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## 2007 Reconditioning of the Tax Collection Engine

### \* Lower withholding tax rates but with wider scope

While many businesses were still closed for the year-end holidays, just a day after Christmas the DGT announced Per-178/PJ/2006 which would be effective from the first day of 2007. The main message was that from 1 January 2007, income from practically any services would be subject to Article 23 withholding income tax. The only exception will be income from drilling services rendered by permanent establishments and Indonesian security-related services rendered by the Indonesian securities clearing and custodian houses (KSEI and KPEI).

Article 23 of the 2000 Income Tax Law requires tax withholding from payments of considerations for “management, technical, construction, and consulting services” to resident taxpayers or Indonesian permanent establishments. This applies to the extent to which the payments are not

subject to Article 21 income tax. The law leaves it up to the DGT to stipulate the effective withholding tax rates. Moreover, it also authorizes the DGT to extend the withholding scope to include income from any other services.

While the withholding mechanism runs like a tax collection engine, the DGT with this authority has a broad flexibility to recondition the engine. Typically each reconditioning is achieved by tuning up the estimated net income (ENI) of the designated services to adjust the effective withholding rate and adding the services to which Article 23 income tax is to be applied.

The 2007 reconditioning does not deviate from this pattern. The withholding scope is stretched to its maximum capacity by including virtually all possible services. The other striking feature is the reduction of the highest effective withholding rate from 7.5% to 4.5%. Certain services will still have the same withholding tax rates as before (Figure 1). Other designated services will be subject to a special withholding tax rate of 3% (Figure 2). Any other services outside these first two groups, including technical, management and consulting services, are subject to a general withholding tax rate of 4.5% (Figure 3).

It is noted that Per 178 lacks any transitional provision arrangements. Questions are likely to arise on the tax treatment of certain events taking place near the cut-off date (31 December 2006). For example:

- Whether a particular event should be subject to Article 23 withholding tax at all; eg in the case of services not subject to Article 23 withholding tax under the old regime (Kep-170/PJ/2002).
- Whether the old or the new withholding tax rate is applicable for the other services.

Black and white answer to those questions are rarely available. Uncertainty will therefore continue unless the DGT issues another regulation on the transitional period. As the show must go on irrespective of the absence of such a regulation while the uncertainty needs to be mitigated, a set of principles is required to answer those typical questions.

Whether a particular event should be subject to the old or new withholding tax regime will depend on the incurrence of three main attributes (see Figure 4):

- payment/billing;
- contractual terms
- service performance

Care should still be taken, because while these do not provide certainty, this uncertainty is particularly pronounced in respect of services continuing from 2006 through to 2007.

## Tax Facilities to Boost Investments

**\*Just a step further, but not yet ready for implementation**

Six years ago, GR 148/2000 - which would provide tax facilities for investments in certain designated areas - was put into effect. However, no designation of areas had ever been made until the regulation was cancelled early this year. Implementation has accordingly never been possible and during its life, GR 148 has only stayed as a good faith without real benefits for investors or taxpayers.

With a view to boost investments in the country, early this year, the government repacked the same tax facilities in GR 1/2007, and thereby cancelled GR 148. The facilities consist of the following:

- **Investment allowance at 30% of the qualifying investments.** This must be proportionally allocated into six years (5% per year) and may be transformed into net income reduction or tax loss increase.
- **Accelerated depreciation.** The basic idea is to depreciate assets and claim the corresponding tax deduction twice as fast as the conventional method. For instance, Group-1 assets, which have a four-year useful life under the conventional method, will have their useful life reduced to two years. Consequently, if the assets are depreciated using the double-declining balance method, such assets may be expensed at once in the same year of acquisition.
- **Withholding tax rate reduction from 20% to 10% for dividends payable to non-residents.** This will apply if no particular tax treaty is applicable or the applicable tax treaty provides a withholding tax rate higher than 10%. If the withholding tax rate under the tax treaty is lower than 10%, the tax treaty should prevail.
- **Extension of the time to carry forward tax losses up to ten years.** By default, a tax loss from a particular year can be offset against future profits and the remaining balance can be carried forward only within five years. After five years, unused tax losses will automatically evaporate. Under GR 1/2007, the time may be extended if certain conditions are satisfied (Figure 5).

Qualifying investments include new investments as well as expansion of the existing ones in the designated business areas (Figure 6). Investments in certain other business areas may also be granted the same tax facilities if they are made in certain designated regions (Figures 7). The investments must be in the form of tangible assets and may include land used to run the main business of the company concerned. Only limited-liability (PT) companies and cooperatives qualify for the tax facilities.

The Minister of Finance (MoF) is to issue decrees regarding the grants of tax facilities, taking into consideration the recommendation of the chairman of the National Coordinating Board of Investment (BKPM).

Within six years from the grant of tax facilities, designated fixed assets may not be used for purposes other than the main business. Transfers of such assets are also prohibited unless they are replaced with new fixed assets. Ignorance of these prohibitions will result in the cancellation of the tax facilities, administrative penalties, and denial of rights to obtain the same tax facilities.

Compared with its predecessor (GR 148), GR 1/2007 gives more clarification. Nevertheless, implementing regulations (MoF and DGT regulations) are yet to be issued. Until such regulations are issued, GR 1/2007 will still remain as a good faith without any real benefits, just like its predecessor.

