Report:

Income Tax Reform in Vietnam

Visit to Hanoi, Vietnam
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Report on Visit to Hanoi, Vietnam

by Michael J. McIntyre

1. Background

This report contains my reactions to the income tax reforms contemplated by the Government of Vietnam. In October of 1996, the government introduced, for discussion purposes only, draft legislation that would establish a modern corporate and personal income tax system and a value-added tax (VAT). The government expects to submit a revised version of that draft to the legislature in April of 1997. Issues relating to the VAT were dealt with by Professor Oliver Oldman during his visit to Hanoi in early October of 1996. That visit was made under the auspices of Government of Vietnam–UNDP Programme VIE/94/003, "Strengthening The Legal Capacity in Viet Nam," executed by the Ministry of Justice of Vietnam.

I visited Hanoi in mid-December of 1996 to consult with government officials and provide technical assistance with respect to the income tax aspects of the reform. My visit may be seen as a continuation of the Oldman mission. The sponsoring agency for my visit was the OECD, which has a long-term interest in providing technical support to Vietnam, especially on international tax matters. The OECD initiative was undertaken at the request of Vice Minister of Justice, Dr. Nguyen Ngoc Hien, acting as the National Programme Director of GVN-UNDP Program VIE/94/003. Local arrangements for the visit were made by the Ministry of Justice staff of GVN-UNDP Programme VIE/94/003 and by various officials in the Ministry of Finance. Mr. John Bentley, Resident Legal Advisor at the Ministry of Justice to the GVN-UNDP Programme, was my liaison prior to my arrival in Hanoi.

I arrived in Hanoi on the afternoon of Wednesday, December 11, having left Detroit in the afternoon of December 9. On Thursday, December 12, I met with members of the corporate tax law drafting team, headed by Mr. Ngo Dinh Quang, Director, Policy Department of the General Department of Taxation. On Friday, I met with various members of the drafting team for the personal income tax, including the head of the team, Dr. Do Thi Thin, Director of the Department of Profit, Income and Capital Taxes of the General Department of Taxation. On Saturday, I met with both drafting teams to discuss certain common elements. These meetings, which I found to be very productive, lasted from 9:00 a.m. to 4:30 p.m. Mr. Bentley attended all of these meetings.

On Sunday, December 14, I met at John Bentley's house with Mr. Quach Duc Phap, the overall head of the three tax law drafting teams and the Vice Director for Tax Policy in the Ministry of Finance. We discussed various issues relating to the reform for most of the morning, and our discussions continued over lunch.

On Monday and Tuesday, December 15 & 16, I helped conduct a workshop at the Ministry of Justice on the proposed draft laws for personal and corporate income taxes. The workshop was organized by GVN-UNDP Programme VIE/94/003 and co-chaired by Mr. Quach Duc Phap, the Vice Director for Tax Policy of the Ministry of Finance and Dr. Dinh Trung, Director of Civil and Economic Legislation for the Ministry of Justice. The two workshop sessions began at 9:00 a.m. and continued until 4:30 p.m., with a break for lunch. The heads of the two drafting teams made presentations at the workshops for a total of about two hours. The rest of the time I made presentations or responded to questions. I caught my plane for the trip back to Detroit early on the evening of December 17, 1996, and arrived home in the afternoon of December 19.

2. Objective of Report

This report is not being funded by any agency. It reflects my own views and does not necessarily reflect the views of the OECD, the UNDP, or any other institution with which I am associated.

My general impression from my visit to Hanoi is that the Vietnamese officials I worked with are serious about developing a sound income tax system and are receptive to well reasoned suggestions for modifying the current system. Of course the Vietnamese officials who have direct experience with their current tax system are the experts on the application of tax theory to the particular circumstances of Vietnam. I have tailored my suggestions to reflect my best understanding of the economic and social circumstances of Vietnam, the limitations of the Vietnamese tax administration, and the political restraints under which the government must operate.

A major objective of the Vietnamese government is that their revised income tax system conform to international norms. By conforming to those norms, the government hopes to obtain for Vietnam a reasonable and fair share of tax revenue from cross-border activities and to avoid discouraging foreign economic activity in Vietnam. In this report, I suggest possible changes and additions to the draft legislation that would be helpful in conforming to international norms.

Many of the individuals involved in the drafting of the corporate and personal income tax laws have good educational backgrounds and extensive experience with domestic tax matters. Almost all of them, however, have had very limited exposure to international tax issues. As a result, those issues are dealt with only generally in the current draft legislation or are not dealt with at all. This report provides materials that might be helpful in developing and refining the international aspects of the proposed legislation.

It is anticipated that the tax bill adopted by the legislature will not go into details on international tax matters. Instead, those important details will be left to future regulations. When the time comes to write those regulations, the Government of Vietnam would benefit from assistance by international tax experts under the auspices of the OECD or whatever other agency is willing to be helpful.

During the course of my meetings with the two drafting teams, I made innumerable comments about specific language in the draft legislation that I felt was unclear or inappropriate. I have not attempted to collect those comments in this report. Some of those comments reflected problems of translation, and many were dealt with by the drafting teams at the time. I have limited myself in this report to major structural issues in the design of a corporate and personal income tax.

Although I did not attempt to make an assessment of the tax department in Vietnam, I did learn something about the challenges it faces from my discussions with various tax officials. Based on those discussions and on my experiences in other countries, I have emphasized throughout this report the importance of devoting time and resources to the tax department. Without administrative reforms, all advances in tax design will have little practical significance.

