Technical Update

Tax and Corporate Services

February 2018

Provision of Tax on Petroleum and Mineral Resource Operation

(Chapter 3, 2018 LFM, promulgated by the Royal Kram no. NS/RKM/1217/019)

The 2018 Law on Financial Management (LFM), promulgated by Royal Kram no. NS/RKM/1217/019 dated 9 December 2017, added a new chapter for the 1997 Law on Taxation (LoT), on the "Provision of Tax on Petroleum and Mineral Resource Operations".

The terms "Petroleum Operations" and "Mineral Resource Operations" in the context of this provision refer to the activities of exploring, developing and producing of petroleum or mineral resources which are conducted in a "Contract Area" as defined in the agreement.

The key provisions are summarized as follow:

Tax Rate and Tax Payable

Taxpayers conducting petroleum and mineral resource operations will be subject to Tax on Income (ToI) at the rate of 30%. In addition to this ToI rate, the taxpayer is also subject to Excess Profit Tax (EPT) at a progressive tax rate by tranches as per below table:

Tranche	Excess profit ratio **				Rate of EPT
1			up to	1.3	0%
2	above	1.3	to	1.6	10%
3	above	1.6	to	2	20%
4	above	2			30%

***ratio is determined by accumulated revenue / accumulated expenditure*

The rules and procedure on calculation of the EPT will be determined by the Prakas of the Minister of Economy and Finance (MEF).

Meanwhile, the taxpayer is exempted from Minimum Tax.

Deductions

<u>Any expense related</u> to operations in any contract/license area in any tax year is deductible only against gross income arising from the operations in the contract/license area in that year.

<u>Interest expense</u> deductions are allowed under a 3:1 Debt to Equity ratio.

<u>Decommission or environmental rehabilitation costs reserve</u> can be set up as provision and allowed to be deducted, based on the approval from the relative Ministries.

<u>Loss carried forward</u> is allowed to be deducted in subsequent tax years up to the **tenth** tax year for petroleum operations and the **fifth** tax year for mineral resource operations. Losses that occur in a contract area or licence area may not be carried forward for deduction in other contract areas or licence areas.

Depreciation

Taxpayer must depreciate prospecting, exploration and development expenditures at the end of tax year in which commercial production commences, following the straight-line method as follows:

Operations	Expenditures ***	Depreciation period	If expected life is revised
Petroleum	Prospecting & exploration	expected life or 5 years (whichever is shorter)	adjust depreciation remaining expenditures according to the revised expected life
	Development	expected life or 10 years (whichever is shorter)	
Mineral Resource	Prospecting & exploration	expected life or 5 years (whichever is shorter)	
	Development	expected life or 7 years (whichever is shorter)	

****Definition of these expenditures is included in the 2018 LFM.*

Tangible and intangible assets beside the above that are acquired or created after the commencement of commercial production, shall be depreciated based on the existing article 13(new) and 14 of the LoT.

Transfer of interest

In the event of any transfer of interest in the petroleum and mineral resource operation, the transferor and transferee must comply as follows:

<u>The transferor</u>: must record the income received as income from petroleum or mineral resource operations subject ToI in accordance with the LoT.

<u>The transferee</u> is subject to tax obligations of the transferred interest.

If the transferred interest is higher than net book value, the difference must be deemed as goodwill, to be depreciated following the straight-line method according with remaining expected life or 10 years for petroleum, and 7 years for mineral resource operation, whichever is shorter.

If the transferred interest is less than net book value, the difference must be deemed as income, to be recorded as income for the subsequent years by proportioning to the remaining expected life or 10 years for petroleum, and 7 years for mineral resource, whichever is shorter.

Taxpayer's obligation

For non-resident taxpayer to enter a petroleum or mineral resource agreement with the Royal Government of Cambodia (RGC), a local company for a contract area must be set up within 15 days before the beginning of economic activity. Subsequently, the taxpayer must comply with the tax obligation as well as provide reports and documents of business operations as required.

Our observation and comment

The inclusion of the provisions of Tax on Petroleum and Mineral Resource Operations is welcomed in the 2018 LFM as there have been a range of "draft" versions of the laws for some years. The existing provision under the 1997 LoT did not provide clear guidelines on how these sectors should be taxed and uncertainty and lack of clarity on tax issues has been an impediment to the sector.

