SHARE TRANSFERS IN A CAMBODIAN ENTITY – 5 CRITICAL TAX ISSUES YOU NEED TO KNOW!

CAMBODIA CLIENT ALERT

2021 has continued to see steady activity with respect to acquisitions and re-structuring of businesses in the Cambodian market. There are a number of factors at the forefront of this activity, not least the pending capital gains tax implementation date of 1 January 2022, bargain hunting of distressed assets, and internal re-structuring of multi-national organizations, to name a few.

Only a few years ago the transfer of shares in a Cambodian entity was a fairly tax benign process with the primary emphasis of the purchaser being to inherit a Cambodian entity with few historical tax skeletons in the closet whilst for the selling shareholder the tax implications of a share transfer were typically limited to the tax jurisdiction in which they were domiciled.

How things have changed! In the space of a few years, the regulatory tax environment and the practice of the tax authorities in Cambodia has transformed dramatically, and those parties, buyers and sellers of shares, that fail to take the necessary precautions before embarking on a share transfer in a Cambodian entity do so at their peril.

Based on our experience with recent share transfer transactions, we have summarized the top five tax issues that buyers and sellers of shares in Cambodian entities should be aware of.

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1 IT'S A DIVIDEND JIM BUT NOT AS WE KNOW IT!

The historical problem, from the perspective of the Cambodian tax authorities, with taxing the transfer of shares by non-resident shareholders in a Cambodian company was how to collect taxes from shareholders who don't reside in Cambodia or who have not created a permanent establishment in Cambodia.

Cambodia's withholding tax system applies to payments of Cambodian sourced income that are made to non-residents, but the problem with a share transfer is that the payments are typically made between two non-resident entities, therefore, rendering the Cambodia withholding tax system ineffective.

To partially address this issue, the tax authority introduced Prakas 518 in 2017, which was later repealed and expanded by Prakas 372 in 2019. The key takeaway from the respective Prakas was a change in the tax definition of **dividend** to now treat the retained earnings of a Cambodian entity as a dividend at the time of a share transfer. Those trying to circumnavigate the new expanded definition of dividend by converting retained earnings to registered capital are also caught when the resulting shares are transferred

What this now means is a Cambodian entity with a non-resident shareholder who decides to transfer their shares will need to account for withholding tax, typically at the rate of 14%, on a deemed dividend at the time the shares are transferred. The deemed dividend is made up of retained earnings of the Cambodian company that relate to the percentage of shares being transferred or on those transferred shares that have originated from a earlier conversion from retained earnings.

Prakas 372 took effect from April 2019 however it is not unusual for the tax authority try and re-assess withholding taxes on deemed dividends on share transfers that have taken place prior to 2019.

Some small comfort for the incoming shareholder is that if they subsequently declare a legal dividend distribution, they will be exempted from having to pay withholding tax twice on the retained earnings that were taxed at the time of the share transfer.

2 CAPITAL GAINS TAX – A FALSE START BY TAX AUDITORS?

Prakas 346, auspiciously dated 1 April 2020, introduced a capital gains tax regime to Cambodia with most of the fanfare and reaction at that time relating to the perceived hardships that would be faced by the owners of immovable property and the impact on the property market in Cambodia generally. The scope of Prakas 346 includes gains arising from the transfer of shares in Cambodian entities by individuals and non-resident legal entities. In response to industry feedback the implementation of Prakas 346 was pushed back to 1 January 2022.

The delayed implementation of the capital gains regime does not seem however to have deterred some tax auditors who perhaps find the lure of a potential tax windfall arising from a share transfer too tempting to resist. Hence we have seen in recent months an array of various attempts by the Cambodian tax authority to tax deemed gains from share transfers. These attempts range from trying to treat the transfer of shares in a Cambodian entity as the disposal of a fixed asset to asserting that deemed gains from share transfers be considered to be Cambodian sourced income that should be taxed at the level of the Cambodian entity.

This is where the line between the current provisions of the tax regime and the policy and practice of the tax authority becomes blurred. Prakas 346 was perceived to be the missing link that allowed the tax authority to impose taxes on gains that were derived by individuals and non-resident corporate shareholders from the transfer of their shares in a Cambodian entity. However, as noted earlier, the implementation of that Prakas has been deferred to 1 January 2022.

As provided for in the Law on Taxation, a Cambodian taxpayer is obliged to pay no more tax than what is required under the tax regime. The taxes that a Cambodian taxpayer are obliged to pay do not currently extend to taxes on gains derived by an individual or a non-resident entity on shares that they hold in a Cambodian entity. A Cambodian taxpayer **does have an obligation to act as a withholding tax agent** with respect to payments of Cambodian sourced income that it makes to a non-resident, but for withholding tax to apply a payment of Cambodian sourced income must be made, or a specific regulation such as Prakas 372 on deemed dividends would typically need to be passed to impose that obligation.

2 CAPITAL GAINS TAX – (CONT)

Of course, if a non-resident shareholder is found to have created a permanent establishment in Cambodia, then all bets are off, but the key here is that a permanent establishment needs to have been created by the non-resident thereby allowing the tax authority to tax Cambodian sourced income derived by the permanent establishment which could in theory include gains from the transfer of shares in a Cambodian entity.

