

TaxFlash

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New Transfer Pricing Regulation for Indonesia

The Directorate General of Taxation (DGT) has published a new transfer pricing regulation for Indonesian taxpayers. The new regulation (PER-43/PJ/2010) represents the first specific guidance to Indonesian taxpayers since transfer pricing documentation became mandatory from 1 January 2008. Significant portions of the regulation are based on the Organisation for Economic Cooperation and Development (OECD) Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations (the OECD Guidelines).

The effective date of the regulation is 6 September 2010. The specific contents of PER-43 are summarized below.

Common business practice

An important feature of the compulsory transfer pricing documentation requirement in Indonesia is that a taxpayer's documentation must demonstrate that its transactions with related parties are consistent with the arm's length principle and with ordinary business practice. PER-43 does not elaborate on the common business practice aspect of the documentation requirement; rather, it embeds this within the discussion of the arm's length principle.

PwC's experience is that, whilst the concepts of the arm's length principle and common business practice are related, in practice the Indonesian Tax Office (ITO) usually assesses compliance with these two principles separately in tax audits. The ITO's practical approach (which is articulated in internal audit guidelines issued by the DGT) is to define common business practice as common practice of players within the taxpayer's industry.

Because the regulation does not explicitly elaborate on the common business practice concept, it is uncertain how the ITO would apply this in practice. For example, assume a taxpayer engages in a transaction with related parties which is not common amongst other players in the industry (e.g. if an entity is paying royalties to a related party in an industry where no other companies pay royalties). The question then arises as to whether the ITO would deny the royalty expenses in a partial or entire amount or would require the taxpayer to show that the transaction has enabled it to earn higher profits than its industry peers.

Scope of regulation

The regulation applies to transactions between related parties which have an impact on the reporting of income or expenses for corporate tax purposes. The regulation states that these transactions may include:

- a. Sale, transfer, purchase or acquisition of tangible goods and/or intangible goods;
- b. Payment of rental fees, royalties, or other payments arising from the provision of or use of tangible or intangible property;
- c. Income received or costs incurred for provision of or utilization of services;
- d. Cost allocation; and
- e. Transfer or acquisition of property in the form of a financial instrument, as well as income or costs from the transfer or acquisition of the financial instrument.

Implementation of the arm's length principle

PER-43 indicates that the arm's length principle (ALP) should be implemented by the following steps:

- a. Perform a comparability analysis and identify comparables;
- b. Determine the most appropriate Transfer Pricing Method;
- c. Apply the ALP to the tested transaction based on the result of the comparability analysis and the selected transfer pricing method;
- d. Document each step of the process in determining the arm's length price or profit in consideration of the prevailing tax regulations.

The regulation notes that taxpayers are not required to comply with these steps for transactions with related parties who earn income or incur expenses of less than IDR 10 million. In practice there are unlikely to be many taxpayers who are able to utilize this exemption.

Comparability analysis

The comparability analysis outlined in PER-43 is based upon the five comparability factors contained in the OECD Guidelines. These are:

- a. Characteristics of property or services;
- b. Functional profile of parties involved;
- c. Contractual terms;
- d. Economic conditions; and
- e. Business strategies.

Guidance is provided on how each of these comparability factors should be analyzed. The guidance is consistent with explanations of the comparability factors in the OECD Guidelines.

The regulation indicates that where both internal and external comparable data are available, internal comparable data must be used. Where there is no internal comparable data available, external data such as commercial databases may be used. No specific guidance is contained in the regulation about which databases will be considered acceptable by the DGT. However, in the recent news media, we noted the DGT referring to the use of the OSIRIS and ORIANA databases and industrial reports as its tools to test transfer pricing compliance and combat tax crimes through transfer pricing.

Selection of transfer pricing methods

The five OECD pricing methods are endorsed by the DGT and formally recognized in Indonesian tax law. These are:

- a. Comparable uncontrolled price (CUP) method;
- b. Resale price method (RPM);
- c. Cost plus method (CPM);
- d. Profit split method (PSM); and
- e. Transactional net margin method (TNMM).

