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DO CAMBODIA TRANSFER PRICING REGULATIONS PROVIDE THAT THIRD PARTY COMPANIES IN A BENCHMARKING STUDY MAY NOT HAVE +20% SHAREHOLDERS?

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This article addresses a possible misunderstanding of Cambodia's Transfer Pricing ("**TP**") regulations as set out in Prakas 986 on Rules and Procedures for Division of Income and Expense between Related Parties ("the Prakas"). Under the Prakas, taxpayers are required to use arm's length prices on transactions between related parties and prepare documentation to that effect. More often than not, this means that taxpayers need to compare their related party transaction price with that of a comparable unrelated party transaction price. If the transaction cannot be compared easily with other transactions of the same taxpayer ("internal comparables"), which is very often the case, in practice taxpayers and their advisers resort to finding data from third party sources. Using one of several financial analyses, including "transactional net margin method" ("**TNMM**") on various selectable profit level indicators, the idea is that financial information such as the operating margins from several companies somewhere in the world that conduct a comparable business to the taxpayer will be useful to prove that the taxpayer's margin is normal, i.e. "at arm's length".

This article focuses on the question which one of those companies is in fact "comparable" to the taxpayer. More precisely, whether potentially comparable companies should be rejected or included based on their shareholding. When conducting a comparability analysis, should companies that one or more shareholders for holding more than 20% shares be accepted or rejected as far as the Prakas requires?

Where does this question come from?

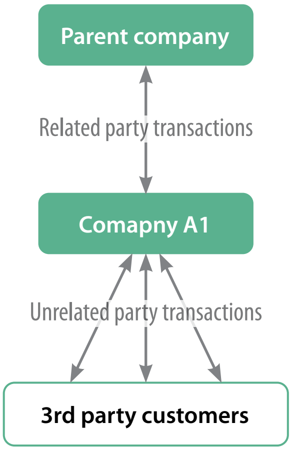
The issue arises for some practitioners from the definition of "related party" in the Prakas art. 4.1.:

> *1- The term "**Related Party**" refers to*
>
> *a) Any member of the taxpayer's relative, and*
>
> *b) Enterprise that controls the taxpayer or enterprise that is controlled by the taxpayer or the enterprise and taxpayer are under common control. The term "control" means ownership of 20 percent or more in the value of direct equity interest in the enterprise or voting power in the board of directors of the company. To determine the size of control of any physical person, calculate both the physical person's direct share of ownership in the equity interest and the direct or indirect ownership by the spouse of the taxpayer.*

This definition is a necessary element to define what is a related party transaction for the Prakas. It is possible to misunderstand the meaning and purpose of the related party definition, with its 20%. Art. 4.1. is not applying the 20% as a "comparability factor" under art. 7. That would be incorrect. The 20% definition is used for the definition of a transfer price, controlled transaction, etc. The 20% shareholding is NOT used as a "factor to determine comparability" in art 7. Art 7 mentions contract, function, conditions, strategy, etc. And it is not referred to AT ALL in the Prakas guidance of the TNMM method or in the examples of profit margin comparables.

The definition. in art 4 of related party It is there only to define which transaction by the taxpayer should be deemed a RPT and which one is not. For example, if the taxpayer did a transaction with another company in which it holds 15% shares, art.4 makes it clear that this IS NOT a related party transaction in the sense of the Prakas. Art. 4

The 20% matters only if the 2 companies involved in a transaction have this 20% relationship. When we examine various comparable companies profit margin, that profit margin does not include transactions with related parties as per IAS 24:4! The fact that such company has a 20% shareholder somewhere, who is not involved in the transactions that we use as comparable profit margin, is completely irrelevant.



Is art. 4.1. a comparability factor?

As art 7 states: "Under the arm's length principle, in order to determine comparability, compare the conditions between controlled transactions and transactions of independent enterprises". This means, enterprises which are not related to the taxpayer. As in art 4 it is stated "Enterprise that controls the taxpayer or enterprise that is controlled by the taxpayer or the enterprise and taxpayer are under common control …".