The key point to note with all of the above for sellers and buyers of shares in Cambodian entities is that they need to hope for the best but make appropriate contingencies for a worst case scenario with respect to adverse findings from the tax authority. Contingencies would include allowing for the time required to dispute an adverse tax audit finding and outlining which party to the share transfer should be accountable for any re-assessed tax liabilities arising from the share transfer.

3 DOUBLE TAX AGREEMENTS – A SILVER BULLET?

The expanding double tax agreement (DTA) network of Cambodia in recent times has been impressive, with the total number of signed DTA's at nine at the time of writing, with more slated to be signed shortly. Countries who have signed DTA's with Cambodia include Singapore, China, Brunei, Thailand, Vietnam, Indonesia, Hong Kong, Malaysia, and the Republic of South Korea.

The scope of DTA's provides much more than reductions in the withholding tax rates of cross-border transactions. In the context of this update, the taxes covered by the DTA's include capital gains tax. As encapsulated under Article 14 of the DTA's, the default position on capital gains tax is that capital gains may only be taxed in the jurisdiction where the transferor of the shares is tax resident unless otherwise stated in Article 14.

The standard exception to this rule to be found in Article 14 of most DTA's is with respect to gains derived from shares deriving more than 50% (the percentage may vary) of their value directly or indirectly from immovable property situated in the other Contracting State. Also note that not all DTA's are the same – for example Article 14 of the Cambodia – Thailand DTA allows for most capital gains to be taxed in the other state from which the transferor resides. It should also be noted that there is no minimum holding period for shares with respect to meeting the capital gains exemption requirement.

Those shareholders in jurisdictions that do not tax capital gains such as Singapore and Hong Kong should note that from a tax residency perspective substance is now a key issue. Having little substance can make it challenging to be considered a tax resident in most jurisdictions and no tax residency means no DTA protection. Do your homework and work out what are the requirements to obtain tax residency in the jurisdiction that you are looking to set up a holding company – it may mean for example that you need to have key people on the ground or that you need to evidence control and management.

The way that DTA benefits work in Cambodia is on an approval-first basis. Formal approval for exemptions and withholding tax reductions must be obtained from the tax authority and as the approval process can take some time to obtain you need to plan ahead!

4 KICKING THE TYRES!

An analogy for acquiring shares in a Cambodian company could be made with acquiring a second-hand car. Of course you can see the potential and benefits of the acquisition, but you could have some serious issues down the road if you don't look under the bonnet!

Historical undisclosed tax liabilities have always been a big factor when acquiring shares in a Cambodian company, and these can be dealt with a number of ways. Carrying out a tax due diligence on the target Cambodian entity can give you some idea of the state of its tax affairs. Once quantified, historical unpaid taxes can be accounted for such as including the requirement for the seller of the shares to obtain tax clearance certificates from the tax authority following a comprehensive tax audit, holding back some of the consideration for the share purchase in escrow until certain conditions are met or perhaps looking at other ways in which the business can be acquired – such as establishing a new entity and acquiring the assets or business of the Cambodian target.

The key points to note here include taking the time to determine the potential historical underpaid taxes that you may be inheriting and ensuring that you have a well-drafted share purchase agreement that considers issues such as tax warranties and indemnities, transactional taxes, control of tax audits, and payment milestones.

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5 IS THAT IT NOW?

We did say salient tax issues to consider right!

Of course this is not an exhaustive list and other issues that need to be addressed when looking at the transfer of shares in a Cambodian company include factors such as the application of Stamp Duty which is levied at 0.1% on the transfer of shares in a Cambodia. This is payable by the purchaser of the shares and needs to be paid to the tax authority within 90 days from the approval of the share transfer with the Ministry of Commerce.

For the purpose of determining the base on which to determine stamp duty the tax authority would typically look for the higher of the share par value, the amount stated in the share purchase agreement or the net asset value of the Cambodian company.

How about the transfer of shares between related parties?

The scope of Cambodia's transfer pricing regulation applies to all business operations between two or more related parties, at least one of whom is a resident taxpayer. Of course, as noted above, often in the event of a share transfer, both parties to the transfer will not be considered to be tax resident in Cambodia.

Related parties to a share transfer should be mindful that fair market value could be used by the tax authority to re-determine stamp duty down the road and the use of fair market value may be a precursor as to how capital gains tax could be determined post 1 January 2022 on related party share transfers.

Similarly under a restructuring scenario within a group there are currently no exemptions with respect to the application of Stamp Duties and Deemed Dividends. In additional how share transfers under a re-structuring will be treated under the new capital gains tax regime is yet to be seen.

In conclusion - as with all important decisions, such as buying a car, we strongly recommend that you seek expert tax and legal advice when looking to buy or sell shares in a Cambodian entity.

TAX

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DFDL was awarded the Regional Tax Firm in Asia of the Year, Vietnam Tax Disputes Firm, and Cambodia Tax Firm of the Year awards at the ITR Asia Tax Awards 2020.

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