3. Implicit Strategy of Reform Package

As noted above, the proposed reform plan has three elements: (1) a VAT; (2) a corporate income tax; and (3) a personal income tax. These three taxes, in combination, are intended (1) to advance social justice in Vietnam by mitigating inequalities in the distribution of societal resources and (2) to raise sufficient revenue to finance government spending programs without substantial inflation.

Goals of the VAT. The proposed VAT is intended as a replacement for an inefficient set of turnover taxes that raise considerable amounts of revenue but presumably have serious distortive effects on the Vietnam economy. Properly administered, the VAT can be used to impose on individuals living in Vietnam (residents, tourists, short-term visitors) a tax that is proportional to their total consumption of goods and services in Vietnam.

Within the existing political and economic framework in Vietnam, it probably is correct to evaluate the VAT solely as a replacement tax. So viewed, the tax gets high marks on fairness and efficiency grounds, due to the clear inadequacies of the taxes it would replace.

In the context of the United States, I have long opposed the introduction of a VAT because of its distributional effects. Because the tax burden of a VAT is imposed with respect to the purchase of domestic goods and services, the VAT does not take into account a taxpayer's ability to pay based on unconsumed income or on income consumed outside the country. It is also mildly regressive with respect to income in the low and middle income levels and steeply regressive at high-income levels. In addition, the VAT tends to discriminate against households with children because those households tend to consume a higher portion of their income than other households.

Most proponents of the VAT tend to defend its regressive distribution of burdens by reference to the potential progressivity of the distribution of benefits that it finances. For example, expenditures for universal health care and universal education tend to have a redistributive effect even if financed by a proportional or mildly regressive tax. Indeed, such a package may be progressive even if the tax and the distribution of benefits are regressive. Assume, for example, that A, with income of 1,000, pays VAT of 200 (20% effective rate) and B, with income of 10,000, pays VAT of 800 (8% effective rate). Assume also that the VAT finances education for

A and B worth $400 for A and $600 for B. Under these facts, both the tax system and the spending system are regressive, yet the overall impact is progressive. A obtains benefits of $400 at a tax cost of $200, whereas B receives benefits of $600 at a tax cost of $800.

The argument in favor of regressive taxation outlined above has limited force within the economic and social context of the United States because the United States can raise the revenue needed for spending from progressive taxes. Indeed, the primary constraint on progressive taxation in the United States is political. The argument has much more force in a developing country, such as Vietnam, however, because of the pressing revenue needs of the government and the absence of good alternative sources of revenue. Even in developing countries, however, the regressivity of the VAT is legitimate cause for some concern, due to the likelihood that a large portion of government spending will benefit members of the most modern sectors of the economy, who typically are relatively well off.

In the current economic context in Vietnam, I believe that the VAT is an essential part of the tax mix. It is highly doubtful -- indeed virtually certain -- that Vietnam could replace VAT revenues with revenues from a more progressive tax, such as an income tax. Developing countries have seldom been successful in raising large amounts of revenue from income taxes. Certainly Vietnam cannot expect to finance the current and anticipated levels of government spending from income taxes alone. To raise the additional revenue needed to replace the VAT, the income tax rates would need to be set at a rate that would compromise Vietnam's competitive position in the world economy. In addition, many more individuals would need to be subjected to the income tax, thereby placing an unbearable strain on administrative resources.

Some defenders of the VAT argue that its regressivity can be reduced substantially by exempting various necessities, such as food, or taxing them at low rates. Studies in several countries indicate, however, that low rates on so-called necessities do not reduce the

regressivity of the VAT very much. Indeed, some common exemptions, such as an exemption for clothing, apparently increase the regressivity of the tax in some countries. It is possible, within the context of a Vietnam VAT, that the practical exemption for village commerce will mitigate the regressivity of the VAT somewhat. In my view, nevertheless, the cure for regressivity must come on the spending side and not from modifications in the VAT itself. Exemptions and special rates greatly complicate the administration of the VAT, and ease of administration should be the number one priority in designing the VAT.

As indicated above, I believe that the VAT is a necessary component of the Vietnam reform package. If properly designed and administered, the income tax (personal and corporate) will yield substantial revenues in the future. At that time, it should be possible to replace some VAT revenues with revenues from the income tax. In the near term, however, income taxes cannot yield the revenue needed to fund the government.

Goals of the Corporate Income Tax. The proposed corporate income tax would replace the revenues obtained under the current profits tax. The profits tax is not well developed and has many identified defects. In theory, those defects could be corrected, but only at the cost of diverting Vietnam's fairly small cadre of trained tax professionals from much more important business. The decision to abandon the profits tax for a corporate income tax, therefore, is a good one. The corporate tax is a familiar taxing scheme and is well accepted by the international community. Foreign corporations operating in Vietnam through a subsidiary or a branch will expect to pay a corporate tax to Vietnam, and the international system of relieving double taxation is based on the existence of a corporate tax.

Vietnamese policymakers will be tempted, as they were under the profits tax, to dissipate the potential revenues from the corporate tax by offering investors overly generous tax holidays and

other tax incentives. Obviously the corporate tax cannot raise significant amounts of revenue from domestic and multinational corporations unless current incentives are sharply curtailed. The general case against tax incentives is by now well established. The investment gains tend to be modest and short lived, due to competition from competing states. Incentives provided to foreign investors have large revenue costs as the foreign businesses grow, and those costs tend to get larger as the incentives almost invariably are expanded to avoid unfair and economically foolish discrimination against domestic taxpayers.

