th>VAT Rates</th>
</tr>
</thead>
<tbody>
<tr>
<td>Vietnam</td>
<td>1498</td>
<td>....</td>
<td>10</td>
</tr>
<tr>
<td>Bangladesh</td>
<td>701</td>
<td>73153</td>
<td>15</td>
</tr>
<tr>
<td>Bhutan</td>
<td>2285</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Cambodia</td>
<td>931</td>
<td>30948</td>
<td>10</td>
</tr>
<tr>
<td>China, P.R.: Mainland</td>
<td>5899</td>
<td>0</td>
<td>17</td>
</tr>
<tr>
<td>India</td>
<td>1455</td>
<td>9963</td>
<td>10</td>
</tr>
<tr>
<td>Indonesia</td>
<td>3797</td>
<td>64018</td>
<td>10</td>
</tr>
<tr>
<td>Lao People's Dem. Rep</td>
<td>1338</td>
<td>49181</td>
<td>10</td>
</tr>
<tr>
<td>Malaysia</td>
<td>10467</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Nepal</td>
<td>624</td>
<td>24938</td>
<td>13</td>
</tr>
<tr>
<td>Pakistan</td>
<td>1305</td>
<td>55807</td>
<td>16</td>
</tr>
<tr>
<td>Philippines</td>
<td>2329</td>
<td>34407</td>
<td>12</td>
</tr>
<tr>
<td>Sri Lanka</td>
<td>3139</td>
<td>19854</td>
<td>15</td>
</tr>
<tr>
<td>Thailand</td>
<td>5851</td>
<td>59150</td>
<td>7</td>
</tr>
</tbody>
</table>

Unweighted Average

<table>
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<tr>
<th>GDP per Capita 2012 (US dollars)</th>
<th>VAT Thresholds (US dollars)</th>
<th>VAT Rates</th>
</tr>
</thead>
<tbody>
<tr>
<td>2973</td>
<td>....</td>
<td>12.1</td>
</tr>
</tbody>
</table>

Unweighted Average (Excluding Vietnam)

<table>
<thead>
<tr>
<th>GDP per Capita 2012 (US dollars)</th>
<th>VAT Thresholds (US dollars)</th>
<th>VAT Rates</th>
</tr>
</thead>
<tbody>
<tr>
<td>3086</td>
<td>38311</td>
<td>12.3</td>
</tr>
</tbody>
</table>

Source: IMF.
### Table 7: (Table 3.5 of OECD Consumption Tax Trends, 2012) VAT as % Age of GDP in OECD

**Consumption Tax Trends 2012 - © OECD 2012**

Chapter 3 of OECD Consumption Tax Trends 2012 Report
Version 1 - Last updated: 05-Oct-2012

**Value Added Taxes (5111) as Percentage of GDP\(^1\)**

<table>
<thead>
<tr>
<th></th>
<th></th>
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<th></th>
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<th></th>
<th></th>
<th></th>
<th></th>
<th></th>
<th></th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td>Australia</td>
<td>0.0</td>
<td>0.0</td>
<td>0.0</td>
<td>0.0</td>
<td>0.0</td>
<td>3.4</td>
<td>3.9</td>
<td>3.8</td>
<td>3.7</td>
<td>3.4</td>
<td>3.6</td>
<td>0.3</td>
</tr>
<tr>
<td>Austria(^2)</td>
<td>0.0</td>
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<td>..</td>
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<td>6.9</td>
<td>7.6</td>
<td>8.0</td>
<td>8.2</td>
<td>7.9</td>
<td>7.3</td>
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<td>8.4</td>
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<td>6.7</td>
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<td>8.7</td>
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<td>8.4</td>
<td>8.5</td>
<td>8.4</td>
<td>-0.3</td>
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<td>0.0</td>
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<td>5.1</td>
<td>6.0</td>
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<td>9.3</td>
<td>9.7</td>
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<td>0.0</td>
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<td>3.9</td>
<td>3.9</td>
<td>3.7</td>
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<td>3.7</td>
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<td>2.7</td>
<td>4.1</td>
<td>5.8</td>
<td>5.3</td>
<td>5.5</td>
<td>5.1</td>
<td>4.9</td>
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<td>-----</td>
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<td></td>
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<td>United Kingdom</td>
<td>0.0</td>
<td>3.1</td>
<td>5.9</td>
<td>6.0</td>
<td>6.5</td>
<td>6.6</td>
<td>6.7</td>
<td>6.6</td>
<td>6.6</td>
<td>6.4</td>
<td>5.7</td>
<td>-0.9</td>
</tr>
<tr>
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<td>0.0</td>
<td>0.0</td>
<td>0.0</td>
<td>0.0</td>
<td>0.0</td>
<td>0.0</td>
<td>0.0</td>
<td>0.0</td>
<td>0.0</td>
<td>0.0</td>
<td>0.0</td>
</tr>
</tbody>
</table>

**Unweighted average**:  
OECD Total | 0.6 | 2.7 | 3.8 | 5.3 | 5.7 | 6.6 | 6.8 | 6.7 | 6.7 | 6.6 | 6.4 | -0.2

*Source: OECD Revenue Statistics 1965 - 2010.*

**Notes to Tables 11.2**

1. **Nomenclature.** The tables are based on a common nomenclature for all OECD countries. Heading 5110 (General taxes on goods and services) is used for Tables 3.1 and 3.2. It includes VAT, sales taxes and other general taxes on goods and services. Heading 5120 (Taxes on specific goods and services) consists primarily of excise taxes, but also includes certain specific taxes such as customs duties and taxes on insurance and certain financial operations in particular. Heading 5111 Value added taxes is used for tables 3.5 and 3.6. It includes all consumption taxes charged on value-added, irrespective of the method of deduction of input tax and the stages at which the taxes are levied. In some countries the heading may include some taxes on financial and insurance activities.

2. **Capital transfer.** The total tax revenues have been reduced by the amount of capital transfer. The capital transfer has been allocated between tax headings in proportion to the report tax revenue.

3. **Averages.** All member counties are taken into account for the calculation of the un-weighted averages, including countries that had not implemented the relevant taxes for the year considered. They are counted with a value of zero in the numerator and 1 in the denominator. However, countries that did not exist at the time considered (Czech and Slovak Republics before 1993; Slovenia before 1991) are not included in the calculation of the averages. Are also excluded from the calculation of the averages the countries for which no data is available for the time considered (Chile before 1990; Hungary before 1995; Israel before 1995, Korea before 1975; Mexico before 1980; Poland before 1995; and Slovak Republic before 2000).

4. **Israel.** The statistical data for Israel are supplied by and under the responsibility of the relevant Israeli authorities. The use of such data by the OECD is without prejudice to the status of the Golan Heights, East Jerusalem and Israeli settlements in the West Bank under the terms of international law.
Table 8: (Table 3.8 of OECD Consumption Tax Trends 2012) VAT/GST Rates in OECD
### Table 3.8. VAT/GST rates

<table>
<thead>
<tr>
<th>Implemented</th>
<th>Standard rate</th>
<th>Reduced rates</th>
<th>Specific regional rates</th>
</tr>
</thead>
<tbody>
<tr>
<td>Australia</td>
<td>2000</td>
<td>-</td>
<td>-</td>
</tr>
<tr>
<td>Austria</td>
<td>1973</td>
<td>18.0</td>
<td>18.0</td>
</tr>
<tr>
<td>Belgium</td>
<td>1971</td>
<td>18.0</td>
<td>16.0</td>
</tr>
<tr>
<td>Canada</td>
<td>1991</td>
<td>-</td>
<td>-</td>
</tr>
<tr>
<td>Chile</td>
<td>1975</td>
<td>20.0</td>
<td>20.0</td>
</tr>
<tr>
<td>Czech Republic</td>
<td>1993</td>
<td>-</td>
<td>-</td>
</tr>
<tr>
<td>Denmark</td>
<td>1967</td>
<td>15.0</td>
<td>22.0</td>
</tr>
<tr>
<td>Estonia</td>
<td>1991</td>
<td>-</td>
<td>-</td>
</tr>
<tr>
<td>Finland</td>
<td>1994</td>
<td>-</td>
<td>-</td>
</tr>
<tr>
<td>France</td>
<td>1968</td>
<td>20.0</td>
<td>17.6</td>
</tr>
<tr>
<td>Germany</td>
<td>1968</td>
<td>11.0</td>
<td>13.0</td>
</tr>
<tr>
<td>Greece</td>
<td>1987</td>
<td>-</td>
<td>-</td>
</tr>
<tr>
<td>Hungary</td>
<td>1988</td>
<td>-</td>
<td>-</td>
</tr>
<tr>
<td>Iceland</td>
<td>1990</td>
<td>-</td>
<td>-</td>
</tr>
<tr>
<td>Ireland</td>
<td>1972</td>
<td>20.0</td>
<td>25.0</td>
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<td>Israel</td>
<td>1976</td>
<td>8.0</td>
<td>12.0</td>
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<tr>
<td>Italy</td>
<td>1973</td>
<td>12.0</td>
<td>15.0</td>
</tr>
<tr>
<td>Japan</td>
<td>1989</td>
<td>-</td>
<td>-</td>
</tr>
<tr>
<td>Korea</td>
<td>1997</td>
<td>-</td>
<td>10.0</td>
</tr>
<tr>
<td>Luxembourg</td>
<td>1970</td>
<td>10.0</td>
<td>10.0</td>
</tr>
<tr>
<td>Mexico</td>
<td>1980</td>
<td>-</td>
<td>10.0</td>
</tr>
<tr>
<td>Netherlands</td>
<td>1969</td>
<td>18.0</td>
<td>18.0</td>
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<tr>
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<td>1986</td>
<td>-</td>
<td>-</td>
</tr>
<tr>
<td>Norway</td>
<td>1970</td>
<td>20.0</td>
<td>20.0</td>
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<td>Poland</td>
<td>1993</td>
<td>-</td>
<td>-</td>
</tr>
<tr>
<td>Portugal</td>
<td>1986</td>
<td>-</td>
<td>16.0</td>
</tr>
<tr>
<td>Slovak Republic</td>
<td>1993</td>
<td>-</td>
<td>-</td>
</tr>
<tr>
<td>Slovenia</td>
<td>1999</td>
<td>-</td>
<td>-</td>
</tr>
<tr>
<td>Spain</td>
<td>1986</td>
<td>-</td>
<td>-</td>
</tr>
<tr>
<td>Sweden</td>
<td>1969</td>
<td>23.46</td>
<td>23.46</td>
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<tr>
<td>Switzerland</td>
<td>1995</td>
<td>-</td>
<td>-</td>
</tr>
<tr>
<td>Turkey</td>
<td>1985</td>
<td>-</td>
<td>-</td>
</tr>
<tr>
<td>United Kingdom</td>
<td>1973</td>
<td>8.0</td>
<td>15.0</td>
</tr>
<tr>
<td>Unweighted average</td>
<td>15.4</td>
<td>16.6</td>
<td>16.9</td>
</tr>
</tbody>
</table>

Source: national delegates - position as at 1 January 2012
Notes

1 Yearly data: the rates shown in the table are rates applicable on 1 January of each year. Reduced rates and specific rates applicable in specific regions are those applicable as at 1 January 2012

2 Reduced rates: reduced rates include zero-rates applicable to domestic supplies (i.e. an exemption with right to deduct input tax). This does not include zero-rated exports.

Country notes

Australia: the GST was introduced on 1 July 2000

Austria: A standard rate of 19% applies in Jungholz and Mittelberg.

Canada: The following provinces have harmonized their provincial sales taxes with the federal Goods and Services Tax and therefore levy a rate of GST/HST of: British Columbia 12%; New Brunswick, Newfoundland and Labrador, Ontario: 13%; Nova Scotia 15%. Québec applies GST at a rate of 5% and Québec Sales Tax at a rate of 9.5% (applied on a tax base that includes GST). Other Canadian provinces, with the exception of Alberta, apply a provincial sales tax to certain goods and services. British Columbians have voted to return to a separate provincial sales tax regime effective April 1, 2013.

France: Rates of 0.9%; 2.1%; 8.0%; 13.0%; 19.6% apply in Corsica; rates of 1.05%; 1.75%; 2.1%; 8.5% apply to overseas departments (DOM) excluding French Guyana.

Greece: Rates of 5.0%; 9.0% and 16.0% apply in the regions Lesbos, Chios, Samos, Dodecanese, Cyclades, Thassos, Northern Sporades, Samothrace and Skiros.

Israel: The statistical data for Israel are supplied by and under the responsibility of the relevant Israeli authorities. The use of such data by the OECD is without prejudice to the status of the Golan Heights, East Jerusalem and Israeli settlements in the West Bank under the terms of international law.

Mexico: A VAT rate of 11% applies in the border regions (the border zone is up to 20 kilometers within the Mexican borders and the whole territories of the states of Baja California, Baja California Sur, Quintana Roo and part of the state of Sonora).

