



With a lack of thin capitalization rules in Cambodia, interest free loans have been the norm for many Multinational Enterprises funding their investment and ongoing operations in Cambodia.

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Kieron is an ACCA-qualified, international tax professional with 10 years of experience, including four years in Cambodia. Recognized as the 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.

INTEREST FREE LOANS – TAX REASSESSMENT RISK

The Hot Button Issue

With a lack of thin capitalization rules in Cambodia, interest free loans have been the norm for many Multinational Enterprises funding their investment and ongoing operations in Cambodia. However, **loss making or small profit margin Cambodian Taxpayers with interest free loans have found themselves facing large tax reassessments** over the past three and a half years. This has taken the form of deemed interest on inbound loans creating withholding tax ("WHT") reassessments. The reason this is particularly pertinent for loss making and small profit margin companies is that even if a corresponding adjustment in respect of Corporate Income Tax is successful this will either not offset the WHT amount due at all (loss making taxpayers) or in totality (small profit margin taxpayers).

Below, we discuss the issues facing Cambodian Taxpayers with interest free loans and how international guidance may help to mitigate their risk.

Introduction

When the concept of transfer pricing was formally introduced to Cambodia on 10 October 2017, upon issuance of Prakas No. 986 MEF.PrK. ("Prakas 986"), **it notably omitted specific guidance on financial transactions.** Many Tax Advisors and Cambodian Taxpayers at the time believed this was due to there already being specific

Highlights of this note

- ▶ Tax Audit Risks on Interest Free Loans;
- ▶ Limitations of Cambodian guidelines;
- ▶ How VDB Loi can help;
- ▶ International Guidance;
- ▶ Test of Substance;
- ▶ Next Steps.

regulations in place which guided both interest free and interest-bearing loans. Firstly, inbound interest free loans had long been an accepted method of funding in Cambodia and were **automatically permitted without adjustment** by the General Department of Taxation ("GDT") in line with Circular 151. Secondly, **Circular 151 automatically allowed the rate applied** on interest bearing loans if the interest rate was below the annual benchmark rate, which was published by the GDT after each calendar year.

In hindsight however the original omission may have merely been down to the reliance on the OECD and its guidelines when drafting Prakas 986. At the time the OECD had very limited guidance on financial transactions compared with other transaction types, thus it is understandable that Cambodia

omitted financial transactions in its original TP guidelines. This omission however only lasted until 21 August 2018, when the GDT issued Instruction Number 11946 **which emphasized all related party loans provided from overseas to Cambodian taxpayers should be consistent with the “Arm’s Length Principle”**, thus removing the prior automatic allowances under Circular 151. IN11946 became effective immediately and is often applied retrospectively by the GDT from 1 January 2018.

As most sectors in Cambodia are not subject to thin capitalization rules, interest free loans had long been the preferable choice of funding new investments in Cambodia by foreign investors, thus this was a seismic shift for the private sector in Cambodia.

Current Day – the VDB Loi approach

Over three years later there remain advocacy efforts to either reinstate automatic allowance of interest free loans as a Foreign Direct Investment Incentive or to grandfather in interest free loans executed prior to 21 August 2018. While such advocacy efforts of course have a place, they have often come at the expense of guiding Cambodian Taxpayers with interest free loans on what they should be doing now. At VDB Loi, we are however advising Cambodian Taxpayers to assess whether their interest free loan is technically justifiable from a transfer pricing perspective. As there is no technical guidance in the Cambodian tax law on this, we must look to international

guidance and most notably Chapter X of the 2022 OECD Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations which is dedicated to the transfer pricing aspects of financial transactions to make such assessments. **Using the OECD guidelines and select foreign jurisdictions practical implementation, we help Cambodian taxpayers with interest free loans as follows:**

- **Loan Substance Assessment:** International guidelines and best practice will be utilized by our dedicated transfer pricing team at VDB Loi to complete a detailed review to determine whether the inbound loan is justifiably interest free.
- **Pricing Clearance:** If our loan substance assessment concludes the loan is justifiably interest free, we can make a submission to the GDT requesting they confirm agreement with the assessment.
- **Supporting Documentation:** VDB Loi can assist with completing supporting documentation for the interest free loan as required by Instruction No. 4909, including Loan Agreement with clear terms and conditions, Business Plan outlining the intended use of funds, Document outlining interest free basis rationale and Board Resolution detailing approval of the loan.
- **Comparability Analysis:** VDB Loi can help Cambodian Taxpayers

who have loans which are interest free in form but in substance should be interest bearing to understand what the interest rate should be by undertaking a comparability analysis where we benchmark what the “Arm’s Length Range” of interest rates for such a loan is.