On the other hand, we would think that the introduction of this law cannot be without potential challenges for potential investors/existing operators in these sectors as a lack of clarity still remains on certain matters. Those challenges, for example, are as below:-

Profit tax

The operators of this sector will be subject to the 30% ToI. This ToI rate itself is in excess of the standard rate of 20% for normal taxpayers. This higher rate of tax is now to be increased with the excess profit tax. We have noted that certain countries that introduced similar taxing already have a highly developed and mature Energy and Natural Resources (ENR) sector which comprises large scale infrastructure and systems – roads; transport; rail; electricity; ports; etc, etc – which have been partly funded or serviced by their government. Clearly, none of these factors are currently the case in the ENR sector in Cambodia. We would think that investors from those countries who want to invest in this sector in Cambodia would likely feel that the imposition of an EPT may be a tax burden while the ToI rate is already high (and would seem to already include an EPT on the sector).

Furthermore, the clarification on operation of the EPT is stated to be the subject of a Prakas to be introduced later by the MEF. We would think that such a clarification should be issued as soon as possible for consultation with the Industry. There has been a number of precedence in Cambodia where long delays are experienced in the issue of "clarification" by Prakas or guideline regarding provisions of the law and in the meantime tax officials are making tax audit adjustments on taxpayers, based on the tax auditors' interpretation of a provision which is pending for the Prakas to be issued.

Limitation of deduction

The 2018 LFM indicates that "*any expense related to operations in any contract/license area in any tax year is deductible only against gross income arising from the operations in the contract/license area in that year*".

Of note, the existing tax law is based on the concept of Tax being levied on a "taxpayer" – a legal entity being taxable on its income in Cambodia. Accordingly, if a taxpayer has 2 factories under the same tax rate and one makes a loss and the other a profit, then the taxpayer is taxable on the **net** result. Therefore, the loss in one factory is set-off against the profit in another and tax – at 20% - is paid on the net taxable income. However, we seem to have the position under the above 2018 LFM that a taxpayer which has 2 contract areas cannot net-off its position. Accordingly, if the taxpayer makes a profit in one contract area and a loss in another contract area, it cannot net-off its position. In conjunction with the imposition of the EPT also, a potential issue arises that the taxpayer could be paying EPT in one contract area, yet be unable to deduct its expenses or carry forward a loss in the other contract area because of limitations imposed in the above 2018 LFM. Investors may view that this is a discriminatory to the ENR sector as such a position does not arise for a standard rate taxpayer, for example, that operates 2 manufacturing operations – so why is the ENR sector discriminated against in such a way – with a tax rate of 30% and EPT imposition.

Loss carried forward

The 2018 LFM states that "*any loss carried forward is allowed to be deducted in subsequent tax years up to the **tenth** tax year for petroleum operations and the **fifth** tax year for mineral resource operations*". The relevant question to be raised is - Why is there a limitation period where expenses are validly incurred in this sector? Our thought on this would be that there are certainly differences between the normal business sectors, such as manufacturing, for example, and ENR. Clearly the ENR sector has a long "lead-in" time frame, which may be, for example, 10 years. Whereas the manufacturing sector can open business and be productive within the one financial year. Therefore, there might be a question whether, from an industry perspective, a 10 or 5 year timeframe is appropriate.

Limitation of the interest deductibility

Interest expense deduction is now allowed under 3:1 Debt to Equity ratio for this sector. Where this Debt to Equity rules are in place there can be a variation between ratios; what the ratios may apply to – for example, related party debt only; what is "debt"; what is "equity" and so on. The 2018 LFM does not provide the details on this and has not also indicated that further guidelines or explanatory will be issued by the MEF later. Therefore, further analysis or clarifications on this should be undertaken or obtained – but the point remains that it should not be a case of a simplistic application of a Debt to Equity ratio of 3:1 without any consideration/detail of what it will apply to and how it will apply. We have noted that some countries that have introduced such rules have taken considerable time to draft and implement the rules and undertaken detailed consultation.

Transfer tax for transferee

It is indicated that in the event of any transfer of interest in the petroleum and mineral resource operation, the transferee must comply with tax obligations on the transferred interest. If the transferred interest is higher than net book value (NBV), the difference must be deemed as goodwill, etc... If the transferred interest is less than NBV, the difference must be deemed as income. However, the 2018 LFM fails to clarify what should be the NBV (i.e. sunk cost?) for this transfer tax purpose and how it will work in detail. Therefore, we would think that further clarifications should be issued by the MEF also.

Local company requirement

It is required that a local company must be set up to undertake the operation of this sector. In fact, normally the choice of investment for non-residents can be either a branch or a subsidiary/local company depending on legal, business, etc. perspective in addition to tax. Now, they are required to set up a subsidiary/local company, and branch set up is not allowed. This requirement limits their alternate options of investment.

Apart from the key points above, there are also other various unclear matters in respect of the contents of the 2018 LFM

As such, we expect the relevant Ministries would, in a timely manner set out such details in a future Prakas or Circulars. We will cover any additional regulations (if any) regarding above matters in our future publications.

As a committed tax advisor to our clients, we welcome any opportunity to discuss the relevance of the above matters to your business.

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