

10th SGATAR Joint Training Program



INDONESIA

WORKING PAPER

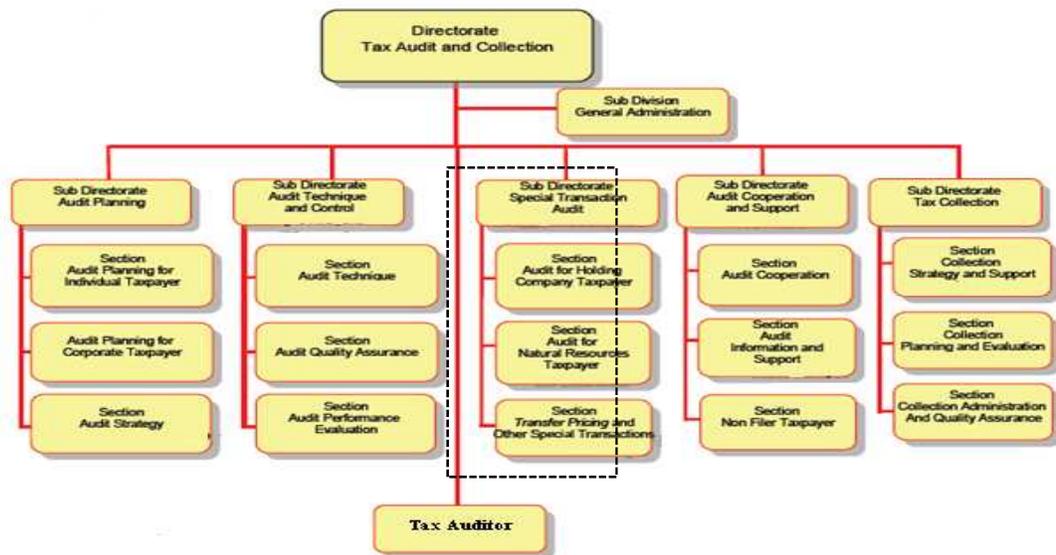
**RECENT DEVELOPMENT
TRANSFER PRICING IN INDONESIAN**

1. Introduction

Transfer pricing is currently one of the most prominent tax issues in Indonesia, as in many other countries. This issue was first revealed in 2005 when the Ministry of Finance announced that he had received a list of 750 Foreign Direct Investment companies (PMA) that do not pay taxes because of continuous loss. It is then alleged that the transfer price is not arm's length¹.

To address this issue, Directorate General of Taxes established Sub Directorate of Special Transaction Audit handling Transfer Pricing case and other special transaction audit in 2007.

Diagram I
Organization Structure of Sub Directorate of Special Transaction Audit



During the last several years, after the establishment of the sub directorate, transfer pricing practice has undergone an incredible growth and caught the taxpayers' immediate attention as a result of aggressive tax audits regarding the reasonableness of related-party pricing. The audit experience has largely improved significant changes in Transfer Pricing Guidelines and Dispute Settlement provisions.

¹ <http://berita.kapanlagi.com/ekonomi/nasional/menkeu-750-pma-tidak-bayar-pajak-lima-tahun-berturut-turut-02j6efp.htm>

2. Legislative Changes

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|------|------------------------------------------------------------------------------------------------------------------------------------------------------------------------|
| 1983 | Transfer Pricing Provision was stipulated on Indonesia Income Tax Law |
| 1993 | DGT Regulation (KEP-01) Guidelines for Audit on Related Parties Taxpayers and DGT Circular Letter Instructions for Handling Transfer Pricing Cases (SE-04) were issued |
| 2007 | Disclosure of related party transactions in the corporate income tax return |
| 2008 | Minor changes of Transfer Pricing Provision on Indonesia Income Tax Law |
| 2009 | Change to the level of disclosure in the 2009 corporate income tax return and the need for a declaration regarding the existence of certain documentation. |
| 2010 | Circular regarding approach to be taken in assessing whether the pricing of related-party transactions is correct. |
| | DGT Regulation (PER-43) which subsequently changed by PER-32 regarding transfer pricing regulation |
| | DGT regulation (PER-48) regarding procedures of MAP |
| | DGT regulation (PER-69) regarding procedures of APA |
| 2011 | Government Regulation number 74 of 2011 (to be covered in the last part of this paper) |

The key article in the Indonesian Income Tax Law which is covering the ability of the Directorate General of Taxes to assess taxpayers regarding the pricing and nature of related-party transactions has been stated in Indonesia income tax law since 1983. However, no further implementation or enforcement of that provision at that stage.