Portugal: The standard VAT rate in the Islands of Azores is 16%. In the Islands of Madeira the standard rate is 22% (since 1st April 2012); reduced VAT rates in Azores are 4% and 9%. In Madeira reduced rates are 5% and 12% (since 1st April 2012).

Spain: Rates of 2.0%; 5.0%; 9.0%; 13.0% apply in the Canary Islands. Rates of 05.% and 4% apply in Ceuta and Melila
Table 9: (Table 3.10 of OECD Consumption Tax Trends 2012) Turnover Thresholds
### Table 3.10. Annual turnover concessions for VAT/GST registration and collection

<table>
<thead>
<tr>
<th>National currency</th>
<th>General threshold</th>
<th>Reduced threshold for suppliers of services only</th>
<th>Special threshold for non-profit and charitable sector</th>
<th>Registration/collection allowed prior to exceeding threshold (2)</th>
<th>Minimum registration period (3)</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>National currency</strong></td>
<td><strong>Nat. curr.</strong></td>
<td><strong>USD (4)</strong></td>
<td>Nat. curr.</td>
<td><strong>USD</strong></td>
<td><strong>Nat. curr.</strong></td>
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<tr>
<td>Australia</td>
<td>AUD 75 000</td>
<td>48 123</td>
<td></td>
<td>150 000 96 247</td>
<td>Yes 1 year</td>
</tr>
<tr>
<td>Austria</td>
<td>EUR 30 000</td>
<td>35 309</td>
<td></td>
<td>5 580 6 443</td>
<td>Yes None</td>
</tr>
<tr>
<td>Belgium*</td>
<td>EUR 5 580</td>
<td>6 443</td>
<td></td>
<td>Yes None</td>
<td>None 5 years</td>
</tr>
<tr>
<td>Canada</td>
<td>CAD 30 000</td>
<td>24 402</td>
<td></td>
<td>50 000 40 670</td>
<td>Yes 1 year</td>
</tr>
<tr>
<td>Chile*</td>
<td>CLP None</td>
<td>0</td>
<td>See note</td>
<td>See note</td>
<td>Yes 1 year</td>
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<tr>
<td>Czech Republic</td>
<td>CZR 1 000 000</td>
<td>71 840</td>
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<td>Yes 1 year</td>
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<td>Denmark</td>
<td>DKK 50 000</td>
<td>6 399</td>
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<td>Yes None</td>
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<tr>
<td>Estonia</td>
<td>EUR 16 000</td>
<td>30 075</td>
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<td>Yes None</td>
<td>None 1 year</td>
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<tr>
<td>Finland</td>
<td>EUR 8 500</td>
<td>8 983</td>
<td></td>
<td>Yes None</td>
<td>None 1 year</td>
</tr>
<tr>
<td>France</td>
<td>EUR 81 500</td>
<td>94 006</td>
<td>32 600 37 602</td>
<td>Yes 2 years</td>
<td>None 5 years</td>
</tr>
<tr>
<td>Germany</td>
<td>EUR 17 500</td>
<td>21 927</td>
<td></td>
<td>Yes 5 years</td>
<td>None 5 years</td>
</tr>
<tr>
<td>Greece</td>
<td>EUR 10 000</td>
<td>14 133</td>
<td>5 000 7 067</td>
<td>Yes 5 years</td>
<td>None 5 years</td>
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<tr>
<td>Hungary*</td>
<td>HUF 5 000 000</td>
<td>38 494</td>
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<td>Yes 1 year</td>
<td>None 1 year</td>
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<tr>
<td>Iceland</td>
<td>ISK 1 000 000</td>
<td>7 263</td>
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<td>Yes None</td>
<td>None 1 year</td>
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<tr>
<td>Ireland</td>
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<td>89 579</td>
<td>37 500 44 790</td>
<td>Yes None</td>
<td>None 1 year</td>
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<td>Israel</td>
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<td>Italy</td>
<td>EUR 30 000</td>
<td>37 575</td>
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<td>Yes None</td>
<td>None 1 year</td>
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<tr>
<td>Japan</td>
<td>JPY 10 000 000</td>
<td>93 566</td>
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<td>None 5 years</td>
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<td>Korea</td>
<td>KRW 24 000 000</td>
<td>29 170</td>
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<td>Luxembourg</td>
<td>EUR 10 000</td>
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<td>None 5 years</td>
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<td>Mexico</td>
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<td>No None</td>
<td>None 5 years</td>
</tr>
<tr>
<td>Netherlands*</td>
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<td>1 616</td>
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<td>Yes 2 years</td>
<td>None 5 years</td>
</tr>
<tr>
<td>New Zealand</td>
<td>NZD 60 000</td>
<td>39 388</td>
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<td>Yes None</td>
<td>None 1 year</td>
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<tr>
<td>Norway</td>
<td>NOK 50 000</td>
<td>5 196</td>
<td>140 000 14 549</td>
<td>Yes 2 years</td>
<td>None 5 years</td>
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<td>Poland</td>
<td>PLN 150 000</td>
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<td>Yes 1 year</td>
<td>None 5 years</td>
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<td>Portugal*</td>
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<td>15 826</td>
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<td>Yes None</td>
<td>None 1 year</td>
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<td>95 833</td>
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<td>Yes 1 year</td>
<td>None 5 years</td>
</tr>
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<td>Slovenia</td>
<td>EUR 25 000</td>
<td>39 685</td>
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<td>Yes 5 years</td>
<td>None 5 years</td>
</tr>
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<td></td>
<td>Yes 2 years</td>
<td>None 5 years</td>
</tr>
<tr>
<td>Sweden</td>
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<td>Yes 1 year</td>
<td>None 5 years</td>
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<td>150 000 100 248</td>
<td>Yes 1 year</td>
<td>None 5 years</td>
</tr>
<tr>
<td>Turkey</td>
<td>TRY None</td>
<td>0</td>
<td></td>
<td>Yes 2 years</td>
<td>None 5 years</td>
</tr>
<tr>
<td>United Kingdom</td>
<td>GBP 73 000</td>
<td>110 744</td>
<td></td>
<td>Yes 1 year</td>
<td>None 5 years</td>
</tr>
</tbody>
</table>

Source: national delegates; position as at 1 January 2012
Notes:

(1) **Registration/collection thresholds** identified in this table are general concessions that relieve suppliers from the requirement to register and/or to collect for VAT/GST until such time as they exceed the threshold. Except where specifically identified, registration thresholds also relieve suppliers from the requirement to charge and collect VAT/GST on supplies made within a particular jurisdiction. Relief from registration and collection may be available to specific industries or types of traders (for example nonresident suppliers) under more detailed rules, or a specific industry or type of trader may be subject to more stringent registration and collection requirements. In countries marked by *, a collection threshold applies: all taxpayers are required to register for VAT/GST, but will not be required to charge and collect VAT/GST until they exceed the collection threshold. Thresholds shown in this table apply to businesses established in the country. In most countries, the registration threshold do not apply to foreign businesses i.e. businesses having no seat, place of business, fixed establishment, domicile or habitual residence within the country.

(2) "Yes" means a supplier is allowed to voluntarily register and collect VAT/GST where their total annual turnover is less than the registration threshold.

(3) Minimum registration/collection periods apply to general concessions. This period is the minimum term during which the concession is applied to taxpayers which have opted for it.

(4) **Exchange rates** for conversion into USD are Purchase Parity Rates (PPPs) for private consumption. Data is taken from OECD Dotstat http://stats.oecd.org/index.aspx?queryid=27286. For further detail see http://www.oecd.org/std/PPP

**Country notes**

**Chile:** Despite that all taxpayers are required to register and obtain a taxpayers' identification number that not only serves for VAT purposes but for all types of taxes, small businesses, craftsman and small service providers can be subject to a special regime in accordance to which they charge VAT for a fixed amount based on the average level of income for the last 12 months, provided they do not exceed the annual collection threshold of 20 Monthly Tax Unit (CLP $782,760 or USD $1,565 approx.). The collection threshold does not apply to legal entities but only to individuals. This system must be adopted for at least 12 months after which the taxpayer can return back to the ordinary regime.

**Czech Republic:** The registration threshold does not apply to fixed establishments in the Czech Republic of non-resident businesses.

**Denmark:** A higher threshold of DKK 170 000 (EUR 22 840) applies to the blind, and a threshold of DKK 300 000 (EUR 40 300) applies to the first sale of works of art by their creator or his successors in title. For the purposes of the latter exemption, the threshold of DKK 300 000 must not have been exceeded in the current or preceding year.

**France:** Specific thresholds apply for certain activities. EUR 41 700 for lawyers, writers and artists; EUR 32 000 for providers of services other than hotel accommodation and restaurants.

**Greece:** The registration/collection thresholds do not apply to certain categories of taxable persons, such as freelancers, taxpayers whose annual turnover from B2B transactions is at least 60%, exporters, technicians who render services in relation to maintenance or repair of buildings and construction sites, such as painters, electricians and plumbers.

**Israel:** The statistical data for Israel are supplied by and under the responsibility of the relevant Israeli authorities. The use of such data by the OECD is without prejudice to the status of the Golan Heights, East Jerusalem and Israeli settlements in the West Bank under the terms of international law.

**Italy:** Self-employed that have an income lower than EUR 30 000 can choose the micro-sized taxpayers scheme (regime dei contribuenti minimi). It involves exemption from IRAP (Regional tax on productive activities) and VAT and a 20% tax rate in place of the ordinary PIT. As from 1 January 2012, such scheme is intended only for individuals under 35 years of age who have started up new business activities as self-employed or enterprises since 31 December 2007. The exemptions from IRAP and VAT have been confirmed, while ordinary personal income taxes will be replaced by a 5% tax.
Japan: Businesses (companies and individuals) are not required to register and account for Consumption Tax (VAT) during the first two years of establishment (except for companies whose capital is of JPY 10 000 000 or more. In this case they should be registered for Consumption Tax from the beginning). After this two year period, whether businesses should be registered as a taxable person is determined every year based on their annual taxable turnover for the accounting period/tax year two years before the current accounting period/tax year. If that turnover has exceeded JPY 10 000 000, the business should be registered. Businesses can opt for a voluntary registration for Consumption Tax, even if their turnover is below the threshold. In that case, the businesses have to remain registered for two years.

Netherlands: The amount of EUR 1 345 is based on the special scheme for small businesses. It is not a threshold based on turnover but on net annual VAT due. If the net annual VAT due (VAT on outputs minus VAT on inputs) is EUR 1 345 or less, the taxpayer gets a full VAT rebate and no VAT is due to the Tax Authorities. In this case, the taxpayer has no obligation to file VAT returns. However, businesses under the small business scheme must still register as VAT taxpayers. In that sense, there is no threshold for registration for VAT purposes. If the net annual VAT due is more than EUR 1 345 but less than EUR 1 883, the taxpayer gets a partial VAT rebate. In this case, the taxpayer must file a VAT return.

Norway: A higher threshold of NOK 3 000 000 applies for admission to sporting events

Portugal: The collection threshold does not apply to commercial legal entities. For small retailers that fulfill some specific conditions the collection threshold is EUR 12 500

United Kingdom: the registration threshold in effect from 1 April 2010 up to 31 March 2011 was GBP 70 000. It went up to GBP 73 000 with effect from 1 April 2011
Table 10 shows an estimate of productivity and consumption efficiencies across the geographical regions. The estimates (for the year 2001) indicate that both production efficiency and consumption efficiency ratios for Asia are comparable to the ones in the EU, Central Europe, North Africa and the Middle East, and Latin America and they are significantly higher than in Sub-Saharan Africa.

**Table 10: VAT Efficiency Across The World (2001)**

<table>
<thead>
<tr>
<th></th>
<th>Sub-Saharan Africa</th>
<th>Asia &amp; Pacific</th>
<th>EU</th>
<th>Central Europe &amp; Russia</th>
<th>North Africa &amp; Middle East</th>
<th>America</th>
<th>Small Islands</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Production Efficiency ratio (%)</strong></td>
<td>27</td>
<td>35</td>
<td>37</td>
<td>38</td>
<td>36</td>
<td>37</td>
<td>48</td>
</tr>
<tr>
<td><strong>Consumption Efficiency ratio (%)</strong></td>
<td>38</td>
<td>58</td>
<td>57</td>
<td>64</td>
<td>62</td>
<td>57</td>
<td>83</td>
</tr>
</tbody>
</table>

*Source: IMF estimates (Ebrill et al. 2001).*

A comparative picture of production and consumption efficiencies for Vietnam and some of its neighboring countries is presented in table 11. Both the productivity efficiency and consumption efficiency in Vietnam compare well with its neighboring countries. In fact, these are significantly higher than the regional averages presented in table 10. In addition to many other factors, this could also be the result of a series of cascading-induced exemptions in the VAT law.

