



A lack of interest

Christopher Marjoram, Tax Partner at PwC Vietnam, takes a look at the new restrictions on interest deductibility introduced in Decree No 20/2017/ND-CP.



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Vietnam has introduced a restriction on the level of tax deductible interest. The introduction of a fixed ratio rule, which follows the recommendations of the OECD in its BEPS initiative, will have the effect of restricting tax deductions to a percentage of EBITDA. The rules may well affect companies that have never used BEPS strategies. Now is the time for companies to look again at the efficiency of their financing arrangements.



Vietnam has moved quickly to implement the OECD's recommendations on Base Erosion & Profit Shifting (“**BEPS**”) Action 4 (limiting base erosion involving interest deductions and other financial payments) which it recently introduced as part of wide ranging new rules on the taxation of controlled transactions in Decree No. 20/2017/ND-CP (“**Decree 20**”).

The key feature of the new interest restrictions, effective from 1 May 2017, is the introduction of a fixed ratio rule which will limit tax relief for a company's total interest costs to 20% of its earnings before interest, tax, depreciation and amortisation (“**EBITDA**”). On the face of it the rule appears straightforward but naturally the devil lies in the (lack of) detail and there are some nasty traps for the unwary.

The new regulations include some important departures from the OECD recommendations and eschew many others. Vietnam has foregone a number of suggestions in favour of a single modified fixed ratio rule which should be simple to administer but which comes at the risk of restricting tax relief for companies whose financing arrangements do not involve base erosion or profit shifting.

Highly leveraged companies and groups including those in sectors such as real estate, private equity or infrastructure are likely to be most affected by these new regulations although the absence of any de-minimis rule means the compliance burden will fall on all companies regardless of their size or risk profile. The one exception to this applies to banking and insurance companies which are excluded from the interest limitation rules.

One of the key limitations of a fixed ratio test is that it fails to take into account the fact that groups operating in different sectors may require different amounts of leverage and that companies may adopt different funding strategies for a variety of compelling non-tax reasons. The OECD recommendations principally sought to address this deficiency through the introduction of a group ratio rule alongside the fixed ratio rule; allowing ‘enhanced’ interest deductions based on the ratio of group interest to EBITDA. In a departure from the OECD recommendations, Vietnam has chosen not to adopt a group ratio test so the limitation on interest deductibility will apply uniformly across all industry sectors and without regard to the financing position of the wider group.

The final OECD report recommended the introduction of a fixed ratio rule which limits an entity's related party and third party net interest deductions. Consultations prior to the introduction of Decree 20 indicated a willingness by the Vietnamese authorities to follow this approach and to apply the



Christopher Marjoram | Partner, Tax and Legal Services

+84 28 3823 0796, Ext: 1502 | christopher.marjoram@vn.pwc.com

interest limitation rule to both related party and third party interest, although in drafting Decree 20 the limitation appears to apply solely to related party interest. Despite this apparent restriction the definition of related party lending relationships extends to loans or guarantees which account for at least 25 percent of the invested capital and over 50 percent of the total value of medium-term and long-term loans; so in practice many loans which might otherwise have been considered unrelated may still be caught unwittingly.

Notwithstanding the fact that rules appear to be targeted solely at related party interest, ambiguity in the drafting of the Decree has created uncertainty in how the fixed ratio rule should be applied in cases where a company has both related party and third party interest costs. The fixed ratio rule takes into account a company's total interest cost and in some instances could lead to the restriction of an entity's entire related party interest expense where it also has third party financing [Figure 1]. Groups that borrow from third parties and on-lend to related companies may be unexpectedly caught by the interest limitation rule and should take steps to assess the on-going tax efficiency of their financing arrangements. Further clarity is urgently required on this point.

In the absence of any transitional provisions it is not clear whether the rules will apply for all accounting periods ending on or after 1 May 2017 or whether it will be necessary to apply the fixed ratio test from that date. Further guidance on this is also eagerly awaited.