PER-43 proposes a strict hierarchy in the selection of transfer pricing methods. The CUP method must be considered first. If no directly comparable transactions are available, taxpayers must consider whether they may be able to apply an adjusted CUP method by making certain adjustments or assumptions. After considering these factors, if there are still no reliable comparable transactions available, then one of the two gross margin methods (RPM or CPM) may be considered. Net profit based methods, such as TNMM or an application of the PSM at the net profit level, may be applied if there are "difficulties" in applying one of the more direct pricing methods.

The hierarchy of methods adopted by PER-43 is consistent with the 1995 version of the OECD Guidelines. In July 2010, the OECD approved a revised version of its Transfer Pricing Guidelines which no longer includes a hierarchy of methods. The hierarchy was removed based on the practical experience of tax administrations and taxpayers in OECD member countries, where it was found that it is often very difficult to identify reliable comparable data to apply the CUP method, RPM or CPM.

Use of a range

PER-43 indicates that it is possible to determine either a single arm's length price/profit or a range of arm's length outcomes. If it is possible to calculate a single arm's length outcome, then a range should not be used. PER-43 does not elaborate on how to determine a single arm's length outcome. Where a range is used, this should be based on the inter-quartile range of comparable data.

Special transactions

PER-43 provides limited additional guidance on the specific requirements in respect of services and intangible property (IP) transactions.

For services transactions to comply with the arm's length principle, it is necessary to confirm that the service is actually rendered, that it provides the recipient with a commercial or economic benefit, and that the value of the service fee is in line with comparable arm's length service fees or with the costs that would have been incurred by the recipient if it had performed the activities itself. No service fee should arise where a parent company performs an activity in its capacity of shareholder of the group.

For royalty transactions to comply with the arm's length principle, it is necessary to confirm that the transaction actually takes place, that the IP provides a commercial or economic benefit to the licensee, and that the royalty paid is consistent with comparable arm's length royalties. For transactions involving the transfer of IP, it is necessary to confirm that the transaction actually takes place, and that the value of the consideration is arm's length. A comparability analysis for IP transactions (either royalties or transfers of IP) should consider the following factors:

- a. Geographical coverage;
- b. Exclusive (or non-exclusive) character of any rights granted; and
- c. Whether the licensee has the right to participate in further developments of the property by the licensor.

Format of transfer pricing documentation

PER-43 states that, at a minimum, a taxpayer's transfer pricing documentation should include:

- a. Overview of the company such as group structure, organization chart, shareholding structure, business operations, list of competitors and description of business environment;
- b. Price policy and/or and cost allocation policy;
- c. Comparability analysis (i.e. the five comparability factors);
- d. List of selected comparables; and
- e. Application of the selected method.

As long as these areas are covered, the specific format and contents of the transfer pricing documentation may be determined by the taxpayer.

The regulation does not discuss how frequently taxpayers should update their transfer pricing documentation, but it does note that taxpayers are required to report their related party transactions in the annual corporate income tax return. Since the corporate income tax return disclosures for 2009 onwards include questions about whether transfer pricing documentation is available, this suggests that updating transfer pricing documentation annually would be advisable.

Transfer pricing adjustments by the DGT

PER-43 clearly states that the DGT has the authority to re-determine the amount of related party income and expenses in calculating the taxable income of a taxpayer. The DGT's adjustments may be based on the taxpayer's own transfer pricing method and documentation. Where the taxpayer's documentation is insufficient, the DGT will conduct its own analysis to re-determine the related party income and/or expense amounts.

If there is evidence of a tax crime, then the DGT may perform an investigation as outlined in Article 44 of the tax administration law.

Correlative adjustments

The DGT has the authority to make correlative adjustments to a taxpayer's income as a follow up to a primary transfer pricing adjustment made by the DGT or an overseas tax authority to the income of one of the taxpayer's related parties. PER-43 does not provide detailed guidance on the process that taxpayers must follow to seek such a correlative adjustment. The regulation is also silent whether taxpayers who received transfer pricing adjustments prior to the enactment of PER-43 are eligible for such correlative adjustments and whether formal applications are required to enable them to have such adjustments.

MAPs and APAs

PER-43 notes that Mutual Agreement Procedures (MAPs) and Advance Pricing Arrangements (APAs) are available to taxpayers. We expect the ITO to issue detailed guidance on the process that taxpayers must follow on the MAPs and APAs.

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