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Kieron is an ACCA-qualified, international tax professional with 10 years of experience, including four years in Cambodia. Recognized as a leading transfer pricing specialist actually located in Cambodia, Kieron established and led KPMG's transfer pricing practice in Cambodia. He has completed thousands of transfer pricing projects, including over 250 in Cambodia, such as preparing transfer pricing documentation in Cambodia and Vietnam for a Japanese-based banking group and saving millions of dollars in tax assessments on a Cambodian transfer pricing audit for a petroleum company. Kieron also has extensive and wide-ranging experience in M&As, IPO readiness exercises, cross-border transaction structuring, and tax regime advocacy across a range of industry sectors, with a particular focus on the energy, banking, real estate, and manufacturing sectors.

INTRA GROUP SERVICES – ARE CAMBODIAN TAXPAYERS WAVING A RED FLAG TO THE GDT? PART TWO

Article Purpose

[Part One](#) of our articles focusing on intra-group services in Cambodia highlighted the importance of Cambodian taxpayers being able to fundamentally prove that intragroup services were actually rendered by its related party and that these services justified a charge being made by its related party. In Part Two, **we consider how Head Offices of Cambodian taxpayers may be leaving them in an indefensible position** by the way they calculate intra-group service charges. If you are responsible for taxation at a Cambodian taxpaying entity, it is important to understand and communicate the issue to your Head Office **in order to protect your own position and the entity you are responsible for.**

While this Article has been drafted so it can be read and considered on a stand-alone basis, we suggest reading "[Part One](#)" beforehand as it is important to consider whether you firstly have defensible proof that services were actually rendered and justify a charge, before considering how these charges are calculated. The Article may be found [here](#).

Highlights of this note

- ▶ Risk created by Head Office approach to intra-group services
- ▶ Recap on relevant domestic law
- ▶ Importance of using correct methodology
- ▶ Importance of financial benchmarking
- ▶ What Cambodian taxpayers should do next

Introduction - Recap on transfer pricing for intra-group services in Cambodia

For many developing countries, one of the most common types of related party transactions is intra group services. This could be domestic, but is predominantly cross border services provided by Regional or Ultimate Headquarter/Group Service Centers. **Cambodia is no different in this regard, which is acknowledged**

by the existence of Article 17 in Prakas 986 (Cambodian Transfer Pricing guidelines) which specifically focuses on intra group services. Article 17 is consistent with the most recent guidance on international best practice, namely Chapter VII of Action 10 of the Organization for Economic Co-operation and Development (“OECD”) framework for “Base Erosion & Profit Shifting” (“BEPS”).

It is therefore important that Cambodian taxpayers are aware of what Article 17 of Prakas 986 outlines in respect of how intra-group service transactions are determined and priced to assess consistency with the “arm’s length principle”. The importance of this cannot be overemphasized as the General Department of Taxation (“GDT”) will under audit, scrutinize the charges paid by Cambodian taxpayers in respect of services provided by their related parties (particularly those overseas). To manage this risk correctly, Cambodian taxpayers will need to pay particular attention to four key points. This article will focus on two of these, namely:

- *Whether the cost methodology used to charge for services rendered is allowable;*
- *Whether the amount charged for services rendered is consistent with the “arm’s length principle”.*

Note: Please read “Part One” which focuses on the other two key points.

In the “Background” and “Conclusion” section, further information is given on what Cambodian taxpayers should be aware of, what they should and should not be doing and **how so many Cambodian taxpayers are exposed to a high level of transfer pricing audit risk in respect of their intra group services expense** paid and claimed as an allowable deduction on its Tax on Income (“ToI”) Return.

Why VDB Loi – How can we help?

Before reading the background and conclusion section, please know that no matter your company’s position **we at VDB Loi have the subject matter expertise and practical experience to help.** Whether that be through helping your Company assess its transfer pricing risk to better understand its position, producing comprehensive “Local File” Transfer Pricing Documentation with financial benchmarking to further assess and enhance compliance or giving strategic guidance to handle a TP Audit.

We strongly suggest being proactive so that you understand your Company’s position and whether it can demonstrate compliance or not. However, if it is already too late, our specialist TP team at VDB Loi prides itself on working closely with our Tax Disputes team to offer strategic guidance and support during TP Audits to obtain the fairest result for

Cambodian taxpayers.

You may have already experienced that tax advisors with limited transfer pricing experience will merely communicate what information the GDT is requesting, rather than guide the process and defense itself. It is therefore important to have **dedicated Transfer Pricing “Subject Matter Experts”** guiding transfer pricing audits, which is exactly why our TP and Tax Disputes team work closely together on TP Audits to ensure you understand strategic options to obtain the fairest result possible.

Background

Whether the methodology used to determine cost is allowable

One of the key concepts discussed in “Part One” was Cambodian taxpayers being able to prove that intragroup services were actually rendered by a related party. One of the red flags for tax authorities in respect of this point is the method being used to calculate the charge for intra-group services rendered (or are they?). Below the importance of the method used is discussed, with reference to domestic law and international guidance.

Article 17 (2) of Prakas 986 details that “Service fees can be calculated directly or indirectly. Direct calculation of the price occurs when the price is set for the actual service. Indirect calculation



of the price occurs when the service is provided by the parent enterprise or the service center, and subsequently, the expenses are divided and charged to the intra-group through an estimation based on turnover, number of employees or computer equipment, etc.”