Figure 1. Related party and third party interest

		Company 1
Accounting EBITDA		20,000,000
Third party interest costs		(4,000,000)
Related party interest costs		(2,500,000)
Fixed ratio cap - max deductible interest (20%)	4,000,000	
Total interest expense	6,500,000	
Excess interest (non-deductible)	2,500,000	
Taxable profits before interest (assuming no adjustment to accounting EBITDA)		20,000,000
Third party interest (deductible in full)		(4,000,000)
Tax deductible related party interest (after cap)		Nil
		16,000,000

In this scenario a company has interest expenses arising on both third party and related party debt. After calculating the maximum amount of interest which an entity is allowed to deduct for tax purposes (20m x 20% = 4m) this is compared to the entity's "total" tax deductible interest expense for the fiscal year. In this case the total tax deductible interest expense will be that relating to both related party and third party loans (6.5m) and as the related party interest cost accounts for 4m the authorities may seek to argue that the entire 2.5m of interest on related party loans should be disallowed.

The calculation

The fixed ratio rule, which is calculated on a fiscal year basis, requires a three step approach to the identification of any disallowed interest expense:

Step 1

An entity's operating profit is adjusted to exclude amounts for interest, tax, depreciation and amortisation (EBITDA). In another departure from the OECD guidance the calculation of EBITDA for these purposes is an entirely accounting based measure with no mechanism to adjust for differences between an entity's accounting and taxable profit.

Step 2

The maximum amount of interest which an entity is allowed to deduct for tax purposes in a fiscal year is set at 20% of the EBITDA calculated in step 1.

Step 3

The maximum deductible interest expense calculated in step 2 is compared to the entity's total tax deductible interest expense for the fiscal year. Tax relief for interest in excess of the maximum amount is disallowed.

The use of an accounting based measure of EBITDA rather than a tax adjusted figure should be relatively simple to administer although it may be unduly advantageous to companies with significant non-taxable income such as those for which there are differences in the tax and accounting recognition of revenue, those with differences in accounting and tax deductible depreciation and those with tax incentives [Figure 2].

Once the maximum amount of interest that an entity is allowed to deduct has been calculated (step 2), this amount is compared to the total tax deductible interest expense incurred by the taxpayer in the fiscal year (i.e. the gross interest expense for the fiscal year before offsetting interest income but after adjusting for other restrictions on the tax deductibility of interest).

The restriction of tax deductible interest by reference to gross interest expense rather than net is another example of where the Vietnamese authorities have chosen to step away from the OECD recommendations in favour of a simpler approach, that should be more robust in its prevention of tax avoidance, but which may lead to double taxation where an entity is taxed in full on its gross interest income but part of the corresponding gross interest expense is disallowed. This will be particularly relevant to companies that raise third party debt and on-lend within a group [Figure 3].

Noticeably absent from the new legislation is any definition of what constitutes ‘interest’ for these purposes and in this respect it is likely that the tax authorities will look to the definition contained in the foreign contractor withholding tax rules. Whilst the scope of the definition in the domestic withholding tax rules is much narrower than that endorsed by the OECD which advocated the application of the rules to interest on all forms of debt, payments that are economically equivalent to interest and payments incurred in connection to the raising of finance, the mischief envisaged by the OECD is likely to be less prevalent in Vietnam where sophisticated and highly structured financing instruments are rarely seen, due in large part to registration requirements imposed by the State Bank of Vietnam and Ministry of Finance. Companies may need to consider whether the rules should be applied to finance leases, certain foreign exchange movements and other payments which are economically equivalent to interest but do not sit easily within the withholding tax definition.

Figure 2. The impact of non-operating income on the cap

	Company A	Company B
Net profit after depreciation and amortisation	20,000,000	20,000,000
Non-taxable income	10,000,000	0
Accounting EBITDA	30,000,000	20,000,000
Gross related party interest costs	(5,000,000)	(5,000,000)
Fixed ratio cap - max deductible interest (20%)	6,000,000	4,000,000
Taxable profits before interest (assuming no adjustment to accounting EBITDA and no tax on dividends)	20,000,000	20,000,000
Tax deductible interest (after cap)	(5,000,000)	(4,000,000)
	15,000,000	16,000,000

In the scenario shown above, Company A and Company B have the same level of interest costs and the same performance however Company A is able to obtain tax relief for all of its interest cost without restriction as it receives non-taxable income which increases the maximum amount of tax deductible interest calculated under the fixed ratio rule.