A major goal of the corporate income tax is to collect a fair share of the revenue that multinational and large domestic businesses derive from economic activities in Vietnam. It is especially important that the Government of Vietnam obtain its fair share of revenue from the economic growth that is anticipated from the modernization of its domestic economy and its full participation in the world economy.

By taxing corporations and not other forms of business, a government tends to discourage, at least in principle, the operation of businesses in corporate form. The fact that most major businesses operate in corporate form, however, strongly suggests that the tax incentive against incorporation by large businesses is overcome by the advantages of incorporation. Indeed, the corporation is generally the best available vehicle for mobilizing large amounts of capital and directing that capital to the operation of a business. Corporate businesses are the engine of development in all modern societies. A tax on corporations, therefore, tends to be a tax on the modern sector of the economy. Vietnam should want to tax that portion of the economy, but it also should want to be sure that its tax is not set at a level that would be destructive of that sector.

Goals of the Personal Income Tax. The long-term goal of the personal income tax in Vietnam should be to reduce the inequalities in income and wealth that almost invariably accompany the

widespread introduction of market mechanisms into an economy. The personal income tax also can offset, to some degree, the regressive aspects of other taxes, such as the VAT. At this stage of Vietnam's development, the revenue yield from the personal income tax is likely to be fairly low, but that yield should increase markedly if Vietnam's attempts at economic development are successful. The political obstacles to the design of a fair and progressive personal income tax are likely to be much less significant now, when the yield from the tax is low, than they will be in the future, when the yield will be high.

The proposed personal income tax would exempt those who are poor by Vietnamese standards. Middle income taxpayers would pay at a higher rate, and high-income taxpayers would pay at the top marginal rate. In general, this basic structure is desirable. For reasons discussed in detail below, however, I believe that the proposed tax rates are far too high, notwithstanding my unqualified support for a redistributive income tax.

As discussed above, even a regressive tax, such as a VAT, can provide for some progressivity if the revenue raised by the tax is spend disproportionately to satisfy the needs of the poor. It is not feasible, however, to reduce inequalities between the rich and the middle class through a combination of a VAT and progressive spending patterns. In the transition toward a more open economy, Vietnam can anticipate the opening up of a significant gap in the living standards of the middle class and the upper class. The personal income tax is the only fiscal instrument available to the government to keep that gap from widening to an unacceptable degree.

A personal income tax with graduated rates can reduce inequalities not only among individuals but also among regions of the country. For example, if one section of the country is more advanced than another, it almost certainly will end up paying a higher share of the personal income tax. If the revenues from the

tax are then spent approximately equally throughout the country, regional inequalities are reduced without the political discontent that typically results when government spending is obviously tilted in favor of one region over another.

4. Draft of Corporate Tax Law

As the name implies, a corporate income tax applies only to corporations. Business activities organized as a partnership or a sole proprietorship would not be subject to the corporate tax, although individuals earning income from those activities would be taxable under the personal income tax. Absent some special relief measures, income derived through a corporation and distributed to its shareholders would be taxable both under the corporate income tax and the personal income tax.

A corporation is a legal entity distinct from its owners or managers. It is treated as a person for legal purposes, in that it can hold property in its own name and can sue or be sued in its own name. Once property is transferred to a corporation by its shareholders, the shareholders no longer have legal ownership of the property. A transfer of the property from a shareholder to a corporation or a transfer of that property back to the shareholders could have major tax consequences, as discussed below.

A. General Comments

Introduction. In the context of Vietnam, most of the revenue from the corporate income tax is likely to come from the modern sector of the economy. In general, corporations are relatively easy to tax, in part because there are relatively few corporations, at least in comparison to the number of persons subject to the individual income tax, and in part because they typically keep extensive and fairly reliable books for financial accounting purposes. To assess tax fairly and uniformly on corporations, however, a tax department

must face up to some special challenges. Corporations frequently engage in complex transactions, the tax implications of which are not always clear. They also employ a cadre of highly trained specialists to help them minimize their taxes. The tax department needs to have sophisticated tax officials who understand corporate transactions and can cope with the tax avoidance schemes of corporate taxpayers.

Administration. A sound tax policy means nothing unless it is supported by a sound tax administration. For the proposed corporate tax to succeed, therefore, various steps should be taken to improve and modernize the tax department.

(1) A regular program of training of tax officials should be put into place. It is particularly important to provide training for at least some officials on the international aspects of taxation. Few officials have such training now. The need for officials with an understanding of international tax will grow with the expected increase in the activities of foreign corporations in Vietnam. At least in the short term, the training program should provide for study abroad by some officials.

(2) The pay scale for tax officials should be increased, at least for those officials staffing the corporate tax sector. Officials should be paid well, not only by traditional Vietnamese standards but by the emerging standards for Vietnamese workers in the modern sector of the economy. Those individuals with the knowledge needed to do proper audits and assessments of corporations are likely to be in high demand in the growing private sector of Vietnam. Good pay will make it possible to attract good people to the department and to retain their loyalty. In addition, a competitive pay scale will assist the department in developing a departmental culture of honesty and professionalism.

(3) The tax rules governing the taxation of corporations must be clearly written and should be readily available to taxpayers and tax officials. Currently many important rules under the profits tax are

contained in various department directives that are not easily available.

Tax Incentives. The effectiveness of tax incentives is difficult to prove or disprove conclusively. The weight of informed opinion in recent years, however, is that tax incentives are generally an ineffective means of national development. To the extent that they favor one sector of the economy over another, they tend to distort private economic decisionmaking in ways that are likely to be inefficient. They are frequently difficult to administer and sometimes invite abuse and fraud. They seem to have little impact on the overall level of domestic investment.