This is generally consistent with B.2.2. of Chapter VII of Action 10 of the OECD framework of BEPS, which outlines when direct and indirect charge methods may be most appropriate, thus should not be a new concept to the Head Office of a Cambodian Taxpayer.

Generally, tax authorities including the GDT prefer the direct charge method, as it is clearer when determining whether the price charged is consistent with the arm's length principle. This is because it allows the service performed to be clearly valued based on actual cost incurred plus a profitable mark-up, which can be financially analyzed with a benchmark comparison. It is however acknowledged that the direct charge approach is hard to apply in practice given the administrative burden for the service provider in the group.

Therefore, the use of indirect methods which rely on estimation and allocation of cost may be accepted by the GDT when appropriate. A typical example of

when the indirect cost allocation approach may be applicable is with respect to Head Office or Group Service Centre Providers, which supply services to multiple related party entities, thus making it impractical to identify what costs directly relate to which entity. In this circumstance, the cost allocated to recipients should be based on an appropriate measure of usage of the overall costs incurred to estimate the fair share of total attributable to each service beneficiary, to which an appropriate margin may be added, as long as financially analyzed through a benchmark. It is important to note that this method is appropriate to use, as there is an actual provable cost base.

While indirect methods of cost allocation as the one described above are allowable under Article 17(2) of Prakas 986, our experience is that there is both widespread misapplication of this method and a lack of adequate supporting documentation even when the method is being applied correctly. **The most common example of misapplication by Cambodian taxpayers is when the price charged for intra-group services provided is not determined based on allocation of costs incurred by the related party, but is an actual percentage of the Cambodian taxpayer's revenue/net profit/ fixed assets etc.** This approach is a red flag to the GDT as there is no correlation between actual

costs, benefits received and prices charged. This often results in large tax re-assessments, with an additional 40% penalty plus interest also being charged.

Whether the amount charged for services rendered is consistent with the “arm's length principle”.

Even when the method used to calculate the charge from a Head Office or Service Provider is appropriate, some Cambodian taxpayers are subject to a mark-up on these charges which is inconsistent with the “arm's length principle”. Below the importance of ensuring the cost allocated and mark-up applied is allowable, and the potential consequences of not doing so are discussed, with reference to both domestic law and international guidance.

Article 17 of Prakas 986 discusses the requirement to demonstrate that “services are provided at an arm's length price”. Furthermore, it outlines that “Under the arm's length principle, a review of the price of services rendered requires analysis of the functions of members of the intra-group, in order to determine the relationship between services and activities that relate to the members.”

This demonstrates the expectation of the GDT that a financial analysis in the Cambodian taxpayers are expected to benchmark their intra-group service



charges payable, against similar comparable transactions between non-related parties to demonstrate that the actual cost amount is consistent with the arm's length principle. This approach is consistent with Section B.2.3 of Chapter VII of Action 10 of the OECD framework of BEPS which discusses how to calculate "arm's length compensation".

Many Cambodian taxpayers are reactive in assessing whether the price charged is "arm's length", While such financial analysis may be produced by an advisor during the Tax Audit process **if the correct cost methodology has been used**, it cannot be guaranteed that the analysis will determine that the charge is consistent with the "arm's length principle". **For example, under a direct charge method, a Cambodian taxpayers Head Office may be adding too large a margin to the cost base. In respect of indirect charges, they may be allocating too high a percentage of cost to the Cambodian taxpayer or once again adding too high of a margin on that allocated cost.**

Not understanding your position prior to a Tax Audit may leave Cambodian taxpayers in the unfavorable position of not knowing how much of the intra-group service expense claimed as a deduction on your ToI Return is at risk of being disallowed by the GDT and the potential penalties and interest that may be charged upon disallowance.

Conclusion

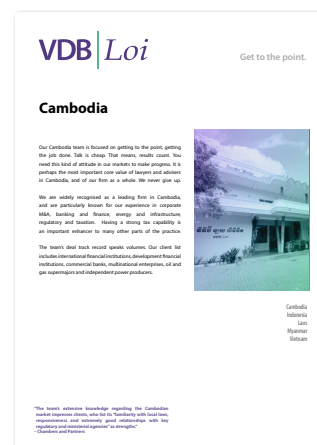
Cambodian taxpayers generally have a high level of influence over their compliance and risk in most areas of taxation. They can choose how much they invest in compliance through personnel, specialist advice, supporting documentation etc. However, it is usually the Head Office of a Cambodian taxpayer who determines how intra group services are to be calculated, allocated and what mark-up may be applied. **This leaves Cambodian taxpayers in the unenviable position** of trying to defend charges claimed as an allowable deduction on their ToI Return, when in practice they have minimal influence over the cost charged and paid.

This however does not excuse those in charge of taxation at Cambodian companies to be passive. At a minimum they should be ensuring they properly understand their position, the potential quantitative exposure and communicating this to their Head Office, so that an informed decision can be made on whether or not to change the approach of how the services provided are calculated, allocated, marked-up and supported through adequate documentation.

RELATED ARTICLES

- ▶ [INTRA GROUP SERVICES – ARE CAMBODIAN TAXPAYERS WAVING A RED FLAG TO THE GDT? PART ONE](#)
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