To ensure that Vietnam has a robust and clean VAT law and yields sufficiently high productivity and consumption efficiencies, the logical sequence to proceed would be to first fix the tax structure and then focus on the tax administration and tax compliance issues. Eliminating or at least minimizing the exemptions would be necessary to give a realistic picture of the performance of the VAT. Once these issues are tackled successfully, the expected revenues can be ascertained by forecasting VAT revenue, using the models outlined in chapter 10, with the help of forecasting models in order to see the level of compliance in the economy and then try to improve it.

Some typical features of the VAT in Vietnam such as tax structure, exemptions, computation method for tax liability, refund and equity are examined below, bearing in mind international practice of VAT regimes.

**Table 11: CIT and VAT Revenue Productivity for Selected Asian and Pacific Countries, 2011**  
*(Based on GDP, using Standard Rates)*

<table>
<thead>
<tr>
<th>Country</th>
<th>GDP per capita 2011 (in US dollars)</th>
<th>Revenue productivity</th>
<th>Corporate Income Tax based on GDP</th>
<th>VAT Based on: Consumption GDP</th>
</tr>
</thead>
<tbody>
<tr>
<td>Vietnam</td>
<td>1498</td>
<td>0.29</td>
<td>1.09</td>
<td>0.77</td>
</tr>
<tr>
<td>Bangladesh</td>
<td>701</td>
<td>0.02</td>
<td>0.27</td>
<td>0.22</td>
</tr>
<tr>
<td>Bhutan</td>
<td>2285</td>
<td>0.00</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Cambodia</td>
<td>931</td>
<td>0.07</td>
<td>0.41</td>
<td>0.38</td>
</tr>
<tr>
<td>China</td>
<td>5899</td>
<td>0.13</td>
<td>1.16</td>
<td>0.55</td>
</tr>
<tr>
<td>Country</td>
<td>Population</td>
<td>Zero-Rating</td>
<td>VAT Refunds</td>
<td>Unweighted Average</td>
</tr>
<tr>
<td>-------------------------</td>
<td>------------</td>
<td>-------------</td>
<td>-------------</td>
<td>--------------------</td>
</tr>
<tr>
<td>India</td>
<td>1455</td>
<td>0.12</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Indonesia</td>
<td>3797</td>
<td>0.23</td>
<td>0.58</td>
<td></td>
</tr>
<tr>
<td>Lao People's Dem.Rep</td>
<td>1338</td>
<td>0.09</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Malaysia</td>
<td>10467</td>
<td>0.34</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Nepal</td>
<td>624</td>
<td>0.06</td>
<td>0.39</td>
<td></td>
</tr>
<tr>
<td>Pakistan</td>
<td>1305</td>
<td>0.24</td>
<td>0.23</td>
<td></td>
</tr>
<tr>
<td>Philippines</td>
<td>2329</td>
<td>0.12</td>
<td>0.19</td>
<td></td>
</tr>
<tr>
<td>Sri Lanka</td>
<td>3139</td>
<td>0.05</td>
<td>0.25</td>
<td></td>
</tr>
<tr>
<td>Thailand</td>
<td>5851</td>
<td>0.31</td>
<td>0.89</td>
<td></td>
</tr>
<tr>
<td><strong>Unweighted Average</strong></td>
<td><strong>2973</strong></td>
<td><strong>0.14</strong></td>
<td><strong>0.55</strong></td>
<td><strong>0.38</strong></td>
</tr>
<tr>
<td><strong>Unweighted Average (Excluding Vietnam)</strong></td>
<td><strong>3086</strong></td>
<td><strong>0.13</strong></td>
<td><strong>0.49</strong></td>
<td><strong>0.35</strong></td>
</tr>
</tbody>
</table>

Source: IMF.

2. **Zero-Rating and VAT Refunds**

Zero-rating of exports is essential in order that all the taxes are taken out of the production chain of an exportable item and it remains internationally competitive. A destination based credit method VAT easily meets this requirement. However, for this to be effective, prompt refund of input VAT is necessary.

In principle, refunds should be paid without any delay otherwise it becomes a penalty against investors. Precise data about the amount of refund paid are not readily available for developing countries but it is possible to have a sense of the dimension of this problem by looking at some of the developed countries. For instance, according to the refund data collected by the IMF for the year 1995–96, the U.K. collected over US$68 billion dollars and returned US$26 billion in refunds. Thus refunds were about 60 percent of net collections which is unusually high. In the case of France, the refund is normally about 40 percent, in Sweden 80 percent while for Korea it is about 50 percent. In most developed countries, VAT refunds exceed 40 percent of the gross VAT collections while in most developing countries of Africa, Asia, and Latin America; it amounts to less than 20 percent of the VAT revenues.

**Some Important Features of VAT Refunds Globally**

A key feature of the credit method VAT is that some businesses would pay more VAT on their inputs than they collect on their sales and would therefore claim excess credit refunds. It is therefore important to have a refund system in place if the VAT regime has to be implemented successfully. At the same time, a large amount of VAT revenue is lost as a result of VAT refund abuse. While countries have found it generally difficult to estimate the extent of revenue loss, it is believed to be substantial. Tax authorities in the U.K. estimated the amount of VAT losses in 2002–03 to be around 16 percent of the net VAT receipts. VAT abuse comes in different forms, ranging from traders omitting sales from records to falsification of invoices.
Sometimes, businesses are launched without any legitimate activity for the sole purpose of stealing money from the government through the refund system. The following are some notable aspects of VAT refunds around the globe.

- Most of the VAT refund claims are made by exporters both in terms of numbers and amounts. Typically, a small number of large exporters account for the bulk of VAT excess credit.
- The other businesses claiming refunds are comprised of those traders that have made large purchases of capital goods relative to current sales. Also, in countries with a dual rate structure, refund claims arise when outputs are taxed at a lower rate while inputs are taxed at a higher VAT rate.
- The VAT registration process should contain sufficient checks and controls to prevent registration of fictitious traders who want to register with the sole intent of stealing from the VAT system. The registration staff should carefully assess and verify initial information presented for registration.
- The level of threshold for compulsory registration is relevant not only for effective administration of VAT but also for reducing refund abuse. If the threshold is too low, the tax administration resources become overstretched in managing the VAT registered businesses and monitoring refund claims. Vietnam, with zero thresholds, faces this problem. So an appropriate level of threshold is important for effective monitoring and management of VAT refund.
- An effective risk-based audit system plays an important role in reducing VAT refund fraud. Exchange of VAT and income tax information and VAT and customs information are important in this regard. Where direct and indirect taxes are administered together in a unified tax administration, exchange of VAT and income tax information is routine. Where these taxes are administered separately, however, exchange of information is generally limited. In some countries, this kind of exchange is legally prohibited. As a substantive share of VAT revenues are collected through the customs agency, the cooperation between VAT and customs also becomes important.

3. International Practice in VAT Refund and Policy Implications for Vietnam

In most developed countries, refunds are usually paid within three to four weeks of the end of the taxable period. Also, there are virtually no restrictions on the refund payment. In developing countries and transition economies, however, the situation is different and this turns out to be one of the weak links in the VAT administration. Many of these countries limit the entitlement to refund. The IMF conducted a survey of 36 such countries and come up with the following findings:

- Ninety percent of the countries in the survey reported that their tax authorities are bound by law to make refunds within a prescribed timeframe, generally 30 days. It is also true that the statutory deadlines are often not met. Around 40 percent of the countries go further and provide for interest payments on late refunds. In eight countries, refunds are focused on exporters only. Six countries give refunds to exporters immediately and the rest give refunds with some time lag, both to exporters and other businesses.
Most countries (60 percent of the surveyed countries) now ask their taxpayers, particularly non-exporters, to typically carry forward the refund for a specific period – generally six months. While this practice enables the tax administration to verify genuineness of refund claims, these measures create hardship to investors and are not welcomed by firms who are making large investments while their production and sales do not begin immediately thereafter. Many VAT systems allow for refunds to be offset against other tax liabilities, for instance, the income tax liability which further delays the actual refund.

Four of the surveyed countries make refunds in excess of a floor credit only. One country adjusts only once every year at the end of the year. One country makes no refunds at all even though it is provided in the law and one other country pays refunds in an ad hoc manner. There is one country that pays refunds only after an audit. Two countries in Africa have enacted legislation to deny all outstanding claims as of a specific date. This, of course, has serious implications for the long-term integrity of the tax system and the credibility of tax administration. Thus clearly there is a great deal of variation among countries. Also, the actual refund practices are found to be quite different from what is laid down in the law.

Two-thirds of the surveyed countries undertake some sort of risk assessment in processing VAT refunds. Sometimes it is quite sophisticated (UK) while in many countries it is often rudimentary and may amount to verifying each refund claim. A quarter of surveyed countries have a statutory requirement to verify every refund claim. This naturally takes a lot of time.

It is also found that a lack of an appropriate audit program in many countries contributes to the existence of a poor refund system. A third of the surveyed countries report that they do not have a VAT audit program. These countries end up carrying out extended prepayment checking of claims rather than relying on a sound post-payment audit. This naturally delays the entire process. It is important for the tax administration to have a sense of the level of refunds payable so that financial resources are in place in a timely fashion and also as a warning signal against attempted fraud.

Exchange of information about VAT registered traders and the value of supplies across countries has become important for international transactions. For instance, EU member states exchange information via a VAT information exchange system (VIES) about VAT traders and sales of goods and services.

Generally, there are two methods of budgeting for VAT refunds: (a) making payments from gross VAT revenues, (b) paying from budget expenditure appropriations. Irrespective of the method used, it is necessary to have a forecasting and monitoring system to estimate VAT collections and level of refunds. Actual collections and refunds should be tracked against forecasts and variances should be explained and reconciled. Some countries have adopted innovative practices to reduce refund fraud. For instance, Kenya provides for mandatory certification of VAT claims by certified public accountants (CPAs) for claims exceeding specified amounts. Sanctions are also imposed on CPAs who knowingly certify false claims.

A number of countries give preferential treatment to taxpayers with sound compliance histories (“gold” status in Pakistan). Some countries (Bulgaria) have introduced a VAT bank account system
where a VAT registered business must open a VAT account for depositing VAT payments and spending money on VAT purchases. This is meant to reduce cash transactions and thus reduce VAT fraud.

The following lessons with significant policy implications for Vietnam’s VAT system can be learned from analysis of international experience in VAT refunds.

1. The number of taxpayers should be kept at a level that can be realistically managed by choosing the right threshold and verifying the VAT registration applications to prevent fictitious traders entering the system.
2. Suitable forecasting and monitoring systems should be established to anticipate refund levels and make provisions for refund payments.
3. Refunds should be processed in a reasonable period of time and interest paid on late payments. Excess VAT credit should be offset against VAT and other tax arrears.
4. Exporters should be paid refunds promptly. In a functioning risk management, the tax department should make a clear distinction between claimants with a history of compliance and those who are new. The Tax department should maintain historical profiles for each refund claimant.
5. Verification of VAT refund claims should be a component of a wider audit program. A pre-refund audit should be implemented for high risk claims while a normal post audit should be conducted for other less risk cases.
6. Given the substantial size of VAT refunds, one part of an audit department may simply focus on refund audits, that is, verifying the facts of refund claims.
7. VAT refunds also create opportunities for corrupt practices by tax and customs officials and this has to be carefully monitored.

Some countries, especially among transition economies, have tended to delay refunds and use the resources to overcome temporary revenue problems. While this kind of interest free loan from the business sector may appear attractive in the short run, it is bound to create a serious backlash and adversely affect the investment climate in the country and therefore such practices should be avoided.

3.1. Importance of Customs in VAT Collection

An important feature of VAT collection brought out by empirical studies of countries in Asia, Africa, Latin America and Central Europe is that the revenue collected on imports normally accounts for a large proportion of total VAT revenues in most countries. A study by the IMF of this ratio in more than twenty developing and transition economies shows that the ratio varies between 40 percent (Peru) to 70 percent (Bulgaria and Haiti). This clearly brings out the importance of customs collection in VAT revenue collection.

There is another way in which customs plays an important role in VAT collection. As the tax policy analysis for VAT would show, under the credit method if the final sales are VAT exempt, the chain terminates at the stage of the previous input purchase. In that case, there is some loss of revenues at the stage of final sales but total revenues are not lost because the VAT collected on the input is not refunded. In many developing and transition economies, this is what happens on the sale by the informal sector of the economy.
The informal sector is responsible for a substantial share of final sales to consumers in these countries and by its very nature this sector often does not pay VAT on its final sales. But if the customs department is effective at the border, the imported inputs used by the informal sector would be collected. Since the informal sector is not registered under VAT, the taxes on inputs paid at the border are not refunded to them even though the tax on value added at their stage is lost. Thus customs effectiveness is an important factor in the effectiveness of total VAT collections in the countries where an informal sector is prominent. In addition, exchange of information between the customs department and the VAT collection agency would help the latter in crosschecking whether the traders who are importing part of their inputs are paying the right level of tax on their production. Thus clearly the extent of cooperation between the customs and VAT administrations is crucial for the successful enforcement of VAT. In fact, close cooperation among the different parts of tax administration is helpful for enforcement of all taxes – income tax, VAT and custom tariffs.