Many governments that operate generous tax incentive programs would like to eliminate their tax incentives. They are reluctant to do so, however, for at least two reasons. First, powerful political interests pressing for the incentives are not easy to resist. Second, there is some legitimate concern that foreign investors will invest elsewhere if the incentives are removed. Many representatives of foreign businesses, seeking the best deal possible for their employers, tend to exaggerate the importance of tax incentives in corporate decisionmaking.

Developments over the past two decades strongly suggest, nevertheless, that foreign investors will not avoid investing in a country with good growth potential simply because that country fails to provide tax incentives as long as the general business climate in that country is favorable. At the same time, multinational businesses are very reluctant to invest in countries that are otherwise unattractive simply because of tax incentives.

As Professor Oldman noted during his visit to Vietnam in October of 1996, the experience of Indonesia in the early 1980s provides encouragement to those who would cut back or eliminate tax incentives. When Indonesia cut back sharply on its tax incentives during that period, the drop in investments that the opponents of

the reform predicted did not occur. Indeed, it has been difficult to ascertain any negative effects from the cut backs. The United States had a similar experience when it repealed its investment tax credit in 1986.

It is always easy to make a list of economic activities that a government might want to encourage through tax incentives. Each tax incentive, however, must be paid for by increasing taxes on those not benefiting from the incentive. In debating the merits of proposed tax incentives, therefore, it may be useful to make up a list of those economic activities that ought be discouraged by having to bear the burden of higher taxes. By attempting to draw up such a list, policy makers may come to realize that most investment is desirable and that the choice of activities to be encouraged or discouraged generally should be left to market forces.

Given the Vietnam government's need for revenue and its inability to determine accurately which economic activities should be given a tax preference, it would seem prudent to provide as few tax incentives as possible. The long-term goal should be to provide a fair and stable tax environment that does not include any incentives. (For my brief essay against tax incentives written in the context of the emerging countries of eastern and central Europe, see appendix.)

If tax incentives are to be provided, the ones most likely to be effective are those that reduce the risks of initial investment in Vietnam. That is, established businesses should not get tax incentives, and whatever incentives are provided to new businesses should be phased out within one or two years. Great emphasis should be given to the administrative aspects of the incentives so as to avoid the diversion of scarce administrative talent into the running of the tax incentive program.

Corporate Integration. The relationship between the corporate income tax and the personal income tax is a perennial tax policy topic in most countries. Under the so-called classical system, still

followed in large measure by the United States, profits earned through a corporation are taxable to the corporation and are again taxable to shareholders when the profits are distributed as a dividend. In effect, the shareholders are allowed a deduction for the corporate tax because they are only taxable on the dividend received and not on the grossed-up amount of the profits out of which the dividend was paid.

Many countries, however, provide special relief either to shareholders or to corporations to eliminate or at least mitigate the so-called double tax on corporate profits. Such measures are referred to generally as corporate integration, by which is meant that the corporate tax is integrated, to some degree, with the personal income tax. For example, Australia completely eliminates the double tax by granting shareholders a tax credit for the amount of the corporate tax attributable to dividends received. Most European countries provide partial relief, either by allowing shareholders a tax credit (or other relief) for some portion of the underlying corporate tax or by allowing the corporation a credit (or other relief) with respect to distributed profits.

In theory, relief for the double tax is supposed to provide some efficiency gains to the economy. In practice, however, countries that have adopted integration plans have not been able to document such gains. Once a classical system has been in place for some years, any integration scheme is likely to provide substantial windfall benefits to shareholders who bought their stock at prices that were depressed on account of the existence of the double tax. It is important, therefore, to get the proper plan in place at the start of the tax system.

The draft legislation in effect provides for corporate integration through dividend relief. That is, corporate profits are taxed at the corporate level in full but dividend distributions of those profits are taxable at the concessional rate of 10 percent. It does not appear, however, that this dividend relief is motivated by concerns about the

double taxation of corporate profits. Instead, it is part of a general scheme for taxing various types of income at flat rates to facilitate withholding. As suggested below, those flat rates generally ought to be eliminated as soon as possible in that they are inconsistent with the underlying theory of the personal income tax. The special low rate for dividends, however, might be justified as a simple form of corporate integration. To avoid problems under the nondiscrimination clause in tax treaties, the flat rate applicable under the income tax and the rate applicable to foreign investors should be the same. My inclination would be to increase the rate on dividends to 15 percent, which is the international norm for taxing dividends paid to foreign individuals.

Scope of the Corporate Tax. The tax officials dealing with corporate taxpayers should be highly trained and well paid and should be provided with computers and other modern equipment. Vietnam at this time simply cannot afford to staff and equip a large corporate tax section at an appropriate level. Thus a small department appears to be desirable. To keep the department small, the government must adopt tax rules that limit the number of taxpayers subject to the corporate tax. In the present context, the only way that I see for keeping the number of taxpayers small is to exclude most or all of the large number of registered family businesses from taxation under the corporate income tax.

The draft legislation would tax registered family businesses under the corporate tax. Vietnamese officials with whom I discussed this issue favor that approach. They argue that many of the family businesses are large and are growing and have activities that are too complex to be audited under the personal income tax. They believe that the officials charged with the administration of the personal income tax would not be successful in collecting proper taxes from these businesses. This argument has considerable merit.

One possible solution to the dilemma set forth above would be to include registered family businesses within the corporate income

tax but to create a special division within the corporate tax section that would deal exclusively with all but the largest registered family businesses. That section would not initially receive the infusion of new resources that I have urged for the division dealing with foreign firms and very large domestic firms.