Year of 1993 was the second stage of transfer pricing regulation in Indonesia. Directorate General of Taxes issued DGT Regulation (KEP-01) concerning Guidelines for Audit on Related Parties Taxpayers and DGT Circular Letter (SE-04) concerning Instructions for Handling Transfer Pricing Cases. This remained largely unchanged since its introduction in 1983.

The first to such changes occurred in 2007 with the requirement to disclose related-party transactions in the corporate income tax return. Then guidance on the completion

of the corporate income tax return mentioned, for the first time, the need for taxpayers to maintain documentation to support pricing in related-party transactions.

A minor of changes² in the latest revision to the Income Tax Law in 2008 has signalled that Directorate General of Taxes would scrutiny transfer pricing issue in the forthcoming time. The changes also resulted a significant change in the manner in which such issues were addressed.

In July 2009 a change to the level of disclosure in the 2009 corporate income tax return and the need for a declaration regarding the existence of certain documentation. Included among many procedural changes announced in July 2009 was the requirement for three new related-party transaction forms to be submitted along with the corporate income tax return for fiscal year 2009:

- Form 3A: full details of all related parties transacted with and details regarding the transactions;
- Form 3A-1: 15 yes/no questions regarding documentation held in relation to the arm's length principle, such as records held in relation to related-party transactions, comparative documentation and the transfer pricing calculation method; and
- Form 3A-2: details regarding related-party transactions with companies in tax haven countries.

Note that for companies reporting in USD the relevant references are 3B, 3B-1 and 3B-2.

In October 2009, DGT published a circular letter providing guidelines on benchmarking ratios that they would expect to see within certain industries. This Circular covers 14 specific ratios (although an additional fifteenth ratio regarding inventory is included in the attachment to the Circular), and the stated use is to identify entities that are outside the norm for the industry in which they operate on the basis that the reason for the deviation may be that such entities are involved in inappropriate transfer pricing.

² "Director General of Taxes is authorized to reallocate income and deductions between related parties and to characterize debt as equity for the purposes of the computation of taxable income to assure that the transaction are those which would have been made between independent parties **using price comparison method between independent parties, resale price method, cost-plus method, or other methods.**"

It is not clear how the information has been collated or how appropriate such comparisons may be. As these will be used in targeting taxpayers for transfer pricing queries and audits, they may provide an indication as to where the tax authorities are likely to challenge a given transfer price. This was followed by four additional circulars covering separate industries which were issued during the course of 2010 (117 industries are covered as January 2011).

In the next major development in May 2010, the authorities issued a circular revising their internal guidelines to tax auditors regarding the approach to be taken in assessing whether the pricing of related-party transactions is correct. This Circular was an update to regulations which had been used as guidance by tax auditors since 1993.

Then, the issuance of Regulation PER-43/PJ/2010 (the Transfer Pricing Regulation) by the Directorate General of Taxation in September 2010 provided further confirmation that Indonesia has adopted the arm's length principle, and gave the most significant guidance yet to taxpayers regarding the requirements for documentation and the expectations of the tax authorities. This is now the main point of reference when considering the specifics of Indonesian transfer pricing issues.

From September to December 2010, the most significant regulations covering transfer pricing analysis and documentary requirements, mutual agreement procedures (MAP) and advance pricing agreements (APAs) application procedures were issued.

3. Indonesia Transfer Pricing guidelines

The Transfer Pricing Regulation largely adopts the OECD approach but differs in certain significant areas. Whilst this is the most comprehensive regulation yet issued, the lack of detail and the wording may allow for interpretation which differs from the spirit of that within the OECD Guidelines.