- **Audit:** In the context of a transfer pricing audit, tax advisors with limited transfer pricing experience will often merely communicate what information the GDT is requesting, rather than guide the process and defend itself. It is therefore important to have **dedicated Transfer Pricing “Subject Matter Experts”** guiding transfer pricing audits. Our dedicated Transfer Pricing Advisory & Audit Team excel at strategically guiding the process and providing technically based defenses to assist Cambodian taxpayers in obtaining the fairest result possible.

Technical Overview

Below we give a high-level overview of how guidance in Chapter X of the 2022 OECD Transfer Pricing Guidelines may be used to help determine whether an interest free loan may be technically justifiable from a transfer pricing perspective.

Substance Test - Is the Financial Transaction debt or de-facto equity?

The term “substance over form” has become a doctrine in tax enforcement globally and is a phrase uttered often in tax planning meetings. In the context of Cambodia, it is



often discussed in supply chain planning meetings where Cambodian Taxpayers explore the possible efficiencies of moving certain services such as procurement to a related party regional service provider. **It however is rarely discussed in the context of financial transactions.** This is predominantly due to a lack of thin capitalization rules in Cambodia, thus whether a loan is in fact more like equity in nature is generally of limited concern.

This conversation is however important when discussing whether a financial transaction with a Cambodian Taxpayer may be justified as being interest free. This is because one of the most common arguments for **a lack of interest being accrued on a related party loan is whether the loan is de-facto equity.** Section 10.5 of Chapter X of the 2022 OECD TP Guidelines highlights how in determining the arm's length range it is important to determine *"whether a prima facie loan can be regarded as a loan or should be regarded as some other kind of payment, in particular a contribution to equity capita"*.

Determining Substance

The above begs the question as to **how it is reasonable to determine substance.** Section 10.13 of Chapter X of the 2022 OECD Transfer Pricing Guidelines thankfully outlines factors for consideration, including:

- "Presence or absence of a fixed repayment date";
- "Obligation to pay interest"
- "Right to enforce payment of principal and interest";
- "Status of the funder in comparison to regular corporate creditors";
- "Existence of financial covenants and security";
- "Source of interest payments";

- "Ability of the recipient of the funds to obtain loans from unrelated lending institutions";
- "Extent to which the advance is used to acquire capital assets";
- "Failure of the purported debtor to repay on the due date or to seek a postponement."

For Cambodian Taxpayers the factors outlined above may be used to aid an argument that their prima facie financial transaction is in fact de-facto equity, **thus no interest should be accrued based on technical transfer pricing guidance, rather than using outdated regulations and commercial arguments.** At VDB Loi, our dedicated Transfer Pricing Team have the knowledge and experience to make determinations based on their understanding of the above and how it is applied in other jurisdictions.

Conclusion

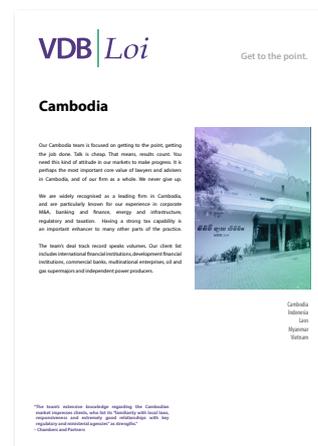
Cambodian Taxpayers who are the recipients of interest free loans may find themselves subject to a tax reassessment where interest is deemed at Cambodian market rates (often 8%/9%) or international credit rates for Cambodia (often 6%/6.5%), thus resulting in significant re-assessments, with an additional 40% penalty plus interest often charged also. **It is no longer reasonable to hope that GDT Auditors will not reassess and determine interest should have accrued.** There is enough tax audit practice to understand that if you have an interest free loan and are a loss making or small profit margin entity, GDT Auditors will pursue a deemed adjustment.

Therefore, if your company is in this position, you should consult **with VDB Loi's Transfer Pricing Team** to better understand how you can prepare for such scrutiny and mitigate the risk of imputed interest being determined, resulting in large tax reassessments which may have been avoidable.

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