Renumbering and Reorganizing the Code. The draft legislation is not organized in a manner that would facilitate the amendments that inevitably will be made to it over the next several decades. The proposed tax code should be reorganized in accordance with some general plan, with provision made for inserting new code sections without upsetting the existing organizational pattern. The *Basic World Tax Code* which I donated (without endorsement) to the department provides one possible organizational scheme. The Singapore code offers another, and the U.S. tax code offers a third.

One issue to be decided is whether the corporate income tax code and the personal income tax code should be consolidated. My mild preference is for consolidation. There are many common elements to both, and it is probably desirable that the common features develop together. Such parallel development is probably more likely with a consolidated code. In addition, it seems efficient to consolidate such matters as filing rules, penalty provisions, withholding requirements, and appeals.

Once a code has been in existence for some time, it becomes nearly impossible to reorganize, due to opposition from those who have become accustomed to the old ways. Countries such as Australia and Canada that have badly organized codes have found it nearly impossible to recover from their initial error. The drafters should have no difficulty developing a useful reorganization of the code once they have focussed on the issue.

B. Weaknesses in Draft Legislation

In the sections below, I discuss certain aspects of the draft legislation that I believe need further development. It may be that the government will prefer to handle most of these issues in regulations or directives rather than in the tax code. Work needs to begin soon, nevertheless, on the development of such directives.

Income Definition Rules. Although the draft statute provides a number of clear rules for computing income, it also omits discussion of a number of income-measurement issues that many tax codes address in detail. Examples of rules that are not adequately addressed include:

(1) The rules for computing depreciation deductions, including rules specifying how much depreciation may be taken in the year the depreciable property is first put into service and the year it is retired from service. I understand that detailed rules are provided currently by circular.

(2) The rules imposing limitations on deductions for business entertainment. Some limitation rules would seem to be appropriate.

(3) The rules for distinguishing deductible business expenses from nondeductible capital expenditures.

(4) The rules making various fringe benefits taxable or nontaxable.

(5) The rules for computing gain or loss on the sale or property. I note with approval that the current draft does not propose a favorable tax rate for capital gains. The controversial elimination of the capital gains preference for corporations by the United States in 1986 has led to significant simplification of the corporate income tax with no discernable economic costs.

Accounting Rules. The draft legislation provides virtually no guidance with respect to the tax accounting rules that taxpayers are expected to follow. The premise of the draft legislation seems to be that taxpayers would report their income in accordance with generally accepted accounting principles (GAAP), although there is no mention of GAAP and no mention otherwise of how taxpayers are expected to keep their books of account. It would be acceptable for the details of the accounting rules to be contained in directives or regulations. Some level of detail, however, should be included in the tax code.

I suggest that the tax code provide the following rules:

(1) That corporate taxpayers generally are required to keep their books according to GAAP except as otherwise provided in the code or regulations;

(2) That taxpayers generally are required to use inventory accounting, with rules specifying what type of methods (e.g. first-in-first-out, last-in-last-out, average cost) are permitted in computing cost of goods sold;

(3) That taxpayers must obtain the permission of the tax authorities to change a method of accounting and that the tax authorities can condition their approval of that change on the taxpayer taking certain specified steps to prevent the avoidance of tax; and

(4) That the tax authorities may disallow a deduction for reserves for future expenses whenever a current deduction would produce an inappropriate result. For example, the tax authorities should be authorized to prevent a taxpayer from deducting a reserve for restoring a mining site until the expenditures for restoring the mining site have actually been made.

Corporate Reorganizations, Formations, Liquidations. Much of the complexity of the corporate income tax regime in many countries involves the rules governing corporate formations, liquidations, and reorganizations. The reorganization rules are typically the most complex, in large measure because of the complexity of the financial transactions that they relate to. The draft legislation has no rules at all in this area.

In most developing countries, governments have struggled with their rules relating to reorganizations and liquidations. On the one hand, they are reluctant to have overly restrictive rules that hinder corporate restructuring that may have important efficiency gains. On the other hand, they have learned from hard experience that overly liberal rules are quickly abused by corporate taxpayers to avoid substantial amounts of tax. After several decades of experience in utilizing tax reorganizations and liquidations for tax avoidance purposes, the international tax bar is prepared to take full advantage of any country that is unsophisticated in allowing liquidations and reorganizations to take place without proper safeguards. Vietnam must quickly gain expertise in this area of the law if it is to avoid being victimized by the sophisticated tax avoidance strategies of tax advisors.

Unfortunately, it is not feasible at this time to incorporate into the draft legislation a detailed set of reorganization, liquidation, and corporate formation rules. I suggest, however, that some transitional rules be provided and that the statute grant the tax department the authority to deal with more complex matters, particularly reorganizations, on a case by case basis. The goal would be to education the department to the problems raised by corporate restructuring, with a view toward developing more detailed rules in the future.

At a minimum, I think the statute should provide as follows:

(1) The transfer of property to a corporation in exchange for stock by controlling shareholders does not cause the shareholders to recognize gain on the difference between the cost (tax basis) of the property transferred and its value at the time of the transfer. That is, the incorporation of a business should be tax free. The shareholders would have a cost for the stock received equal to the cost of the property transferred. As noted above, business activities by corporations contribute in important ways to economic development. Formation of a corporation for business operations should be easy and should not be impeded by taxes.