The DGT has issued Per-32/PJ/2011 dated and effective 11 November 2011 (Per-32). This regulation serves as revision of PER-43/PJ/2000 regarding the application of the arm's length principle (ALP) in a Related Party Transaction (per-43). The key changes which may have a significant impact on taxpayers are follows :

a) Scope of the regulation

The Scope of the application of the ALP covers, firstly, *international related party transactions* conducted by domestic taxpayers or permanent establishments (PEs) in Indonesia. And, secondly, *domestic related party transactions*, if they are carried out with a motive to enjoy different tax rates. Example of the second transactions are transactions with taxpayers who are subject to final tax, Oil and Gas Contractors, or Taxpayers who are subject to luxury sales tax.

b) The Application of of the regulation

Whilst the OECD Guidelines state that tax administrations should balance the need for documentation against the costs and administrative burden to the taxpayer, the previous Transfer Pricing Regulation stated that only transactions less than IDR 10 million (approximately USD 1,100 at January 2011) do not require documentation. Now, in the PER-32 the threshold has been increased to IDR 10 billion (i.e. approx USD 11,1 million) for each counter transacting party per year.

c) Comparability Analysis

- An internal comparable is preferred over external comparables. The external comparables can be obtained from a commercial database or other databases.
- In performing the functional analysis, manufacturing companies must be able to characterize the company as being a toll manufacturing, contract manufacturing, or fully fledged manufacturing company.
- The regulation also states that a contractual arrangement can be determined based on the actual activities of the related parties, if no written contractual arrangement exists.

d) Selection of Transfer Pricing Methods

While PER-43 strictly requires the use of a hierarchy in selecting the most appropriate methods, PER-32 has abandoned this requirement and has adopted the most appropriate method approach. However, it still requires the following considerations:

- 1) The strengths and weakness of each transfer pricing method.

- 2) The appropriateness of the method based on the nature of the related party transaction, determined by a functional analysis.
- 3) Availability of valid information (on independent transactions) to apply the selected method.
- 4) The comparability level between related party transactions and independent transactions, including whether any appropriate adjustment would need to be made to eliminate any material differences between the compared transactions or enterprises.

Furthermore, PER-32 no longer puts the Transactional Net Margin Method (TNMM) as the method of last resort.

e) Cost Contribution Arrangement

PER-32 outlines the definition of Cost Contribution Arrangements (CCAs). A CCA is a framework agreed among business entities to share the costs and risks of developing, providing or obtaining assets, services, or rights and to determine the nature and extent of the interests of each participant in those assets, services or rights. It is unclear whether the intention of this definition is to attract research and development activities in Indonesia.

f) DGT Authority to conduct investigation

PER-32 deletes the clause under PER-43 where it gives the DGT the authority to investigate a company that has a related party transaction with a company that is indicated to have conducted a tax criminal act.

g) Correlative Adjustments

The regulation includes that a correlative adjustment resulting from a primary adjustment made by the DGT now also applies to a PE.

4. Mutual Agreement Procedure (MAP)

a) MAP Initiatives

In early November 2010 the DGT issued Regulation No. 48/PJ/2010 as guidance on the implementation of Mutual Agreement Procedure / MAP (PER-48). Under Article 2 of the PER-48 above, the MAP is conducted as a result of:

- 1) a request proposed by a resident taxpayer of Indonesia;
- 2) a request proposed by an Indonesian citizen who has become a resident taxpayer of a tax treaty partner country as a result of non-discrimination provision in the applicable treaty;
- 3) a request proposed by a treaty partner country; or
- 4) matters considered important by and based on the initiatives of the DGT.

b) Reasons of MAP request

The request for conducting a MAP by an Indonesian resident taxpayer can be made, among other, when:

- 1) the Indonesian resident taxpayer is subject to or will be subject to tax as a result of conducting transfer pricing practices in relation to transactions made with a related taxpayer in a treaty partner country;
- 2) the Indonesian resident taxpayer believes that there is an action by a treaty partner country which has resulted or will result in tax imposition which is not in accordance with the relevant tax treaty in relation to the existence of or income from a permanent establishment in the treaty partner country concerned;
- 3) the Indonesian resident taxpayer believes that there is an action by a treaty partner country which has resulted or will result in tax imposition which is not in accordance with the relevant tax treaty regarding tax withholding in the treaty partner country; or
- 4) the Indonesian resident taxpayer who is also considered a resident taxpayer of another treaty country requests a consultation to determine its status as a taxpayer of one of the treaty countries.

c) Time Limit and Documents requirements

A request for a MAP must be completed by supporting documents and submitted to the DGT within a certain period as stated by the prevailing tax treaty. Most tax treaties state that the period is within three years of the first notification of the action resulting in taxation not in accordance with the provisions of the tax treaty. Under PER-48, the said time limit is calculated after an Indonesian taxpayer has been charged or will be charged tax which is not in accordance with the provisions of the tax treaty.

An Indonesian resident taxpayer requesting a MAP from the DGT through its Tax Service Office must provide certain information or explanations, regarding, amongst other matters:

- Actions taken by a resident taxpayer or the tax authority of a tax treaty partner country, which are considered not to be in accordance with the tax treaty provisions.
- For Transfer Pricing cases, the name, address, type of business, and the taxpayer identification number of the related foreign taxpayer involved.
- Whether the Indonesian resident taxpayer has submitted or will be submitting a request for revision, an objection letter, an appeal to the tax court, or a request for reduction or cancellation on matters requested for MAP.
- Provisions in the tax treaty that are considered by the Indonesian resident taxpayer as not properly implemented and the opinion of Indonesian resident taxpayer in regard to the implementation of the provisions.
- Transactions to which the tax authority of the tax treaty partner country has made an adjustment, including information on the substance of the transaction, their value and basis of the adjustment.
- The Indonesian resident taxpayer's opinion on the adjustment made by the tax authority of the tax treaty partner country.

d) Negotiation Process

The negotiation process between the DGT and the treaty partner tax authority is not discussed in detail in PER-48. The regulation does mention that the DGT may hold consultation meetings with the other tax authority to discuss the MAP request. The DGT will form a team of tax officers for each case to represent the DGT in the

negotiations. In transfer pricing cases, the DGT team may include tax officers with specialized transfer pricing experience.

After the negotiations are completed, the tax authorities will prepare a draft mutual agreement which will be presented to the taxpayers. The mutual agreement will only be binding if the taxpayers accept the draft. This is consistent with common practice in MAP cases in other countries.

e) Rejection or Termination of MAP process

Should the Indonesian taxpayer have filed an objection or an appeal on matters relevant to MAP and the objection or appeal has not been withdrawn, the DGT may reject the request to conduct a MAP or end the MAP process. The DGT terminates the MAP process if:

- 1) the Indonesian resident taxpayer or the Indonesian citizen that has been a resident taxpayer in the partner country that makes the request for MAP processing :
 - submits a cancellation of the MAP request to the DGT;
 - does not agree with the content of the mutual agreement draft;
 - does not meet all the requirements for information or documents as required by the DGT;
 - gives false information to the DGT; or
- 2) the Indonesian resident taxpayer making the request for MAP processing submits an objection letter to the DGT or an appeal to the tax court.

f) MAP and Domestic Remedies

The interaction of MAP and domestic procedures is different in each country. It is common practice in other jurisdictions for the tax authorities to allow domestic procedures to be suspended until MAP discussions have been completed. The DGT has not discussed this option in PER-48. The position taken by the DGT in PER-48 means that, in practice, most Indonesian taxpayers will need to choose either MAP or the domestic Objection and Appeal process (due to the time limitations for filing MAP requests, Objection requests, and Appeal requests).

5. Advance Pricing Agreement (APA)

In November, the DGT issued a MAP regulation i.e. Regulation No.48/PJ/2010 and, more recently, the DGT issued Regulation No.69/PJ/2010 (PER 69) regarding APAs on 31 December 2010.