However, this kind of cooperation in developing and transition economies is more of an exception than a rule. Clearly, a separate VAT department independent of the domestic tax department that administers income taxes is bound to make this kind of cooperation harder to achieve. The same problem would be faced where there is little cooperation between the Customs department and other domestic tax administration including the VAT.

3.2. Some features of VAT regimes in other countries

We present below the broad practices in OECD and BRICS countries as well as among the neighboring countries of Vietnam,

**OECD:** The federal Australian government levies the 10% GST but distributes the proceeds to states. Exempt supplies include residential rents, re-sale of residential property and most financial services (including life insurance). Exports, health (including health insurance), education, most food supplies and medical services are zero-rated, while general insurance is taxed. Reverse charges may apply to purchases made by registered buyers of overseas supplies in some cases.

Korea similarly imposes a VAT at 10% and exempts unprocessed food and agricultural products, medical and health services, financial services etc., and zero-rates exports of goods and services. The unique feature is mandatory registration for and use of e-invoicing by taxpayers in Korea. Singapore has the main VAT (GST) rate at 7%, but only exempts specified financial services and residential properties, and zero rates exports of goods and services. Restrictions are applied to certain inputs for the purpose of VAT credit (car rental, medical expense, club subscriptions etc) and on the claim of refunds by non-residents. GST registration is required if taxable turnover (person or company) exceeds SGD 1 million annually.

UK has the highest VAT rate in the OECD group at 20% on most goods and services, but taxes some goods at 5%. Most exports, most food items, most public transport, books and publications, and

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17 This section is based on the material from PWCs Worldwide Tax Summary 2012 – the relevant portions on VAT for the sample of countries considered below is reproduced from Annex B.
specified essential goods and services are zero-rated. Some supplies are exempt, such as rights in land, insurance, financial services, betting and gaming, education, certain sports services, cultural services, and health and welfare. The USA is the only large country in the world that has no VAT at the federal level.

**BRICS:** Brazil imposes a federal VAT on import, sale and transfers of goods at rates between 10-15% on most items and a state sales and service tax at rates ranging from 7-25%, the coverage of services under the state sales and service tax being restricted to transport, communications and electricity only; most income from services are subjected to a municipal service tax on turnover at 2-5%.

China is gradually moving from a Business Tax to a more comprehensive VAT through its Shanghai pilot project. Currently, the sale or import of goods, and certain services are charged VAT at rates of 13% or 17% with a rate for small taxpayers at 3%. Export refunds are available on materials purchased locally at rates between 0%-17 percent. The Shanghai pilot program has been introduced for certain service industries earlier covered by the business tax at rates of 6%, 11% and 17% (3% for certain small taxpayers). The business tax is currently imposed on services, transfer of intangible assets, and immovable property at rates of 3%, 5% and 20%.

India imposes limited VATs at both the central and state levels. The federal VAT excludes wholesalers and retailers as well as manufacturers below a certain turnover threshold, while the state VAT excludes services and inter-state sales. The typical federal rate is 12% and an education cess at 2% and higher education cess at 1% is applicable over this rate, so the aggregate federal rate is effectively 12.36%. The state VAT is charged at 1%, 4%, 5% and 20% in addition, and a 2% Central Sales Tax is charged on inter-state transactions instead of the state VAT. Input VAT credit on goods and services paid to the center is available for the central VAT liability and input VAT credit for the state VAT for the state VAT (in the same state), credit of state VAT is not available for the central VAT and vice-versa.

In Russia, VAT is a federal tax at a standard rate of 18% and a lower rate of 10% on certain basic foodstuff, children’s clothing, medicines and medical products, certain printed publications, etc. exports are zero-rated and certain financial, educational and transportation and socially desirable services are exempt. Reverse charges are applicable for most payments made to unregistered foreign companies in specified circumstances.

In South Africa, VAT is levied at the rate of 14% on most domestic sales on registered taxpayers (turnover above ZAR 1 million annually or those who elect to register with annual turnover above ZAR 50,000). Exports are zero-rated as are specified farming equipment, sales of enterprises, certain fuel, and deemed supplies by welfare organizations. Certain supplies such as interest charges, basic foodstuff, domestic land transport and education etc. are exempt.

**Vietnam’s Neighbors:** Cambodia has a VAT at 10% applicable to “real regime” taxpayers, with exports being zero rated as well as direct supplies to export oriented specified industries. Exempt supplies include postal services (public), medical services, and electricity, and public transport, insurance and specified financial services.

Indonesia has a VAT applied at the rate of 10%, with zero rating for exported goods and some services. Many goods and services are VAT exempt including machinery and capital equipment in
certain situations, electricity (unless household capacity exceeds 6,600 watts), piped water, livestock, poultry and fish feed and/or raw materials for preparing feeds, certain agricultural crops in their natural state delivered by farmers, agricultural seeds, plantations, forestry, animal husbandry, breeding, and fishery sources, polio vaccines, textbooks etc.

The standard rate in Laos is also 10%; exempted items include unprocessed agricultural products, seeds, fertilizers, textbooks, education services, medical services, banking services, and insurance, while exported goods and services are zero rated. The turnover threshold (compulsory) is annual revenue of 400 million Lao kip (LAK). Companies below this threshold may voluntarily register. One unique feature of Lao PDR VAT is that VAT is charged on withholding taxes (WHTs) at 10% and in the case of a foreign recipient, the WHT is considered a final tax.

The rate in the Philippines is 12%, with zero-rating of exports. Certain services are VAT exempt and taxed on turnover instead. Taxpayers whose annual turnover is below PHP 1,919,500 pay a 3% tax on receipts or sales and do not have to register for VAT.

Malaysia has not yet implemented its proposed 4% goods and services tax (GST) to replace its current sales and service tax systems. In practice, the current sales and service tax already incorporates many features of VAT.

Annex A gives a summary of international trends and experience in Tax Policy Reform, related to consumption/indirect taxes particularly VAT. It covers issues such as equity implications of VAT, and tax incidence. It has considered examples from various countries around the world.

Annex B is the reproduction of PWCs Worldwide Tax Summary 2012 from which the last section of this chapter was summarized.

“The replacement of sales taxes with the VAT –especially the flat-rate VAT-- has tended to make tax systems less progressive. Another key development of the past few decades has been the spread of the VAT across the developing world. VAT revenue has replaced a number of indirect taxes, including tariff and other trade taxes as well as domestic sales taxes. Typically, the introduction of relatively broad-based VATs replacing sales taxes has tended to reduce the progressivity of the tax system. This has taken place by enlarging the tax base to previously exempt goods and services that are basic necessities and reducing tax rates on goods that are more important in the budgets of higher-income households. As a result, revenue-neutral reforms, have generally led to gains by upper-income groups at the expense of lower-income groups (Coady: 277). That being said, it is important to make an assessment country by country as tax incidence very much depends on VAT design (Chu et al. 2000).

VAT rates have also tended to increase as part of the global move toward taxing consumption more heavily and income more lightly. This trend is particularly acute in Latin America, where consumption taxes account for 60 percent of all tax revenues compared to 30 percent in Europe. Countries particularly concerned with income distribution, particularly in Europe but also in the developing world, have introduced VATs with lower rates and/or 0-rating or exemptions for goods featuring especially prominently in the consumption basket of the poor. Countries less concerned with the distributional impact of taxation have introduced VATs with a very broad base and a single rate (see below for further details). Even in Europe, however, the share of household income paid through consumption taxes by the bottom income decile is three times as high as that paid by the top decile.

As a result, rising VAT rates and revenues have compensated for declining personal –and in some cases corporate--income tax revenues and fiscal re-distribution has declined. This trend has combined with the decline in income taxation to create more regressive tax systems. In Latin America, tax reforms from the 1970s to the 1990s typically entailed additional reliance on indirect taxes just as inequality was rising (Mahon, 2012: 2). The result of these changes in the tax system coupled with reductions in social assistance is the progressive erosion of the contribution of fiscal policy to diminishing rising pre-tax-and-transfer income inequality. According to IMF estimates, from the mid-1980s to the mid-1990s, fiscal policy offset 73 percent of the 3 percentage point increase in pre-tax-and-transfer income inequality in the OECD while in the next decade this percentage had declined to 53 percent (Coady 2012: 12).

Moreover, fiscal space for further increasing VAT rates is getting thinner while the stepped up taxing of high income and high wealth individuals remains a green field. As a recent IMF report frankly states:

Continued trade liberalization will put pressure on revenue in many lower-income countries. Scope to meet these and other revenue needs by simply raising standard VAT rates is becoming limited, so the potential lies largely in better improving compliance and scaling back preferential...
treatments. Not least, and important too for the wider legitimacy of tax systems, greater efforts can be made—requiring political will as much as technical capacity—in taxing elites and high-income/wealth individuals (IMF 2011: 5)

As regards the VAT, collection efficiency considerations advocate for the setting of a single rate with 0 rating for exports while equity considerations advise having multiple rates. Ease of administration advises having a single VAT rate. This is the case especially in low-income countries with particularly low capacity and which simply cannot effectively handle multiple rates. Moreover, from an economic efficiency perspective, it can be argued that lower VAT rates and exemptions/0-rating (aside from exports) constitute a generalized subsidy that ends up mostly benefitting those who do not need the rebate (the wealthier, as they consume more). On the other hand, the VAT can easily be made neutral and even slightly progressive by establishing a reduced rate (or exempting or 0 rating18) goods which feature particularly prominently in the consumption basket of the poor.19 IMF advice has typically tried to balance efficiency and equity considerations by advising VATs with a broad base, a single rate, a fairly high threshold and some exemptions, such as those for financial services, government agencies, and basic health and education (IMF 2011: 24).

The equity case for indirect taxation is particularly strong in developing countries. This is the case because, unlike in developed countries, the “equity damage” of a flat rate VAT cannot be as easily undone with the combination of a progressive income tax (to add to the taxation of the rich) and transfers (to compensate the poor) (Keen and Simone: 317; Ebrill et al.; and Stiglitz 2003). On the contrary, as will be shown, even in Latin American countries with conditional cash transfer systems to the poor, the fiscal system can be regressive due to the impact of indirect taxes.

Rate differentiation has also been urged on economic efficiency and stabilization grounds (Bird, 125; Asher and Booth). In this vein, it has been argued that:

In many developing countries, a VAT may be a part of a well-designed tax structure. In a sense, this chapter is a critique of the excess zeal of VAT advocates, who sometimes suggest that there should just be a uniform tax on all goods. This chapter argues that that is seldom the case. There should, in general, be differential taxation. It may be desirable to impose differential taxes on imports, including to promote development. It may be desirable to impose differential taxes on luxuries or oligopolies, including to promote equity (Stiglitz, 2009).

Indirect taxes can increase the post-fiscal poverty rate even in the presence of transfers to the poorest, particularly in middle income countries with high urbanization rates. On average, it is estimated that in most countries taxes eat up around 10 percent of the income of the poor with indirect taxes accounting for a high proportion of the taxes paid by the poorest 60 percent of the population (Bird, 51). Moreover, the introduction of broad-based VATs in place of sales taxes has tended to reduce the progressivity of the tax system by enlarging the base to include previously exempt goods and services that are relatively more important in the budget of the poor (Coady). In low-income countries with high rates of rural population and high informality, the VAT can be progressive. In middle income countries with

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18 Zero-rating is more advisable than exemptions.
19 The advice of a single-rate VAT was largely based on the administrative constraints of low-income countries. Many middle income and most developed countries successfully administer multiple-rate VATs.
high rates of urbanization, low own-food consumption and relatively low informality, the VAT can be highly regressive. Even if its impact on the poorest is mitigated (or even reversed) with transfers, the near-poor and lower-middle income groups will bear the brunt of the tax through the taxation of their necessities. As will be shown below, in many Latin American countries, the VAT is regressive, greatly lowering disposable income for the poor and, in some cases, like Brazil, increasing the post-fiscal moderate poverty rate.

Moreover, “in the absence of well-functioning schemes for income redistribution, there is no theoretical presumption in favor of uniformity of indirect taxation”\(^{20}\) Revenue-neutral indirect tax reforms (such as flattening the VAT) typically lead to gains by upper income groups at the expense of lower income groups (Coady). Therefore, if equity is a consideration and there is no PIT or transfer system to compensate, rate differentiation is arguably the best way to prevent the institution of a regressive tax. Namely: “uniform taxes become unattractive unless the income redistribution system through taxation and transfers is very powerful” (Burgess and Stern)\(^{21}\).

In addition to standard sales tax or VAT and trade taxes, indirect tax systems typically include excise taxes on alcohol, tobacco, petroleum products and some luxury goods. An excise tax on luxury goods needs to be carefully designed to ensure it taxes the goods and populations intended. When properly designed, this tax can help diminish the regressive nature of the overall indirect tax system.