(2) Transfers of property by a corporation in liquidation should cause gain to be taxable to the extent that the value of the transferred property exceeds the corporation's cost for that property. An exception would apply in the case of a liquidation of a subsidiary corporation into a domestic parent corporation. In that case, gain or loss would not be taxable and the parent corporation would take as its cost the cost of the distributing subsidiary. The policy goal should be to allow corporations to change their organizational structure for sound business reasons without tax consequences but to require payment of tax when corporate assets are distributed to individual shareholders.

(3) Corporations may request permission to go forward with a reorganization on a tax-free basis with the approval of the tax department, subject to the conditions set by the tax department to prevent the avoidance or evasion of tax.

Consolidation of Accounts of Related Corporations. The current draft does not address the question of whether corporations that have common ownership will be allowed or required to compute their taxes on a consolidated basis or whether each corporation is expected to file its own tax return without reference to the tax return of other members of its corporate group. For example,

should Company A be allowed to offset its income by the losses incurred by Company B, a related corporation? Developing rules for consolidated returns is a very complex undertaking. At this stage of its development, therefore, Vietnam is probably best off forcing related companies to operate as a single company in Vietnam to enjoy the benefits of consolidation.

There are some situations, however, when the government would prefer to force related companies to operate on a consolidated basis, and the question arises as to whether the tax statute should give that power to the tax authorities. For example, assume that two related parties are operating in Vietnam and one of them sells property at a loss to the other one. Should the tax department have the authority to consolidate the accounts of the two companies so as to ignore for tax purposes the transaction between them? A related question is whether the tax authorities should have the power to prevent related parties from obtaining the benefits of consolidation without actual consolidation. For example, if Company B expects to operate at a loss, should it be permitted to engage in a transaction with Company A, a related party, that has the effect of shifting the loss to that company? The preferred approach probably is to give the tax department general authority to ignore transactions between related parties when necessary to prevent tax avoidance. (See discussion below and in appendix of transfer pricing issues.)

International Aspects. Vietnam needs to formulate a general strategy for taxing foreigners operating in Vietnam and for taxing Vietnamese residents or nationals operating outside Vietnam. No clear strategy is evident in the draft legislation. I suggest that the strategy should embrace the following general principles or goals:

(1) Vietnam should tax all income, to the extent feasible, that arises from business or investment activities in Vietnam (i.e., has a Vietnam source). The implication is that Vietnam should avoid giving away source jurisdiction by tax treaty to the extent possible and should have tight statutory rules that make foreigners subject to tax

in Vietnam if their economic penetration of the Vietnamese market is more than minimal. Countries following the OECD Model Treaty generally are prepared to give up some source jurisdiction over foreigners in order to reduce source taxation of their residents. The theory is that they would tax their residents under their residence jurisdiction. I believe that this tradeoff probably works badly for most developed countries, including the United States. It certainly would work badly for developing countries such as Vietnam.

(2) The international tax regime should be kept as simple as possible to facilitate administration of the tax. To keep the rules simple, Vietnam should coordinate its statutory rules with its treaty rules and should attempt to keep its treaty rules as uniform as possible. The current draft legislation does a good job of coordinating the permanent establishment rule with the comparable treaty rule (keeping the basic structure of the OECD treaty rule but limiting the concession of source jurisdiction). In addition, Vietnam should impose withholding taxes on foreigners whenever possible, and the rules governing withholding should be clear, even at the expense of fairness and efficiency.

(3) Vietnam should keep its effective tax rate on foreign enterprises slightly below the international average effective rate so as to minimize the tax incentive that foreign enterprises otherwise would have for shifting income outside of Vietnam. No one knows what the international average effective tax rate actually is, but whatever it is, it is somewhat below the U.S. corporate rate of 36 percent. A corporate tax rate between 30 percent and 35 percent probably would be below the international average.

(4) Rules must be developed that make it risky for foreign taxpayers to shift income derived from Vietnam to a tax haven. For example, the tax code or regulations should authorize the tax department to ignore transactions between tax haven corporations and corporations operating within Vietnam if necessary to prevent tax avoidance. In addition, Vietnam should avoid entering into tax

treaties that concede source jurisdiction to a tax haven country (such as Switzerland, Cayman Islands, Bermuda, Hong Kong).

As part of the above strategy, Vietnam needs to develop rules to prevent multinational companies (and other taxpayers) from avoiding Vietnam taxes by setting artificial prices on transactions with related parties. The problem of policing so-called transfer pricing abuses has received considerable attention in recent years. In 1994, the United States issued detailed (and largely ineffective, in my view) regulations to combat such tax avoidance, and those regulations have received a qualified endorsement from most OECD countries. The OECD itself has published a detailed report (1995) on transfer pricing issues. For a summary of these developments, see Brian J. Arnold & Michael J. McIntyre, *International Tax Primer*, Kluwer (1995), pp. 53-68. (Complementary copy provided to Ministry of Finance.) I have also included in the appendix of this report a summary of the methods used by the United States for setting transfer prices on the sale or transfer of tangible and intangible property. That summary is adapted from Michael J. McIntyre, *The International Income Tax Rules of the United States*, 2 vol. looseleaf, Michie (1989 with 1996 update).

In the longer run, there are lots of other international rules that Vietnam must develop. Vietnam must be particularly concerned about foreign currency exchange problems. An example of the tax avoidance problems that can arise from currency exchange rules is provided in the appendix.

5. Draft of Personal Income Tax Law

Some of the points made in regard to the corporate income tax are also applicable to the personal income tax. For example, both taxes need better rules for computing gain and loss and for determining the source of income and deductions. In addition, the administration of both taxes needs to be strengthened. The

following additional points are particularly relevant to the personal income tax.