An APA is an agreement between the DGT and taxpayers and/or another country's tax authority on the future application of the arm's length principle to transactions between related parties. An APA can be unilateral (i.e. between the DGT and an Indonesian taxpayer only), bilateral (i.e. also involving a taxpayer and a tax authority in one other country) or multilateral (involving three or more countries). The current regulation focuses primarily on the procedures for obtaining a unilateral APA.

a) Rationale and Benefit of APA

An APA is used to reduce transfer pricing uncertainty arising from related party transactions conducted in the future. APAs are a cooperative compliance tool intended to provide certainty on transfer pricing issues to taxpayers and the tax authorities.

The benefits of an APA can include:

- certainty concerning the transfer pricing method to be applied to particular transactions;
- significantly reduced risk of an audit of transfer pricing issues;
- lower ongoing compliance costs and reporting requirements once the APA has been agreed; and
- reduced risk of double tax, especially in the case of bilateral APAs.

b) Procedures and information required for processing an APA

An Indonesian taxpayer would need to follow five main steps to request and negotiate an APA.

Step 1 : Pre-lodgement meeting between the DGT and the taxpayer

Step 2 : Filing a formal APA request to the DGT based on the pre-lodgement meeting

Step 3 : Discussion of the APA between the DGT and the taxpayers

Step 4 : The issue of the APA letter by the DGT

Step 5 : The implementation and evaluation of the APA

c) Reconsideration or cancellation of APA

The DGT has the authority to reconsider or even cancel the APA under the following circumstances:

- if the taxpayer does not comply with the APA;
- if the taxpayer delivers incorrect data/information to the DGT;
- if the taxpayer does not submit an ACR or the submitted ACR is not in accordance with the prevailing provisions;
- if a critical assumption is breached;
- if errors are found in the APA;
- if the taxpayer has been involved in a tax crime.

These conditions must be included in the APA and, should the DGT cancel the APA, the DGT has to inform the taxpayer in writing.

d) Period and rollback

The APA is valid for a maximum of three tax years after the tax year in which the APA is agreed. The APA can also be applied to tax years before it was agreed if the following conditions are met:

- the tax year has not been audited;
- the taxpayer has not filed an objection or appeal for the respective tax year;
- there is no indication of tax crime.

Rollback of an APA to prior years is not automatic and will be subject to agreement between the taxpayer and the DGT. The regulation does not discuss the procedures for renewing an APA that has expired after the original three year term.

e) APA and Audit

Furrrthermore, the existence of an APA will not prevent the DGT from conducting a tax audit. This leaves some doubt as to whether an APA really will provide certainty on transfer pricing issues. On the other hand, the practice in other countries with APA programs is that any audit of a company with an APA should be limited to reviewing issues that are outside the scope of the APA and reviewing whether the taxpayer has complied with the APA.

6. RECENT UPDATE ON MAP AND APA (GR NO. 74)

GR-74 was dated 29 December 2011 and came into effect on 1 January 2012. Several of the important rules related to transfer pricing and settlement of dispute covered by GR-74 and are as follow :

a) Mutual Agreement Procedure (MAP)

As opposite to DGT Regulation No.48/PJ/2010 (PER-48) in 2010 regarding MAP, GR-74 provides flexibility for taxpayers to apply for a MAP and to continue local dispute resolution at the same time. The local dispute resolution includes applying for a tax objection, appealing to the Tax Court and requesting for a reduction or cancellation of administrative sanctions. However, GR-74 includes the restriction that a MAP application shall be discontinued if an appeal decision is declared by the Tax Court prior to the finalisation of the MAP. If one of the parties is not satisfied with the Tax Court decision, a judicial review by the Supreme Court is still allowed.

b) Advance Pricing Agreement (APA)

In addition to DGT Regulation No.69/PJ/2010, GR-74 stipulates that any documents used during the negotiation of an APA should be returned to the taxpayer if no agreement is reached and the documents cannot be used by the Indonesian Tax Office (ITO) as the basis to conduct a tax audit or audit for preliminary evidence.