1. \textit{Indirect Tax Reform - Results from Country Modeling}

This section presents the results of studies modeling the impact of tax reform on income distribution. The results of various studies carried out across the world are presented in turn and a conclusion summarizes their main findings.

Both general as well as partial equilibrium models tend to find that the introduction of a broad-based VAT tends to reduce the progressivity of the tax system. This takes place by enlarging the base to include previously exempt goods and services that are relatively more important in the consumption basket of the poor and/or by reducing taxes on goods that are relatively more important in the consumption of the better off (Coady).

On the contrary, the introduction of differential rates on goods consumed disproportionately by the poor, such as food, would improve the progressivity of the VAT (Coady). Overall, evidence from country modeling indicates that: “even though the greater part of basic foodstuffs are usually not consumed by the poor, in the face of the strong direct impact on the poor of taxes on such foodstuffs, concern for their wellbeing often suggests the need for their exemption.” (Bird, 127). Regarding personal income taxation, the replacement of multiple rates with a flat rate significantly

\(^{20}\) Specifically, proportional commodity taxes are optimal if Engel curves are linear and differences across households in their demographic position shift the position but not the slope of their Engel curves, and if there is a universal and optimal set of demogrants (i.e. transfers linked to household structure). If any of these assumptions does not hold, indirect taxes should generally depart from uniformity to take account of whether goods are relatively more important in the consumption of the worse off (Burgess and Stern; Deaton and Stern).

\(^{21}\) Still, “using the indirect tax system should generally be viewed as a short-term measure until more cost-effective redistributional policy instruments are developed, for instance, a well-designed and well-implemented social protection program.” (Coady).
reduces the progressivity of the tax system and increases income inequality. Specific country studies are summarized below.

In Jamaica, replacing differentiated consumption taxes with a uniform rate of 20 percent increased the tax burden on low-income households and the tax system’s regressivity. Exempting food, however, reversed those results and lowered all taxes on low-income families dramatically in a progressive manner. (Bird, 59)

In India, reduced rates on fuel and increased taxes on milk products improved the equity of indirect taxation. On the other hand, the shift to a uniform VAT would increase the price of many essentials and reduce the expenditure of the poorest rural households by almost 7 percent and that of urban households by about 5 percent. “The only value judgment for which it (such a shift) would be considered optimum would be that involving no concern whatsoever for income redistribution in favor of the poor” (Ahmad and Stern, 1983)

In Pakistan, analysis concluded that any degree of concern for inequality at all made wheat and sugar poor candidates for increased taxation compared to meat and eggs (Ahmad, Leung and Stern, 1984). A two-tier VAT makes little difference in rural areas given the food consumption out of home-grown stocks, but it sharply increases the number of poor urban gainers and reduces the number of gainers among the top 5 percent (Ahmad and Ludlow, 1989). Similarly, the marginal social costs of raising revenue by taxing rice, edible oils, housing, fuel, light and clothing were always below the median cost while the attraction of taxing cereals, on the other hand, depended on how concerned one was about income distribution (Ahmad and Stern, 1991).

In Cote d’Ivoire, sales taxes were found to be neither progressive nor regressive, with urban dwellers being heavy payers of the manufacturing level VAT (Choon Sia, Wahba and Whalley).

In Bosnia and Herzegovina, replacing a multiple rate with a single rate VAT was found to be slightly less progressive. The effect of introducing a VAT with a single rate of 17 percent to replace a sales tax with a standard rate of 20 percent, a preferential rate of 10 percent and a zero rate for exports and a number of basic food items as well as certain services, was modeled. The analysis found that the VAT was slightly less progressive than the sales tax and would result in an increase in the average tax burden in the range of 1.9 to 2.6 percent across deciles with the highest impact being for the lower-income deciles. (Tareq et al. 2005)

In Bangladesh, replacing the existing indirect tax system (which taxed food) with a zero-rating system for food was found to be less regressive. The existing system was compared with a system that zero-rated food grains and vegetables, applied a uniform rate on other goods and services, and levied excise taxes on tobacco, energy goods, and sugar. This system was found to be less regressive and would lead to gains for lower-income households in the range of 1.2 to 2.7 percent and losses for higher-income groups in the range of 0.8 to 6.6 percent (Hossain 1995, 2003).

In Mexico, the incidence of VAT increases was found to be progressive while reducing VAT, combined with higher energy prices had a progressive incidence as well (Sobarzo, 2000).
In the Philippines, indirect taxes were found to be near neutral. Energy taxes were found to be progressive while import taxes and VAT were found to be neutral in incidence. The VAT was found to be more regressive than sales taxes due to the relatively high VAT rate on food whereas sales taxes were relatively higher on goods consumed by wealthier households. It was found that removing the VAT on food and increasing the base rate on other goods to 16.4 percent to make the reform revenue-neutral transforms VAT into a progressive tax (Devarajan and Hossain, 1995). Similarly, another study finds that excise taxes are regressive, import taxes progressive and the VAT ranges from being almost proportional (neutral) to slightly progressive (Clarete, 1991). More recently, a Bank study found similar results (World Bank, 2010).

In South Africa, the VAT has been found to be mildly regressive. Low income households pay over 5 percent of their income in VAT compared with only 3.5 percent among high-income groups. This was the case despite the fact that certain food items (such as brown bread, maize meal and milk powder, rice and unprocessed vegetables and fruits) were zero-rated and small-scale firms were not required to register for the VAT (Go et al., 2005).

In Costa Rica, broadening the VAT base supplemented with transfers to the bottom deciles would be progressive. The VAT currently exempts a large number of goods and services and the rate (at 13 percent) is relatively low by regional standards. In addition, around 8 percent of GDP is zero-rated. A simulation maintains the 13 percent rate, but broadens the tax base leaving education, health, passenger transport, financial services and real estate sales and renting out of the tax base and includes a targeted transfer to the bottom deciles. The reform reverts the contribution of the first four deciles from 12.1 percent of total VAT revenue to a negative amount (owing to the transfer system) and the revenue-neutrality of the reform requires the contribution of upper income deciles to increase.22

2. Indirect Tax Reform - Results from Tax Incidence Analysis

This section presents some examples of tax incidence studies carried out across the world to assess the impact of indirect tax reform. The studies use household income and expenditure surveys to estimate the tax burden on households by income group. As in the above section, a tax incidence in which a higher percent of income is paid in taxes by higher income groups than by lower income groups is qualified as progressive, an equal share of taxes being borne by all income groups is qualified as neutral while a lower percentage of income being contributed in taxes by higher income groups is qualified as regressive.

In Ethiopia, the introduction of the VAT increased the tax burden of poorer households more than three times than it did for the highest decile, mainly due to the inclusion of food. A study assessed the tax incidence of the replacement of the sales tax with a VAT in 2003 in Ethiopia. The VAT was introduced at a higher rate (15 percent) and with a broader base than the sales tax it substituted. It exempted sales of used dwellings, financial services, medical and educational services, electricity, kerosene, water and transportation, but not food. The new VAT was found to be very mildly progressive with the poorest deciles facing a burden of 4.3 percent and the richest decile a burden of 5.78 percent. The estimated progressivity of the VAT depended entirely on the shares of consumption of exempt items

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22 Though this is unclear from the paper, the tax burden of the middle deciles (middle class) probably increases.
and items obtained in kind (despite the fact that the exempt goods and services are consumed mostly by the households in the highest deciles). This is mainly because the poor spend a much larger share of their income on food and therefore pay a disproportionately larger fraction of their expenditure on the food items they purchase. As is typically the case, for rural households, the VAT is more progressive than for all households while for urban households, the VAT is regressive. Inclusion of food under exempt items would significantly reverse this regressivity (Munoz and Cho).

In Uganda, it was because of the zero-rating of commodities consumed by the poor that the introduction of the VAT did not make the poor worse off. The tax system was by and large progressive before the reforms and all taxes were progressive except excise taxes and the graduated personal tax. The personal income tax was the most progressive and import duties the second most progressive, followed by sales taxes. After the introduction of the VAT, it is not clear whether it was more or less progressive than the sales tax. (Chen, Matovu and Reinikka)

In Bolivia, indirect taxes are found to be highly regressive, taking 18.4 percent of the income of the poorest and only 2.6 percent of the income of the richest deciles respectively. Despite the existence of non-contributory pensions and conditional cash transfers, the post-fiscal Gini coefficient is higher than the market/disposable income Gini due to the highly un-equalizing effect of indirect taxes. As a result, the post-fiscal (tax-and transfer) headcount ratio for poverty and extreme poverty is substantially higher than the market headcount ratio. This is the case because the Bolivian indirect tax system does not include exemptions for the items most commonly consumed by the poor. The tax system also affects the overall redistributive capacity of Bolivia’s fiscal system through its low yield. Therefore, as a whole, the Bolivian fiscal system is just neutral because of a combination of a low and non-progressive tax system and a low level of not particularly progressive transfers. (Arauco et al. 2013)

In Mexico, indirect taxes are close to neutral due to exemptions on foods and medicine (jointly with the assumption that rural households do not pay VAT). Non-oil tax revenues have stagnated at around 10 percent of GDP for the past thirty-five years. Direct taxes are highly progressive since workers in the first four deciles are exempted and benefit from a negative income tax. Nevertheless, the overall tax system nationally and in urban areas is only very slightly progressive due to the small weight of income taxes relative to indirect taxes. Total taxes are more progressive in rural areas reflecting the VAT assumption. (Scott 2013)

In Peru, indirect taxes are also found to be progressive due to extensive informality and exemptions are found to have greater incidence on the middle deciles. Direct taxes are progressive, but have little effect on inequality due to their little weight in the overall tax effort and as a percent of GDP. Overall, the fiscal system is found to have little effect on poverty and income inequality due, not to low efficiency of spending, but rather to the low overall level of taxes and social spending (Jaramillo 2013).

Uruguay has a strong tax effort and achieves a significant reduction in inequality and poverty through its fiscal tax-and-transfer system though indirect taxes are regressive. This is due to the fact that it raises a substantial amount of resources through its tax system allowing it to spend 28 percent of GDP in social spending (2009 data). Direct taxes are progressive (with the poorest decile paying 0.9 percent of its income in direct taxes and the richest decile 9 percent). All social programs are
also progressive with in-kind transfers in the form of education and health benefits having the largest impact in lowering income inequality. Indirect taxes, on the other hand, are highly regressive with the two poorest deciles being hit the hardest (the poorest decile pays 17 percent of its income in indirect taxes while the richest deciles pay only 7-8 percent). As a result, indirect taxes increase income inequality and poverty. (Bucheli et al. 2013)

In addition, tax incidence analysis, therefore, confirms the results of country modeling that indirect taxation which does not exempt basic necessities tends to be regressive.

All Scandinavian countries—like almost all OECD and many middle income countries—have a multiple rate VAT. As we saw above, this is also the case in many developing countries. The objective of the multiple rates is to make the VAT less regressive (even if less efficient). Moreover, in OECD countries such as Scandinavia, the revenue foregone in VAT payments in the consumption of low-rated items by high-income individuals may be seen as compensated by high PIT rates on these income groups. The standard VAT rate is 25 percent for Denmark, Norway and Sweden and 23 percent in Finland. In 2008, VAT collections ranged between 7 percent (in Norway) and 10 percent in Denmark.

All four Scandinavian countries have lower rates and exemptions on goods and services considered to be of high public utility. Denmark, 0-rates exports and newspapers and exempts a number of services with positive externalities such as education, health, welfare and public passenger transport services. Similarly, Sweden, has three reduced rates of: (i) 12 percent on goods and services such as food and hotel accommodations, (ii) 6 percent, on services such as domestic passenger transportation, books, newspapers and certain sporting and cultural events; (iii) 0 percent on the exports of goods, fuel to aircrafts, ships and aircrafts for commercial transport and services related to them and prescription pharmaceuticals; and (iv) exemptions, for health and welfare, education, and the sale and letting of real property. Norway has reduced rates of 14, 8 and 0 percent as well as exemptions while Finland has reduced rates of 13, 9 and 0 percent on similar goods and services as in the other two Scandinavian countries. All four countries—as is still common globally—exempt financial and insurance services. Unlike in the preceding cases, however, this latter exemption is not determined by “public good” considerations but rather by the fact that the international community has not yet found an effective way of taxing financial services.

3. The Tax Systems of Two Successful Middle-Income Countries - Brazil and China

The two sections below will trace the main lines of the tax systems of Brazil and China, which hold useful lessons for middle income countries undertaking tax reform.