Rates. The proposed personal income tax rates seem to me to be far too high. I favor a larger exemption level (zero bracket), and I would not allow the top rate to go above 30-35 percent. Moreover, that top rate should apply only at income levels that are high by international or regional standards. I would also make comparable rate reductions in the middle-income range. It is not that I think the proposed top rate of 60 percent is unfair in principle. A well administered tax that actually collected taxes at that level from all wealthy taxpayers might get high marks on fairness grounds, although it might be objectionable in the context of Vietnam on efficiency grounds.

Whatever the theoretical arguments for high rates, they are not defensible in the economic and social circumstances of Vietnam. No one can reasonable expect that the Vietnam tax department will be able to collected taxes at such high rates in a uniform manner. They will be able to collect the tax from government officials, thereby lowering what are already inadequate salaries, and from certain highly visible taxpayers. Other taxpayers will not be taxed uniformly. The high rate will discourage development, promote fraud, and reduce the long-term revenue potential of the personal income tax.

Under current administrative procedures, the income of many individuals will be estimated, rather than measured accurately based on audited books of account. Such estimation methods are not likely to work well when the tax rate is very high. With high rates, fairly small measurement errors can have major tax consequences for the affected individuals. In general, I believe that an accurate and refined system of income measurement is required if tax rates above 50 percent are to be adopted.

As shown in the appendix, the proposed top rate of 60 percent is way out of line with rates of comparable countries in the region. It

is double the top rate in Singapore. In addition, the top rate of 30 percent in Singapore does not apply to taxpayers with income below around US $280,000, whereas the proposed top rate of 60 percent in Vietnam would apply to taxpayers with income over around US $16,000. Many of the Vietnamese taxpayers subject to the top rate would be the most mobile segment of the population. Thus the threat of the tax may entice Vietnamese residents with the most marketable skills to give up Vietnamese residence or, in the case of highly-skilled expatriates, may discourage them from returning to Vietnam. The very high proposed rates would give some impetus to foreign firms to hire nonresidents to do jobs that could very well be done by residents, thereby retarding the develop of local skills.

The high rates also are likely to provide strong temptations for under-the-table payments and other forms of corruption. I do not believe that problems of corruption can be solved by having a relatively low tax rate. Most taxpayers prefer a zero rate, given the choice, to a 30 percent rate. But problems of corruption are likely to increase when the rate is very high and is not uniformly enforced.

As indicated above, I believe that the primary goal of the personal income tax in Vietnam should be to capture for the government a fair share of the fruits of future economic development and to curtail the nearly inevitable increase in the income gap between the middle class and the upper class. That tax should not be seen as a mechanism for reducing substantially the existing levels of inequality. In 20 or 30 years, top rates of 40 or 50 percent might make good sense, assuming that economic growth has substantially increased the overall levels of income in Vietnam and the tax administration has greatly improved its ability to collect taxes due. For the present, however, an overly aggressive redistributive policy is likely to retard economic development and weaken the ability of the tax department to administer the personal income tax.

Indexing. I favor the indexing of the tax brackets and exemption levels for inflation. Under the typical indexing scheme, used by many

countries including the United States, the bracket amounts are multiplied each year by the inflation rate over the prior year to create a new rate schedule that is functionally equivalent to the old one. The effect of indexing is to prevent changes in effective tax rates and exempt amounts without legislative action.

The table below illustrates how indexing of rate brackets would work. Rate Schedule A is the original rate schedule. Rate Schedule B is the indexed version of Schedule A, adjusted for an inflation rate of 16 percent. Following a common practice in many countries, I rounded amounts down.

Rate Schedule A		
Income Greater than	**Income No Greater than**	**Rate**
0	80	0
80	160	20
160		30
Rate Schedule B		
Income Greater than	**Income No Greater than**	**Rate**
0	92 (80 × 1.16)	0
92	185 (160 × 1.6)	20
185		30

The draft legislation accepts the principle of indexing, but it provides that indexing would occur only if the inflation rate exceeds 20 percent. Very major changes in the real rate schedule will occur over a fairly short period at inflation rates well short of 20 percent.

To protect low-income taxpayers from the impact of inflation, the government has made many changes in the exemption levels over the past several years. It seems likely that the government would do so in the future. These changes are commendable. Periodic increases in the exemption level, however, are not enough. It is also

important to adjust other parts of the rate schedule. The adjustments, moreover, should not be dependent on positive action by the government. Otherwise there may be a tendency for the government to deal with budget shortfalls during difficult times by allowing taxes on low- and middle-income taxpayers to creep up simply by not making a specific adjustment for inflation.

Schedular Features. In principle, a personal income tax should apply the same rates to all taxpayers in the same circumstances without regard for the source of their income. The draft legislation has several features that violate that principle. One violation is the flat rate of 33 percent applicable to business income. Other violations of the principle include the special rate schedule for noncitizens and the flat rates applicable to dividends (10%), interest (15%), gifts (5%) and other assets (10%). I understand that some of these special rates are intended to facilitate withholding. The lower rate on dividends may be defended as an appropriate adjustment to mitigate the so-called double tax on corporate profits.

The pressure for special rates on various categories of investment income would be reduced if the rates under the normal rate schedule were reduced, as recommended above. Certainly the special lower rate for noncitizens could be eliminated if the top rate on the normal schedule was reduced to 30 percent and the rate brackets were widened. To the extent possible under existing administrative constraints, the other special rates also should be eliminated, absent some strong policy justification for their continuation. As noted above in the discussion of corporate integration, there is some justification for the flat rate on dividends. A flat, low rate on gifts from foreign relatives of Vietnamese residents is also appropriate in that such gifts normally should be exempt from tax and are only made taxable because of perceived special circumstances.