Art 7 continues: "Comparison of characteristic relating to economic environment must be done in detail based on estimation or similarity through certain factors as follows:

- Contract conditions
- Functional analysis
- Conditions of products or services
- Economic analysis
- Business strategy

And here, the amount of shareholding is NOT mentioned. Why? Because one is comparing transactions in this case, profit from all transactions. This is the golden rule of TP that some loose track of. A transaction between independent parties is by definition at arm's length. Data one may use for TNMM analysis comes from the transactions between company A and its third party customers, which are by definition at arm's length. Because one needs to look at the transaction parties, ask if they are related to each other. The customers and company a are not related.

The alternative interpretation, rejecting Company A because it has a shareholder who owns over 20%, is the opposite. That would mean, company A has a 20% shareholder mr.

A, so all the transactions between Company A and its third party customers, are NOT at arm's length, unable to use for comparability. What we need to focus on is the transaction data: do we have reason to believe that the transactions from which we are using the data from is NOT between mr. A and Company A, but it is from Company A with the third-party customers? This is a really fundamental basic principle of TP.

To sum it up, the 20% reference in art. 4.1. has nothing to do with data drawn from transactions between comparable companies (in terms of functional analysis) and their third party customers.

The databases: Private company data versus public company data

When seeking data from third party transactions, this usually means consulting specialized subscription based databases which collect financial information from global or regional markets. The amount and nature of information that is publicly available varies greatly internationally, and thus there are considerable differences in that information.

One big difference is if the databases include only publicly listed companies or also private companies. In many Asian markets, financial statements of private companies are not available by the public, or in very rudimentary form only.

The difference in using public company or private company data is illustrated by an OECD submission, which also highlights the need for consolidated financial statements which we will discuss further below.

> *"In evaluating public information on 'listed' and private companies, practitioners can come across information, including the unconsolidated financial statements, of the affiliates of MNEs. This type of data is most frequently encountered in Europe, where statutory reporting requirements in several countries make private company information publicly available. To a lesser extent, data from 'listed' companies within MNE Groups is also available in some countries*
>
> *To reliably use data on third-party enterprises that are part of an MNE group as comparable data, one must assume that the data reflects arm's-length dealings between the related parties. In practice, it is almost impossible to verify that is the case. Even when the data is from public companies, which ostensibly are held to higher reporting requirements, it may not be possible to ascertain the full nature of dealings between affiliated companies. In some instances, segmented data from the above sources that is clearly between unrelated parties may be useful if all other comparability criteria are met. In practice, however, lack of detailed segmented public data make it very difficult to verify that the data from the above sources are reliable and reflect arm's-length transactions. While rejection of unconsolidated affiliates of MNEs may systematically exclude the extremely remote possibility of locating useful unrelated transaction data, the cost required to verify the arm's-length nature of the above data sources, and making any necessary comparability*

adjustments (as would likely be the case) would be prohibitively high.

What is the difference between public companies and private ones in relation to the issue of independence? While it is theoretically possible that a publicly listed company is only or mainly transacting with related parties, and is not independent in its business activity, that is far less likely than for private companies. Listed companies are subject to stricter transparency rules, stricter penalties and more oversight than private companies. After all, they are using money from the public and stock market regulators as well as other financial regulators closely monitor them. That is normally less the case with private companies. Captive real estate or services companies, captive IP companies, holding companies, group finance vehicles are almost without exception private companies. It would be difficult to get them listed anyway, on most stock exchanges.

That does not mean private company data is less valid. It just means that most likely additional precautions may be called for.

Consolidated financial statements and related party transactions

One reason to include consolidated financial statements is that based on IAS 24, consolidated FS data does not contain related party transactions.

International Accounting Standard 24:4 reads:

"Related party transactions and outstanding balances with other entities in a group are disclosed in an entity's financial statements. Intragroup related party transactions and outstanding balances are eliminated, except for those between an investment entity and its subsidiaries measured at fair value through profit or loss, in the preparation of consolidated financial statements of the group."

So, one can be more confident that any transactions between group entities have not been included in the financial results of the comparable company. Again, the use of independence criteria is among other reasons useful in this context when one seeks to filter out private (or listed) companies who do not have consolidated financial statements.

Conclusion

In a comparability analysis we focus on financial information from unrelated party transactions. The fact that a comparable company has or does not have one or more major shareholders does not in and of itself disqualify that information as long as we are confident that the financial information we are using is derived from unrelated party transactions, for example between a comparable company and its third-party customers.