Brazil

There are a large number of indirect taxes operating at the federal, state and municipal level with multiple rates, including lower rates for food and a number of exemptions. Like in the United States, each state has its own sales tax rates and regulations. There are two types of VAT in Brazil: a state sales tax and a federal excise tax. The standard rate of the state’s sales tax ranges from 17 to 19 percent depending on the state. There are reduced rates of 7 percent and 12 percent which apply to

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23 The description of the tax system draws heavily from Higgins and Pereira 2013.
inter-state supplies within Brazil depending on the region into which goods are sold and to certain intra-state supplies, such as diesel oil and hydrated ethyl alcohol fuel, motor vehicles and transport services (12 percent). Goods that are part of the basic food basket and products from the electronic data processing industry are taxed at a reduced rate of 7 percent while supplies of books, newspapers, periodicals, and the paper consumed in the printing of such products, sale of fixed assets, fruits, vegetables, and farm and garden produce and preservatives are exempt. Imports are taxed at rates ranging from 4 to 25 percent while communication services are taxed at a rate ranging between 13 and 25 percent.

Table 12: Federal Taxes as a Share of Total Government Receipts in 2002

<table>
<thead>
<tr>
<th>Federal Taxes as a share of total government receipts in 2002</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Total Federal taxes</strong></td>
</tr>
<tr>
<td><strong>Direct Taxes</strong></td>
</tr>
<tr>
<td>Personal Income Tax</td>
</tr>
<tr>
<td>Social Security contributions</td>
</tr>
<tr>
<td><strong>Indirect Taxes</strong></td>
</tr>
<tr>
<td>Tax on industrial products</td>
</tr>
<tr>
<td>Contribution to the financing of social security</td>
</tr>
<tr>
<td>Social integration programs and program for public servant</td>
</tr>
<tr>
<td>Education Salary</td>
</tr>
<tr>
<td>Social security contribution of firms</td>
</tr>
</tbody>
</table>


The tax system on its own, on the other hand, is regressive. Direct taxes are strictly progressive, with the first five deciles paying 0, 1, 2, 3 and 4 percent of their income in income taxes while the top decile pays 10 percent. Indirect taxes, on the other hand, are highly regressive with the bottom decile bearing almost three times the burden of the top decile. This incidence, which is much more regressive than in other Latin American and middle income countries, is not mainly due to the tax structure (which includes lower rates for goods consumed by the poor). Rather, it is the result of the extremely high level of inequality of market income and the lower percentage of rural population in Brazil. Because the tax system is dominated by indirect taxes, it is regressive as a whole. On the other hand, because income is so strongly concentrated at the top, the government collects most of its taxes from the upper income groups (See Table 13).

24 The percentage of rural population in Brazil is only 15 percent while it is 21 percent in Latin America and the Caribbean region as a whole and 51 percent in middle-income countries. The rural poor are typically much less hard hit by indirect taxes than the urban poor as they have some home-grown production and purchase much of the rest in local agricultural markets which do not pay taxes.
Table 13: Distribution of Tax Payments by Income Group (deciles) (%)

<table>
<thead>
<tr>
<th>% of total taxes paid by each income group</th>
<th>1</th>
<th>2</th>
<th>3</th>
<th>4</th>
<th>5</th>
<th>6</th>
<th>7</th>
<th>8</th>
<th>9</th>
<th>10</th>
</tr>
</thead>
<tbody>
<tr>
<td>Direct Taxes</td>
<td>0</td>
<td>1</td>
<td>1</td>
<td>2</td>
<td>2</td>
<td>3</td>
<td>5</td>
<td>7</td>
<td>13</td>
<td>66</td>
</tr>
<tr>
<td>Personal</td>
<td>0</td>
<td>0</td>
<td>0</td>
<td>0</td>
<td>0</td>
<td>0</td>
<td>0</td>
<td>0</td>
<td>3</td>
<td>97</td>
</tr>
<tr>
<td>Corporate</td>
<td>0</td>
<td>1</td>
<td>2</td>
<td>3</td>
<td>4</td>
<td>6</td>
<td>10</td>
<td>14</td>
<td>22</td>
<td>38</td>
</tr>
<tr>
<td>Indirect Taxes</td>
<td>3</td>
<td>4</td>
<td>5</td>
<td>6</td>
<td>7</td>
<td>7</td>
<td>10</td>
<td>13</td>
<td>16</td>
<td>29</td>
</tr>
<tr>
<td>Total</td>
<td>2</td>
<td>3</td>
<td>4</td>
<td>4</td>
<td>5</td>
<td>6</td>
<td>9</td>
<td>11</td>
<td>16</td>
<td>40</td>
</tr>
</tbody>
</table>

Taxes paid as a % of gross income by income groups (deciles)

| Direct Taxes                              | 0   | 1   | 2   | 3   | 4   | 4   | 5   | 5   | 6   | 10  |
| Indirect Taxes                            | 22  | 17  | 16  | 14  | 14  | 13  | 13  | 12  | 11  | 8   |

Source: Rezende and Cunha (2002).

As a result of indirect taxes, a non-trivial share of the non-poor/moderate poor/extreme poor become poor/extreme poor/ultra-poor respectively, despite transfers. Indirect taxes move 11 percent of those vulnerable to poverty into poverty, 15 percent of in moderate poverty into extreme poverty and 4 percent of those in extreme poverty into ultra-poverty despite any cash transfers they receive (Lustig and Higgins). In fact, the effective tax rate on the basic food basket is 13 percent on average despite lower state taxes on food. Because the poor spend a larger proportion of their income on food, they are hit very hard by the amount of indirect taxes.

China

China collects 23 percent of GDP in taxes and, through its state-owned enterprises, sustains a level of public investment of 26 percent of GDP. Tax and expenditure responsibilities are split across the various levels of government. Direct and indirect taxes account for 25 and 60 percent of overall government revenues respectively. Personal income tax collections are still very low, amounting to 6 percent of tax revenues in 2006.

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25 To measure the impact of fiscal policy on poverty in a middle income country, Higgins and Pereira and Lustig and Higgins use the international poverty lines proposed by the World Bank of US$1.25 PPP per day (ultra poverty), US$2.50 PPP per day (extreme poverty), and US$4.00 PPP per day (moderate poverty), as well as the lines used to determine eligibility for the Conditional Cash Transfer program Bolsa Família’s fixed benefit (70 reais per month [$1.34 PPP per day]) and variable benefit (140 reais per month [$2.69 PPP per day]).
China has relatively high tax rates for personal income on labor, moderate rates for corporate and capital income gains and makes extensive use of tax incentives.

Personal income tax rates are progressive, with a top rate of 45 percent. Capital gains, on the other hand, are taxed at a flat rate of 20 percent. Corporate income is taxed at 25 percent, since 2007 irrespective of ownership. China has a system of tax incentives designed to subsidize all high-tech companies and companies investing in equipment for environmental protection, water conservation and production safety. The first subsidy is characteristic of industrial policy while the latter two can be justified in terms of correcting for positive externalities generated by these activities. China, however, arguably makes excessive use of tax incentives, eroding the neutrality of the tax system and reducing the tax base sometimes with questionable results (See Box X).

China has three VAT rates, including reduced rates for basic necessities and small-scale producers, 0-rating as well as special consumption taxes on luxury goods.

The standard rate is 17 percent. A reduced rate of 13 percent applies to items such as grain and edible oil, books and newspapers, tap water and heating, feeds, and agricultural products while exports are 0-rated. Exports of some goods, however, are not wholly zero-rated and the associated input tax is not refundable in full to the exporters. Most services, such as transportation, telecommunications, construction, and hotel services are taxed between 3 and 20 percent. Unlike many countries, China does not exempt financial and insurance services from VAT. The VAT rate for small-scale VAT payers is 3 percent. A special consumption tax is imposed on luxury goods and services at higher rates on goods presumably consumed by high-income earners – alcohol, tobacco, cosmetics, firecrackers, gasoline and diesel and automotive products.

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**Box 1. The Impact of China’s 2004 VAT Exemptions Pilot**

Beginning in 2004, the Chinese government implemented a VAT reform in three Northeast provinces which removes fixed asset investment from the tax base. These provinces were chosen because, whereas many coastal cities had undergone rapid changes and upgrades in capital assets and technology, the traditional industrial base of the northeast regions had been left behind. The objective of the reform was to encourage firms in these provinces to invest more on fixed productive assets and upgrade their technology and thus revitalize these old industrial bases.

The reform significantly reduced firms’ tax burdens, but also reduced employment while its effect on investment was limited and only positively significant for state-owned enterprises. The profits of domestic firms improved after the tax burden was partially removed while the profits of foreign firms fell. The impact on firm productivity was only significant for domestic firms and the effect was negative. Moreover, for most firms, their exports fell in conjunction with the tax reform.

The reform led firms to use fewer workers, increased profits for SOEs and led to some increase in productive investment among SOEs, but no significant change for other firms. Treated firms reduced employment between 6 and 8 percent.

Despite the fact that the main impact of the reform seems to have been inducing labor-saving growth, it was extended to the rest of China in 2009.

(Cai and Harrison, 2011)
Over the past three decades, VAT collections have increased across the world and room for increasing VAT rates is shrinking. VAT revenues have been used to substitute for declining revenues from other sources, especially trade taxes and, in some countries, CIT revenues. As a result, economic and political room for increasing VAT rates is very limited in both developed and developing countries.

Broadening the base of the VAT tends to increase the tax burden on lower and lower-middle income groups, particularly in highly urbanized middle income countries. Some policy advice focuses on broadening the base of the VAT, but tax incidence analysis and country modeling results show that including basic necessities in the VAT base turns a potentially neutral tax into a regressive one. This is not necessarily the case in low income countries with high levels of rural population and high levels of informality.

A VAT without sufficient exemptions or lower rates for necessities makes it highly regressive in many Latin American countries despite the presence of transfers to the poor. The standard prescription of having a broad-based VAT supplemented with transfers to the poor is found to be insufficient to make the overall tax-and-transfer system progressive. It hits particularly hard lower-middle income groups, which do not benefit from the transfers the poorest income deciles receive.

Efforts to increase VAT collections should thus particularly focus on increasing collection efficiency and broadening the base to financial transactions. This can be achieved through strengthened tax administration, including simpler regulations, greater ease of paying taxes, more effective use of third-party information and overall improvement refund management. A potential area for broadening the base of the VAT would consist in extending it to financial transactions which have, to the present, been exempt in most countries. This would greatly enhance the horizontal neutrality and the vertical equity and overall fairness of the tax system, enhancing its legitimacy.

Globally, there is a need to re-balance tax composition increasing the weight of direct taxes relative to indirect taxation. The case for this rebalancing is particularly strong in developing countries as there is no robust evidence of the impact of tax composition on growth. Moreover, broad-based VATs weigh heavily on lower and lower-middle income groups especially in highly urbanized middle income countries with low informality. Easing the weight on indirect taxes would help improve the distributive impact of tax policy and enhance the legitimacy of the tax system. It would also foster aggregate demand and enhance the working of automatic stabilizers.

Developing countries would be well advised in avoiding labor demand-dampening measures such as high payroll taxes and measures to cheapen the cost of capital. There is evidence that in OECD countries as well as in Latin America payroll taxes have fostered labor substituting technology. Moreover, capital-favoring measures (such as accelerated depreciation and VAT exemption for capital investments) have similarly led to less labor-intensive growth in many countries, including in China. A labor-intensive growth model, therefore, should resist these policies.
# Annex B

*Reproduced from PWCs Worldwide Tax Summary 2012 – relevant portions on VAT for sample of 15 countries*

<table>
<thead>
<tr>
<th>COUNTRY</th>
<th>REGIME</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>OECD</strong></td>
<td></td>
</tr>
<tr>
<td>Australia</td>
<td>The federal government levies GST at a rate of 10%, and distributes the revenue to state governments. The GST is a value-added tax (VAT) applied at each level in the manufacturing and marketing chain and applies to most goods and services, with registered suppliers getting credits for GST on inputs acquired to make taxable supplies. Exemptions: Food with some significant exceptions; exports; most health, medical, and educational supplies; and some other supplies are ‘GST-free’ (the equivalent of ‘zero-rated’ in other VAT jurisdictions) and so not subject to GST. A registered supplier of a GST-free supply can recover relevant input tax credits, although the supply is not taxable. Residential rents, the second or later supply of residential premises, most financial supplies, and some other supplies are ‘input-taxed’ (‘exempt’ in other VAT jurisdictions) and are not subject to GST. However, the supplier cannot recover relevant input tax credits, except that financial suppliers may obtain a reduced input tax credit of 75% of the GST on the acquisition of certain services. Health insurance is GST-free. Life insurance is input-taxed. General insurance is taxed. Reverse charges may apply to services or rights supplied from offshore, where the recipient is registered or required to be registered, and uses the supply solely or partly for a non-creditable supply.</td>
</tr>
<tr>
<td>Korea</td>
<td>VAT is levied at a rate of 10% on sales and transfers of goods and services, except zero-rated goods and services (e.g. goods for exportation, services rendered outside Korea, international transportation service by ships and aircraft, other goods and services supplied for foreign exchange earnings) and exempt goods and services (e.g. basic life necessities and services, such as unprocessed foodstuffs and agricultural products; medical and health service; finance and insurance services; duty-exempt goods). Electronic VAT invoicing is a compulsory requirement. If a taxpayer fails to issue the electronic VAT invoice or report electronically to tax authorities, the relevant penalties shall be imposed.</td>
</tr>
<tr>
<td>Singapore</td>
<td>Goods and services tax (GST) is charged at 7% on the supply of goods and services made in Singapore by a taxable person in the course or furtherance of one’s business. The only exemptions from GST are prescribed financial services (including life insurance) and the sale or rental of residential properties. Zero-rating only applies to</td>
</tr>
</tbody>
</table>
the export of goods and international services.