Family Tax Issues. Most income tax systems provide some measures to take into account the impact on ability to pay of a

taxpayer's family circumstances. The draft legislation, however, has no family taxation rules. This lack of attention to the tax implications of family sharing practices is an important weakness in the legislation that should be corrected.

Unfortunately, Vietnam probable cannot provide an appropriate level of relief for family circumstances due to the administrative constraints under which the tax department must operate. My favored approach to marital equity in taxation is marital income splitting. That approach, however, complicates withholding. In the current circumstances in Vietnam, I doubt that income splitting could be made to work very well. I suggest, therefore, that a consideration of marital or family income splitting be deferred until the administrative capacity of the tax department has been strengthened considerably. I would achieve most of the effects of marital income splitting, however, through the use of a rate schedule that applied a flat, moderate rate to about three quarters of the taxpaying population.

Some allowances for family circumstances are desirable. At a minimum, I would provide a generous deduction or exemption for a dependent spouse, and I would favor a smaller allowance for dependent children. For reasons of simplification and to reduce administrative problems, I would be inclined to provide a per capital allowance for the first and second dependent child and to give no allowance for additional children.

International Aspects. The current draft does not deal very much with the international aspects of a personal income tax, but those issues that are addressed are handled properly. For example, the tax is applicable to worldwide income, without any territorial limitation. That is the proper rule in my view.

Residency in Vietnam is defined as being present in Vietnam for more than 183 days (the international norm is 183 days or more). I find that rule to be too inflexible. It will cause Vietnam not to tax

certain individuals who ought to be taxable (persons who keep just under 183 days year in and year out) and to tax certain other individuals on their worldwide income who ought to be taxable only on their Vietnam source income (genuine residents of another country who happen to be in Vietnam for over 183 days). For my views on residency rules, see Brian J. Arnold & Michael J. McIntyre, *International Tax Primer*, Kluwer (1995), pp. 21-25. (Complementary copy provided to Ministry of Finance.)

Modification of the 183-day rule by domestic legislation may not be needed to deal with taxpayers who have close ties to another countries because of Vietnam's fairly extensive tax treaty network. (See appendix for a list of Vietnam's current and contemplated tax treaties.) The problem of overlapping residence jurisdiction is handled well in tax treaties based on the OECD Model. The undertaxation problem created by the 183-day rule, however, must be addressed through domestic legislation. In principle, a taxpayer who has no close ties to another country and is regularly present in Vietnam, year after year, for extended periods should be taxable by Vietnam on his worldwide income. The United States deals with this issue by generally treating a person as a resident if (1) he is present in the country for at least 30 days and (2) the sum of days present in the current year, plus 1/3 of days present in the prior year plus 1/6 days present in the second prior year is at least 183. An alternative rule of the same type would be to treat a person as a resident if he is present for 183 days in the current year or 400 days over a three year period.

The following types of international tax rules need to be added some time soon to the personal income tax statute or to the accompanying regulations:

(1) Rules specifying the source of income and source of deductions (see my suggested source rules in the appendix);

(2) Rules for taxing individuals with respect to their foreign activities, for taxing them on income derived from assets held in a foreign fund, and for claiming a tax credit for foreign taxes.

The international rules of the personal income tax are currently of importance to a very tiny proportion of the taxpaying population. Those rules will be of increasing importance in the future, however, if Vietnam continues to develop as expected. The time to formulate and adopt those rules is now, before tax-avoidance practices develop that will be difficult to stop.

6. Concluding Comments

Vietnam has made a promising beginning in developing a modern corporate and personal income tax system as part of its general movement towards a more market-oriented economy. All of the individuals with whom I worked on this mission recognize that the current legislation is only a first step. Much work needs to be done in developing additional technical rules and in improving the tax administration. In this report, I have outlined what I consider to be the most important work left to be done. I emphasize that I am expressing my personal views, which I formed after only a brief period in Vietnam. In no way do I view this report as providing a detailed or final blueprint for tax reform in Vietnam.

The most important issue for Vietnam to confront is the weaknesses in its tax administration. I did not have the opportunity to visit any tax offices during my December visit. My sense, however, is that Vietnam's administrative capacity exceeds that of many countries at a comparable level of development. Yet the tax department is still not ready to administer a modern tax system. Immediate and major steps are required to remedy that situation. A major increase in resources devoted to training of tax officials, perhaps with some foreign assistance, would be an early step to take.

Very little attention has been given by Vietnam to international tax issues. This lack of attention is understandable, as those issues have only become important to Vietnam in very recent years. Fortunately, Vietnam should not have great difficulty in remedying this current weakness. I believe that various foreign governments and foreign agencies are willing to provide technical assistance, and Vietnam has many well-educated members of the tax department who could benefit from such assistance. On-site training should be an important component of any foreign assistance program, but I also feel that arrangements should be made for a significant number of tax officials to study taxation abroad for an extended period (e.g., 6 months to a year). My general recommendation is that officials sent aboard for training should go in pairs, so that they can provide mutual support for each other and can discuss with each other the application of what they are learning to the situation in Vietnam.

In formulating this report, I have recommended the setting of realistic goals that I believe can be accomplished with minimal risks of large failures. For example, I suggest that tax rates should not be set too high, and the tax department should not be asked to perform tasks that are clearly beyond its present capacity. It is high folly to set lofty goals that cannot be met and that only serve to define the terms of failure.

Appendix

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