

# Tax Alert

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## Related party transactions have become a focus issue for tax audits



### Introduction

We have seen an increase in the review level of the General Department of Taxation (GDT) in respect of related party transactions.

The related party provision of the Tax Law (Article 18) gives wide power to the GDT to re determine related party transactions. The GDT may re determine related party transactions to impose pricing that the GDT considers 'arms length' parties would have undertaken in the transactions.

A related party relationship is one where there is a 20 percent group relationship or 'control'. The general proposition is that related parties may enter into transactions that unrelated parties would not. For example, an entity that sells goods to its local/foreign parent at cost might not sell on those terms to another customer, e.g. a margin would be required.

In international tax principles, a related party transaction could lead to a distortion of the tax liabilities of the resident companies, and result in a distortion of the tax revenue of the government. Accordingly, the 'arms length' principle of comparing transactions between related parties and those between independent parties has been established as the guiding principle.

It must be said that in many cases the GDT determination of an 'arms length' comparison totally lacks commercial and practical reality.

To avoid the problems of having to deal with an unrealistic GDT determination of related party transactions, we strongly advise clients to undertake a prudential review of current and proposed related party transactions to ensure that all appropriate steps are taken to mitigate risk of GDT attack.

## Increase in Tax audit activity

Cambodia is no exception to the regional trend where the tax authorities are taking action to protect (or increase) their Tax revenue. Under the Tax Law, the GDT is able to review related party transactions with a focus on 'comparing' transactions between companies in the same multinational group, with similar transactions between unrelated companies – so called 'arms-length' transactions. It is apparent from the most recent tax audits that the GDT has been much more aggressive in challenging multinationals' related party transactions. Of note, some of the major queries raised by the GDT with regard to related party transactions are:

- Different prices/mark-ups charged between related parties and unrelated parties for comparable transactions or goods. We note that the GDT has adopted a wide interpretation of 'comparable' transactions or goods.
- Interest free loan/funding from foreign parent company. The GDT target being withholding tax.
- Profit margin lower than the industry average – as determined by the GDT.
- Persistent losses or low operating profits of the local company.
- Absence of inter-company agreements or other documentation.
- Significant inter-company management, technical and/or royalty fees paid to associated companies, where the expenses were not adequately substantiated in term of price setting and benefits rendered to the Cambodian entity.

## Tax regulatory background of the related party transaction

Tax authorities in most major market economies in developed countries have implemented Transfer-Pricing rules setting out guidelines on the application of the 'arms-length' principle and other Transfer-Pricing issues, including documentation requirements.

Meanwhile, the GDT has yet to establish Transfer-Pricing regulations or issue Circulars, Pronouncement, Rulings or Directives as guidance to taxpayers when dealing with related parties.

The principal measure in the current Cambodia Tax Law is Article 18 which states:

*“In the case of two or more enterprises, whether incorporated in or outside of the Kingdom of Cambodia, which are under common ownership, the tax administration may as may be necessary **distribute**, gross income, deductions or other benefits among such enterprises and their owners in order to prevent the avoidance or evasion of taxes or to clearly reflect the income of such enterprises, or their owners”*

In addition, under the Tax Law the burden of proof is on the taxpayer to ensure that – in dealings with any entity with which it is related – it is able to demonstrate that the dealings or transactions are carried out in an 'arms-length' manner.

The lack of any guidance from the GDT as to its position on Transfer Pricing matters means that there will be continued uncertainty in operation of the Tax Law in this regard.

## Action plan

The GDT is able to review related party transactions and make its own determination of the profit that should be generated from the transactions or expenses that should be paid.

Therefore, as an initial step, clients should undertake an immediate review of what related party transactions they have.

Once the related party transactions are identified an analysis needs to be undertaken of what supporting documentation is in place for each relevant year of the related party transactions as an important preliminary step.

In respect of the supply of goods or services to a related party, clients should ascertain if a supply is made for the same or similar services or goods (or what the GDT may consider is the 'same or similar' goods or services) to a related party as that made to a non-related party.

In respect of group charges, appropriate documentation should be in place which supports and substantiates the basis of payment made, e.g. technical service agreement to support various types of management and administration support from Head Office, or a royalty agreement to support the rate of royalty on a trademark and/or implementation of a 'system' associated with a company operation.

The next step is to determine whether there is support available that the transactions have been conducted on an 'arms length' basis. Such support may comprise independent or internal comparables.

As this issue can be one of uncertainty and as the GDT has such wide powers to make adverse tax adjustments, we recommend that you seek our advice if in doubt about any related party transactions or if you require a prudential review of related party transactions that have been undertaken.



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