Financial information derived from transactions between related parties, such as transactions between the company and its major shareholder, should not be used. As a rule, in many South East Asian markets, focusing on consolidated financial statements under IAS by publicly listed companies rather than unconsolidated data, is one of several ways to select useful, valid data for further comparability analysis based upon the factors of art. 7 of the Prakas.

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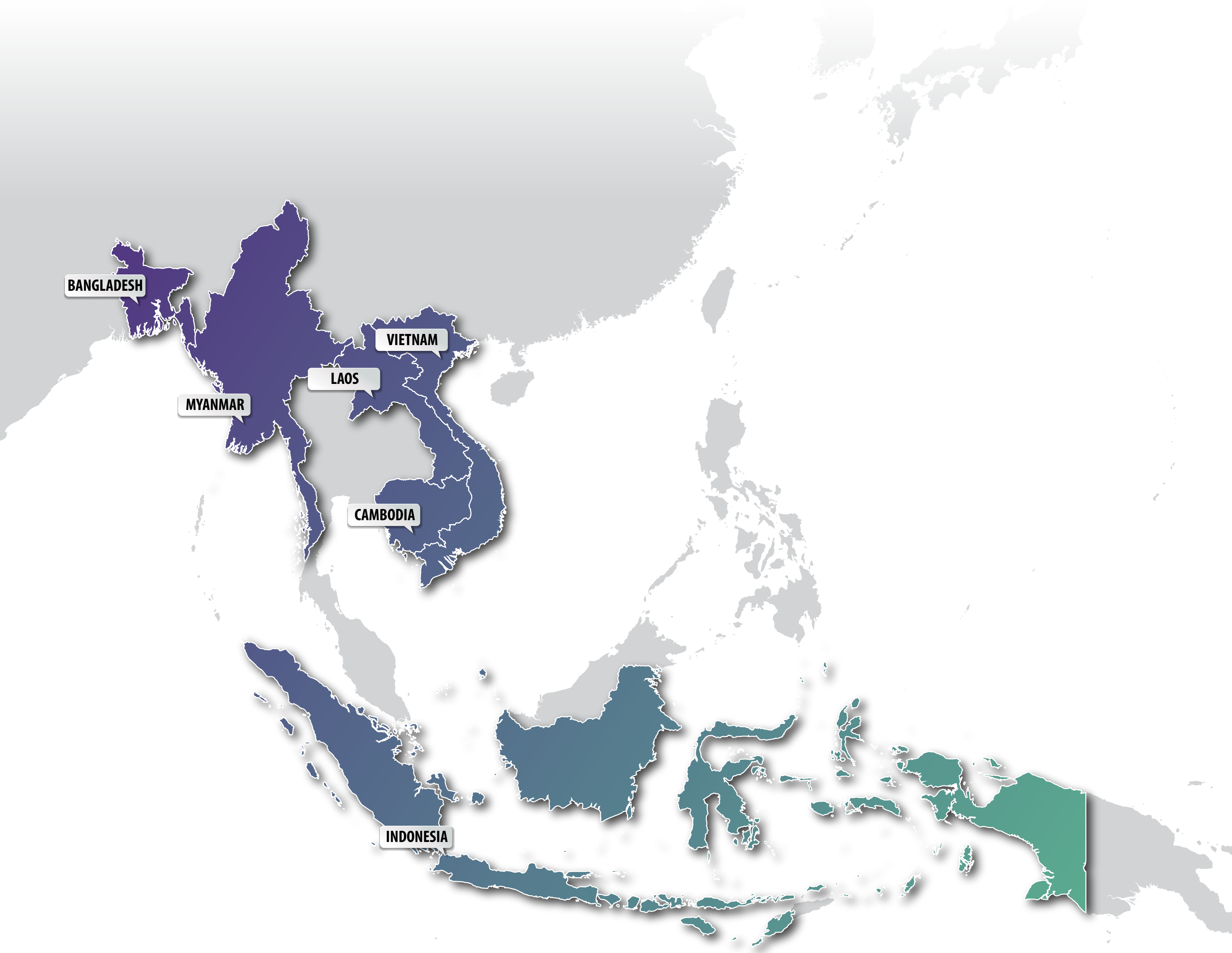

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