Figure 3. On-lending of third party debt within a group

	Parent	Subsidiary 1	Subsidiary 2
Accounting EBITDA	20,000,000	10,000,000	4,500,000
Third party interest costs	(5,000,000)		
Related party interest income	2,500,000	1,000,000	
Related party interest expense		(2,500,000)	(1,000,000)
Fixed ratio cap - max deductible interest (20%)	4,000,000	2,000,000	900,000
Taxable profits before interest	22,500,000	11,000,000	4,500,000
Tax deductible interest (after cap)	(5,000,000)	(2,000,000)	(900,000)
	17,500,000	9,000,000	3,600,000

In the scenario above, despite the fact that the company has borrowed entirely from third party lenders, in on-lending to its subsidiary the Parent company is taxable in full on the interest income but the tax deductibility of the interest expense is partially restricted. The interest cost in Subsidiary 2 is restricted despite the fact that the net interest amount would be below the cap and that the corresponding interest income is taxable.

Carry forward

The rules do not contain any provisions which allow for the carry forward of excess interest capacity or the carry forward of excess non-deductible interest expenses. In the absence of any such relieving provisions companies are likely to face far greater volatility in their effective tax rates with the impact particularly pronounced for those companies with volatile earnings or where an entity has incurred interest expense to fund an investment which will give rise to earnings in a later period [Figure 4].

There are no transitional rules setting out the treatment of excess interest expenses carried forward at 1 May 2017 which have not expired under the existing 5 year loss carry forward rules. Further guidance is eagerly awaited on whether these losses will continue to be available and companies will need to give careful consideration to the impact on their deferred tax position.

Figure 4. Volatility in earnings

	Year 1	Year 2	Year 3
Accounting EBITDA	20,000,000	(10,000,000)	25,000,000
Gross related party interest costs	(3,000,000)	(3,000,000)	(3,000,000)
Fixed ratio cap - max deductible interest (20%)	4,000,000	0	5,000,000
Taxable profits before interest (assuming no adjustment to accounting EBITDA)	20,000,000	(10,000,000)	25,000,000
Tax deductible interest (after cap)	(3,000,000)		(3,000,000)
	17,000,000	(10,000,000)	22,000,000

In this example, the company performs well in Year 1 but experiences a one-off drop in results in Year 2 before performance again recovers in Year 3. Interest costs remain unchanged throughout.

The negative EBITDA in Year 2 means that the maximum amount of interest which the entity is allowed to deduct for this period is restricted to VNDo. The amount by which the total interest exceeds the maximum tax deductible interest amount (3m) cannot be carried forward and utilised in Year 3 despite the fact that there is 2m of excess interest capacity in this year.

What next

Proponents argue that one of the key advantages of the BEPS initiative is its ability to limit tax avoidance by binding multinationals to a consistent set of global tax rules, although the steps taken by Vietnam in adopting these rules once again highlights the challenges faced by companies from the inconsistent application of the BEPS recommendations around the world.

Now more than ever it will be important for investors with businesses in Vietnam to review the on-going sustainability and efficiency of their financing arrangements and the impact of the new rules on investment decisions, deferred tax and the company’s on-going effective tax rates. The ‘matching’ of interest in the same companies as taxable profits and EBITDA and the impact of intra-group lending will take on added significance.

The introduction of international standards and initiatives of this kind is a very positive and progressive step by the Vietnamese authorities in the prevention of BEPS and the speed of their adoption of the BEPS Action 4 recommendations should be applauded. The authorities may now switch their attention to the adoption of rules implementing other BEPS action plans and companies should plan early for this too.