GST is also levied on imports of goods, at the time of importation. However there are reliefs available to ease the cash-flow burden of import-export traders by suspending GST at the time of importation. GST is not currently charged on imports of services.

A taxable person is one who is, or is required to be, registered for GST. GST registration is required if one’s taxable turnover exceeds SGD 1 million per year. Voluntary registration is permitted if the taxable turnover is below the registration limit, subject to conditions.

A supply of goods is made in Singapore if the goods are in Singapore at the time of supply, and a supply of services is made in Singapore if the supplier belongs in Singapore. Generally, a person belongs in Singapore if one’s business (including carrying on a business through a branch or agency) or fixed establishment is in Singapore.

A taxable person is allowed to offset the input GST paid on taxable purchases against the output GST chargeable on supplies made. However, certain purchases are specifically denied an input GST deduction. These include supplies of goods and services such as non-business expenses, club subscription fees, family benefits, car rental expenses, motor vehicle expenses, medical expenses, and transactions involving betting, sweepstakes, lotteries, fruit machines, or games of chance.

A non-resident is not entitled to GST refunds except by appointing a resident tax agent to act on one’s behalf. The resident tax agent can then recover import GST paid on behalf of the non-resident business but will be required to account for output GST on any subsequent supply of the non-resident’s goods in Singapore.

The standard VAT rate of 20% applies to most goods and services, apart from domestic fuel and power and certain other reduced-rate supplies, which are subject to VAT at 5% (note that the standard rate was increased from 17.5% with effect from 4 January 2011).

Most exports, most food, most public transport, books and publications, and certain other essential goods and services are zero-rated. Some supplies are exempt, the main categories being the grant of certain interests in land, insurance, financial services, betting and gaming, education, certain sports services, cultural services, and health and welfare. Zero-rating is preferable to exemption because the VAT on costs incurred in making a zero-rated supply can be recovered while that incurred in making an exempt supply cannot.

VAT is chargeable on the supply of most goods and services made in the United Kingdom by ‘taxable persons’ in the course of business, when their taxable turnover
exceeds the registration thresholds. Taxable persons include individuals, companies, partnerships, clubs, associations, or charities.

Taxable persons who are not normally resident in the United Kingdom, do not have a business establishment in the United Kingdom, and, in the case of companies, are not incorporated in the United Kingdom, but who make taxable supplies, sales to unregistered persons in the United Kingdom, or acquisitions of goods in the United Kingdom above the relevant limits, may be required to register and account for VAT in the United Kingdom.

If the value of taxable supplies is over a specified limit, registration for VAT is compulsory unless the taxable supplies made are wholly or mainly zero-rated, in which case it is possible to apply for exemption from registration. The government confirmed in Budget 2012 that with effect from 1 December 2012, a zero VAT registration threshold will apply for businesses not established in the United Kingdom.

The rules applying to VAT and territoriality are different to those applying to direct tax in that they derive from the principles of the place of supply in EU law, as enshrined in European Commission (EC) VAT Directives. Having determined that a supply of goods or services has taken place, the second condition to be determined, if the transaction is to fall within the scope of UK VAT, is whether the supply takes place within the United Kingdom. The place of supply rules is different for goods and for services. A person or business belonging outside the United Kingdom, with no place of business in the United Kingdom, may nevertheless be liable to UK VAT registration where the place of supply of those goods or services is in the United Kingdom.

For goods, the basic rule is that a supply of goods is taxable in the territory where those goods are physically located at the time of supply. Hence, if goods are supplied in the United Kingdom by a non-established taxable person, there will still be a liability for VAT purposes, and the person must register for VAT in the United Kingdom if the taxable supplies exceed the current UK VAT registration thresholds.

For services, the basic rule is that services are treated as made where the customer ‘belongs’ or is established for VAT purposes, and the customer is responsible for accounting for the VAT due via the reverse charge procedure. However, this is subject to a number of special rules and exceptions. Determining where a business is established for VAT purposes is based on EU law criteria.

For business to consumer (B2C) supplies, the basic rule is that services are treated as made where the supplier ‘belongs’ or is established for VAT purposes.

**VAT returns and payments**

VAT returns must be completed at preset intervals (usually every three months).

Larger companies may be required to file monthly returns or make monthly payments on account. As of 1 April 2012, all businesses are required to file VAT returns online.
and make electronic payments. Smaller enterprises can apply for annual returns. VAT returns are usually required to be filed 30 days after the end of the period. Annual accounting is available for taxable persons with annual turnover (taxable supplies, excluding VAT) not exceeding GBP 1,350,000.

Cash accounting is available for taxable persons with annual turnover (taxable supplies, excluding VAT) not exceeding GBP 1,350,000.

In addition, a flat rate scheme operates for small businesses and is intended to simplify VAT accounting procedures.

USA

NO VAT

BRICS

BRAZIL

VAT is payable on imports, sales, and transfers of goods and products in the form of (j) a federal excise tax Imposto sobre Produtos Industrializados or IPI) at various rates in accordance with the nature of the product (normally around 10% to 15%, but in certain cases ranging to over 300%) and (ii) a state sales and service tax (Imposto sobre as operações relativas à Circulação de Mercadorias, e sobre a prestação de Serviços de transporte interestadual e intermunicipal e de comunicação or ICMS) with rates ranging from 7% to 25%.

Except for services related to freight and transportation, communications, and electric energy, which are subject to ICMS, income from services rendered is normally subject to a municipal service tax (Imposto Sobre Serviços de qualquer natureza or ISS), which is not a VAT, with rates ranging from 2% to 5%.

CHINA

Pilot Program of indirect tax reform in Shanghai

In order to mitigate the multiple taxation issue associated with goods and services and to support the development of ‘modern service industries’ in China, the State Council resolved in early 2011 to introduce a Pilot Program in the city of Shanghai to expand the scope of value-added tax (VAT) to cover selected industries that were originally subject to business tax (BT).

The Pilot Program in Shanghai started from 1 January 2012. This earmarks the official kick off of the long-awaited transformation of BT to VAT for service industries in China.

The industries selected for the Pilot Program and the applicable VAT rates (for general VAT-payers) are set out in the following table.
Small-scale VAT-payers in the above Pilot Industries are subject to the VAT rate of 3%.

Enterprises (including foreign enterprises) providing Pilot Services in Shanghai are subject to VAT instead of BT from 1 January 2012.

There are some other cities, including but not limited to Beijing, expressing interest to run similar Pilot Programs in the near future. It is possible that after the Pilot Programs in different localities, the Chinese authorities will collect the experience and modify the Pilot Programs before the transformation is implemented nationwide. It is generally contemplated that the transformation will need to be completed within China’s 12th Five Year Plan (2011 to 2015).

Value-Added Tax (VAT)

The sales or importation of goods and the provision of repairs, replacement, and processing services are subject to VAT. VAT is charged at a standard rate of 17%, and the rate for small-scale taxpayer is 3%. The sales of certain necessity goods may be subject to VAT at a reduced rate of 13%, as specified in the VAT regulations.

The VAT system is a consumption-based VAT system, which means that input VAT on fixed assets is fully recoverable except for situations specified in the VAT regulations.

Export of goods from China may be entitled to a refund of VAT incurred on materials purchased domestically. The refund rates range from 0% to 17%. There is a prescribed formula for determining the amount of refund, under which many products do not obtain the full refund of input VAT credit and suffer different degree of export VAT costs.

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<table>
<thead>
<tr>
<th>Pilot industries</th>
<th>Applicable VAT rate (%)</th>
</tr>
</thead>
<tbody>
<tr>
<td>Transportation service industry</td>
<td>11</td>
</tr>
<tr>
<td>Certain modern service industries:</td>
<td></td>
</tr>
<tr>
<td>Research, development, and technical services</td>
<td>6</td>
</tr>
<tr>
<td>Information technology services</td>
<td>6</td>
</tr>
<tr>
<td>Cultural creative services</td>
<td>6</td>
</tr>
<tr>
<td>Logistic auxiliary services</td>
<td>6</td>
</tr>
<tr>
<td>Certification and consulting services</td>
<td>6</td>
</tr>
<tr>
<td>Tangible movable property leasing services</td>
<td>17</td>
</tr>
</tbody>
</table>

Small-scale VAT-payers in the above Pilot Industries are subject to the VAT rate of 3%. Enterprises (including foreign enterprises) providing Pilot Services in Shanghai are subject to VAT instead of BT from 1 January 2012.

Business tax (BT) A BT is imposed on services, transfer of intangible assets, and immovable property taking place within China. Services taking place within China refers to situations where the service provider, the service recipient, or both are in China. This may make services even being rendered outside China subject to BT in China. BT rates are 3% or 5%, except for the leisure and entertainment industry, which may be subject to a rate of up to 20%. BT is not recoverable but is deductible for CIT purposes.

As indicated above, under the Pilot Program of the indirect tax reform in Shanghai, enterprises providing Pilot Services in Shanghai will be subject to VAT instead of BT from 1 January 2012.

INDIA

The sale of movable goods in India is chargeable to tax at the central or state level. The Indian regulatory framework has granted power to state legislatures to levy tax on goods sold within that state. Such sales are, therefore, chargeable to VAT at the rates notified under the VAT laws of the relevant state. All goods sold in the course of interstate trade are subject to CST.

Where goods are bought and sold by registered dealers on an inter-state basis for trading or for use as inputs in the manufacture of other goods or specified activities (such as mining or telecommunication networks), the rate of sales tax is 2%, provided Form ‘C’ is issued by the purchasing dealer. In the absence of Form ‘C’, the applicable rate would be the rate of VAT on such goods in the originating state. Interstate procurement, on which CST is charged by the originating state, is not eligible for input tax credit in the destination state and hence is a cost to a buyer.

State level sales tax has been replaced by VAT in all the states. Under the VAT
regime, the VAT paid on goods purchased within the state is eligible for VAT credit. The input VAT credit can be utilized against the VAT/CST payable on the sale of goods. It is, thus, ensured that the cascading effect of taxes is avoided and only the value addition is taxed.

Currently, there is no VAT on imports into India. Exports are zero-rated. This means that while exports are not charged to VAT, VAT charged on inputs purchased and used in the manufacture of export good or goods purchased for exports is available to the purchaser as a refund.

The state VAT is charged at tax rates of 1%, 4%, 5%, and 20%. Goods other than those notified to be covered under the above rates are charged in the range of 12.5% to 15%. The rate of VAT depends on the nature of goods involved and varies from state to state.

Turnover threshold is prescribed so as to exclude small traders from the ambit of the VAT.

A tax tender composition scheme, at a lower rate, may be levied on small traders, within a specified turnover limit, in lieu of VAT.

CENVAT (Excise Duty)

Central Value Added Tax (CENVAT) is an excise duty levied by the Central Government on the manufacture or production of movable and marketable goods in India. The rate at which excise duty is leviable on the goods depends on the classification of the goods under the Excise Tariff. The Excise Tariff is primarily based on the eight digit HSN classification adopted so as to achieve conformity with the Customs Tariff.

The excise duty on most consumer goods, which are intended for retail sale, is chargeable on the basis of the MRP printed on the package of the goods. However, abatements are admissible at rates ranging from 15% to 55% of the MRP. Goods, other than those covered by MRP based assessments, are generally chargeable to duty on the ‘transaction value’ of the goods sold to an independent buyer. In addition, the Central Government has the power to fix tariff values for charging ad valorem duties on the goods.

Typically, the duty rate is 12%. However, notifications granting partial or complete exemption for specified goods from payment of excise duties are also available.

Education cess at 2% and secondary and higher education cess at 1% are applicable on the aggregate of excise duties. Thus, the effective rate of excise duty is 12.36%.

The central excise duty is a modified VAT wherein a manufacturer is allowed credit of the excise duty paid on locally sourced goods and the CVD and ADC paid on imported goods. The CENVAT credit can be utilized for payment of excise duty on
the clearance of dutiable final products manufactured in India. Manufacturers of
dutiable final products are also eligible to avail CENVAT credit of the service taxes
paid on input services used in or in relation to the manufacture of final products and
clearances of final products from the place of removal, subject to fulfillment of
conditions.

RUSSIA

VAT is a federal tax in Russia, payable to the federal budget.

There is no separate VAT registration in Russia. The established general tax
registration requirements are applicable to all taxes, including VAT.

Taxpayers follow a ‘classical’ input-output VAT system, whereby a VAT payer
generally accounts for VAT on the full sales price of the transaction and is entitled to
recover input VAT incurred on inventory costs and other related business expenses.
The Russian VAT system, although not originally based on the European Union (EU)
model has moved towards it. However, it still currently differentiates from the EU
VAT system in multiple ways.

Output VAT

Generally, VAT applies to the value of goods, works, services, or property rights
supplied in Russia. The standard VAT rate is 18% in Russia (with a lower rate of
10% applicable for certain basic foodstuff, children’s clothing, medicines and medical
products, certain printed publications, etc.). The same VAT rates apply for imports of
goods into Russia.

Exports of goods, international transportation and other services related to the export
of goods from Russia, international passenger transportation, and certain other
supplies are zero-rated with an input VAT recovery right. The application of the 0%
VAT rate and recovery of the respective input VAT should be confirmed by
submitting a number of documents to the tax authorities within certain time limits.
Special rules are provided in respect of the documentary confirmation of the right to
tax export supplies to Customs Union member countries with a 0% VAT rate,
including an input VAT recovery right.

The list of VAT exempt goods and services includes basic banking and insurance
services, educational services by certified establishments, sale of certain essential
medical equipment, passenger transportation, and certain other socially important
services. Most accredited offices of foreign legal entities (as well as the accredited
employees of these offices) may be exempt from VAT on property rental payments.

Performance of VAT exempt supplies gives no right for the recovery of the
attributable input VAT; instead, costs associated with non-recoverable input VAT are,
in most cases, deductible for profits tax purposes.
Withholding VAT

Russian VAT law contains rules for determining where services are supplied from a VAT perspective. These rules divide all services into different categories for determining where they are deemed to be supplied for VAT purposes. For example, certain services are deemed to be supplied where they are performed, some where the ‘buyer’ of the services carries out the activity, others where the immovable property is located, etc.

Under the reverse-charge mechanism, a Russian company must account for VAT on any payment it makes to a non-tax registered foreign company, if the payment is connected to a supply of goods or services regarded as supplied in Russia, based on the VAT place of supply rules and not falling under any VAT exemption based on the domestic VAT law. In such circumstances, according to the law, the Russian buyer shall act as a tax agent for Russian VAT purposes by withholding Russian VAT at the rate of 18/118 from payments to the foreign supplier and remit such withheld VAT to the Russian budget.

The withheld VAT may be recovered by the Russian payers in accordance with the standard input VAT recovery rules provided by law.

Input VAT Recovery

Generally, taxpayers are eligible to recover input VAT associated with the purchase of goods, works, services, or property rights, provided a set of rules established by the VAT legislation is met. Input VAT could potentially be recovered by the taxpayer in the following cases:

VAT related to goods, services, or works acquired for the purpose of conducting VATable Transactions

VAT related to the purchased goods, works, or services used in non-VATable transactions, if the portion of expenses related to non-VATable operations does not exceed 5% of total amount of expenses.

Input VAT related to advance payments performed to Russian suppliers of goods (works, services) provided such acquired goods (works, services) are aimed at being used in VATable activities. Please note that application of this rule is the right of taxpayers (rather than an obligation), and taxpayers may choose whether to enjoy this right or not.

VAT Compliance Requirements

Each taxpayer performing supplies of goods, works, services, or property rights is liable to issue VAT invoices and provide them to customers. VAT invoices shall be issued within five days after the supply has occurred. The form of the VAT invoice is
a standard one, established by the government. Compliance with invoicing requirements is critical to the buyer’s ability to recover input VAT.

E-invoicing is also allowed under the Russian Tax Code. However, the e-invoice format and the necessary protocol are not yet established by the respective authorities.

E-invoicing requires digital signature and data transfer via operators and is subject to mutual agreement of the transaction parties. Operators are companies who provide services for exchange of open and confidential information via telecommunication channels.

Generally, incoming and outgoing VAT invoices shall be registered by taxpayers in special purchases and sales VAT ledgers.

VAT returns shall be submitted to the tax authorities on a quarterly basis. VAT must be paid to the Russian budget after the end of each quarter in three installments not later than the 20th day of each of the three consecutive months following the quarter except for the remittal of VAT withheld by Russian buyers tinder the reverse charge mechanism, which is to be transferred to the Russian budget at the date of the external payment.

**Import VAT**

Import VAT is payable in customs upon importation of goods. The tax base for import VAT purposes is generally the customs value of the imported goods, including excise payments. Either the 18% or 10% VAT rate may apply upon import of goods in Russia, depending on the specifics of the goods.

A limited range of goods is eligible for exemption from import VAT. The list of such goods includes, for example, certain medical products and goods designated for diplomatic corps. Relief from import VAT is available on certain technological equipment (including their components and spare parts) analogues of which are not produced in Russia. The list of such equipment is established by the Russian government.

**SOUTH AFRICA**

VAT is an indirect tax, which is largely directed at the domestic consumption of goods and services and at goods imported into South Africa. The tax is designed to be paid mainly by the ultimate consumer or purchaser in South Africa. It is levied at two rates, namely a standard 14% rate and a zero rate (0%).

Very few business transactions carried out in South Africa are not subject to VAT. The tax is collected by businesses which are registered as vendors with SARS on all taxable supplies throughout the production and distribution chain. Sales or supplies by non-vendors are not subject to VAT.

**VAT Registration and Administration**
All suppliers of goods and services having an annual turnover currently exceeding ZAR 1 million are obliged to register as VAT vendors and to charge output VAT. Other vendors may elect to register as VAT vendors, provided their annual turnover exceeds ZAR 50,000. If they do not register, they are prohibited from charging VAT on goods or services they supply and claiming an input tax (rebate of VAT paid) on goods and services which they acquire.

Under the VAT system, vendors normally pay VAT on expenses (input tax) and charge VAT on supplies made (output tax). This mechanism, therefore, ensures that only the so-called ‘added-value’ is taxed. Due to VAT being a self-assessment system, the output tax collected may be reduced by input tax paid. Thereafter, the net amount is payable to, or refundable by, the SARS. The self-assessment returns are due regularly within prescribed periods (tax periods).

Taxable Supplies

Standard rated and zero-rated supplies are known as taxable supplies. Other supplies are known as exempt and non-supplies.

Goods and Services

For a liability for VAT to exist, there must be a supply or importation of goods or services. Goods are corporeal movable things, fixed property, and real rights in such things and property. The meaning of ‘services’ is very broad and includes the granting, assignment, cession, or surrender of any right or the making available of any facility or advantage.

Imports

Services imported by a vendor and utilized or consumed by the vendor for the making of taxable supplies are not subject to VAT. In addition, the VAT Act has a schedule that lists goods that are exempt from VAT on importation, whether by a vendor or an unregistered person.

Zero-rated Supplies

The VAT Act contains a list of the supplies of goods or services that are taxed at the zero rate. Most of the items refer to exports and international transport, but other specified goods utilized for farming purposes, the sale of an enterprise as a going concern, fuel subject to the fuel levy, and deemed supplies by welfare organizations are also zero-rated.

A zero-rated supply made by a vendor is subject to VAT but at a rate of 0%. Under a zero-rated supply, a vendor does not charge VAT on the consideration for the supply and obtains a refund or credit for the VAT paid on taxable supplies utilized in the making of the zero-rated supplies.
Exempt Supplies

In addition to zero-rated supplies, the VAT Act contains a list of the supplies of goods or services that are exempt from VAT. While all fee-based financial services are subject to VAT, the charging of interest is exempt. Other exempt supplies include residential rentals, basic foodstuffs, non-international passenger transport by road or rail, and educational services.

Under exempt supplies by vendors, the vendors do not charge VAT on the supply, and they are not entitled to a deduction or credit for the VAT paid by them on goods and services supplied to them for the making of the exempt supply. Accordingly, vendors treat the VAT paid by them, and for which they do not obtain a deduction or credit, as another cost and recover it in the consideration they charge for the making of the exempt supply.

NEIGHBORS

CAMBODIA

VAT is applicable to real-regime entities and is charged at 10% on the value of the supply of most goods and services.

Exported goods and services rendered outside Cambodia are zero-rated. In addition, 0% VAT applies to the supporting industries or contractors who directly supply goods or services to the export-oriented garment manufacturers, textile, footwear industries, and domestic supplies of paddy rice.

Some supplies are VAT exempt, the main categories being public postal services, medical and dental services, electricity, transportation of passengers by wholly state-owned public transport systems, insurance services, and primary financial services.

VAT returns and payments are due within 20 days of the following month. Note that strict record-keeping requirements do exist.

INDONESIA

With a few exceptions, VAT is applicable on deliveries (sales) of goods and services within Indonesia at a rate of 10%. VAT on export of goods is zero-rated while the import of goods is subject to VAT at a rate of 10%. Zero-rated VAT is also applicable on exported services, but subject to a MoF limitation. Currently, only certain exported services, including toll manufacturing services, are subject to the 0% VAT rate. Services performed within the Customs Area for customers outside of the Customs Area are considered as locally delivered and are therefore subject to the regular VAT rate of 10%. Inbound use or consumption of foreign services or intangible goods, with a few exceptions, is also subject to a self-assessed VAT at a rate of 10%.

The VAT law allows the government to change the VAT rate within the range of 5% to 15%. However, since the enactment of the VAT law in 1984, the government has never changed the VAT rate.
In general, VAT collection is based on the accrual principle, whereby VAT must be collected at the time of delivery of taxable goods or services. The term delivery, in this case, is defined as the time when risk and ownership of goods have been transferred or when income from a service delivery can be reliably estimated or measured. In the accrual system, income or receivables are acknowledged when a transaction takes place, regardless of whether the transaction has been paid for or not. The recognition of revenue or receivables is indicated by the issue of a commercial invoice, which is a source document for this recognition and a basis for recording it.

VAT filing is done on a monthly basis, with payment and filing being due no later than the last day of the month following the taxable delivery.

**LAOS**

The Standard VAT Rate is 10%.

VAT is imposed on the final consumer of goods and services. Goods and services used for production, trading, and consumption in Lao PDR, goods imported into Lao PDR, and services rendered by foreigners to Lao PDR customers are subject to VAT.

Certain goods and services are exempt from VAT. Exempted items include unprocessed agricultural products, seeds, fertilizers, textbooks, education services, medical services, banking services, and insurance.

Exported goods and services are zero rated. The conventional credit method is used to calculate the VAT payable (i.e. output VAT less input VAT). Excess input VAT can be carried forward for six months (extendable). Input VAT for exports is refundable.

Organizations engaged in production or trading of taxable goods and services must register for VAT if their annual revenue is 400 million Lao kip (LAK) or more. Companies below this threshold may voluntarily register. Only registered VAT taxpayers may claim VAT refunds.

One unique feature of Lao PDR VAT is that VAT is charged on withholding taxes (WHTs). WHT is applied to various types of payments made to domestic and foreign recipients.

<table>
<thead>
<tr>
<th>Payment</th>
<th>WHT rate (%)</th>
</tr>
</thead>
<tbody>
<tr>
<td>Dividends</td>
<td>10</td>
</tr>
<tr>
<td>Profit from the sale of shares</td>
<td>10</td>
</tr>
<tr>
<td>Interest and guarantee fees</td>
<td>10</td>
</tr>
<tr>
<td>Payments for use of trademarks and intellectual property</td>
<td>5</td>
</tr>
</tbody>
</table>

VAT of 10% is charged on the above WHT. In the case of a foreign recipient, the WHT is considered a final tax.

**MALAYSIA**

A GST of 4% was originally expected to be implemented in mid-2011, but its
Implementation is now delayed indefinitely. The reason reported for the delay is to allow the government more time to engage with the public in order to gather feedback on the implementation of the GST. When implemented, GST will replace the current sales tax and service tax.

Sales Tax

A single-stage ad valorem tax (sales tax), at rates ranging from 5% to 10%, is imposed on all goods imported into or manufactured in Malaysia, unless specifically exempted.

Service Tax

Service tax is imposed at the rate of 6% on the value of taxable services sold or provided by taxable persons. A list of ‘taxable services’ and ‘taxable persons’ is found in the Service Tax Regulations 1975.

PHILPPINES

VAT applies to practically all sales of services and imports, as well as to sales, barter; exchange, or lease of goods or properties (tangible or intangible). The tax is equivalent to a uniform rate of 12%, based on the gross selling price of goods or properties sold, or gross receipts from the sale of services. On importation of goods, the basis of the tax is the value used by the Bureau of Customs in determining tariff and customs duties plus customs duties, excise taxes, if any, and other charges. Where the valuation used by the Bureau of Customs is by volume or quantity, the VAT basis is the landed cost plus excise taxes, if any.

Certain transactions are zero-rated or exempt from VAT. Export sales by VAT registered persons are zero-rated.

Certain sales of services exempt from VAT, including services provided by financial intermediaries, are subject to percentage taxes based on gross sales, receipts, or income. A 3% percentage tax also applies to persons who are not VAT-registered because their annual sales or receipts do not exceed PHP 1,919,500.
REFERENCES