## Redefinition of “Strategic Goods” for VAT Exemption

### \* VAT exemption applies for agricultural products irrespective of who delivers the goods

The government finally redefined the “strategic goods” qualifying for VAT exemption by amending GR 12/2001 for the third time with GR 7/2007 early this year. Put into effect on 1 January 2007, the amended regulation preserves the same list of items designated as strategic goods. In summary, these include:

- Capital goods such as plant machinery and equipment
- Cattle, poultry and fish feed
- Agricultural products (including farming, plantation, forestry, and fishery products)
- Seeds and seedlings for agricultural, plantation, forestry products.
- Water distributed through pipes by the Drinking Water Company (PAM);
- Electricity except household electricity above 6600 watts.

The amendment is reflected in the removal of the condition for agricultural products to be exempt from VAT. In the past, agricultural products were only exempt from VAT if they were delivered by individual farmers. Under GR 7/2007 VAT exemption applies irrespective of who delivers the goods. Figure 8 contains samples of agricultural products qualifying for VAT exemption.

Please contact your regular PricewaterhouseCoopers adviser if you would like to discuss the issues above or require further details. (Robertus Winarto).

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# Figures:

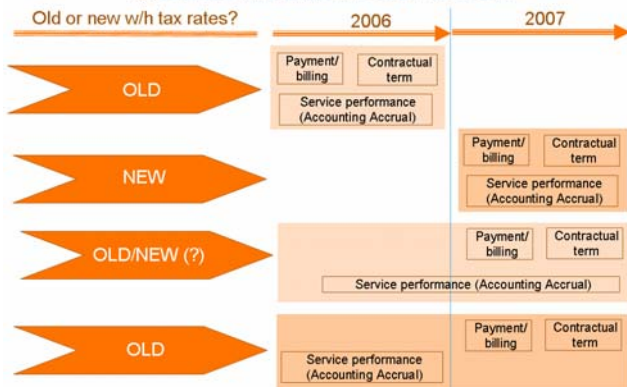
**Figure 1**  
Services with unchanged withholding tax rates

No.	Service type	ENI (%)	Effective w/h rate (%)
1.	Rental and other income for the use of land transportation vehicles	20	3
2.	Rental and other income for the use of assets other than land transportation vehicles and land and buildings, which are subject to final income tax	40	6
3.	Construction planning, supervisory, and consulting (other than business and tax consulting)	26 <sup>2</sup> / <sub>3</sub>	4
4.	Construction contracting by licensed construction companies, including: • Building maintenance and improvement • Installation of machinery, electricity, telephone, water and gas equipment, AC, and cable TV • Advertisement	13 <sup>1</sup> / <sub>3</sub>	2
5.	Catering	10	1.5
6.	Pest control	10	1.5
7.	Cleaning service	10	1.5

**Figure 2**  
Services with a special withholding tax rate

Services	ENI (%)	Effective W/h Rate (%)
1. Investigation and security services	20	3
2. Courier services		
3. Travel agent		
4. Travel bureau		
5. Convention, exhibition, event organization		
6. Freight forwarding		
7. Packaging		
8. Toll manufacturing ("maklon")		

**Figure 4**  
Hypothetical Transition Period Provision



**Figure 3**  
Other services with a general withholding tax rate

Services	ENI (%)	Effective W/h Rate (%)
1. Technical services	30	4.5
2. Management services		
3. Other services, except for:		
• Drilling services in oil & gas mining conducted by a permanent establishment;		
• Security trading services conducted by BEJ, BES, KSEI, and KPEI;		
• Custodial/storage/consignment services conducted by KSEI;		
• Services covered in Figures 1 and 2		

**Figure 5**  
Time extension for carrying forward a tax loss

One-year extension is granted cumulatively for each of the following conditions:

- New investment in a bonded zone in any of the 15 designated business areas (Figure 6)
- Employing at least 500 employees for 5 years consecutively
- New investment calling for at least Rp 10 billion for economic and social infrastructure
- Spending at least 5% of the investment for R&D activities in Indonesia
- Local content of 70% from the 4<sup>th</sup> year of the designated investment

**Figure 6**  
Business Areas for Which Tax Facilities Are Available

Business areas	Business classification Code (KBLI)
1. Food industry (cooking spices, flavour)	1597
2. Garment and textiles	17111-17114,1801
3. Pulp & paper	21011, 21012, 21015
4. Industrial chemical materials	2411-24132
5. Pharmaceutical & other chemical materials	24231
6. Rubber and rubber-made products	25192
7. Porcelain-made products (laboratory, electrical/technical instruments)	26203
8. Iron and steel making and rolling	27101-27102
9. Non-iron metal industry	27201-27204
10. Machinery and equipment	29111-29299
11. Electric motor, generator, and transformer	31101-31102
12. Electronics and telematics	30003-32303,72200
13. Land and transportation vehicles	29211-35912
14. Ship building and reparation	35111-35112
15. Non-iron basic metal manufacturing	27201

**Figure 7**  
Business Areas for Which Tax Facilities Are Available Only in Certain Regions

Business Areas	KBLI	Regions
1. Food processing (fish canning)	15121	Maluku, Papua, Sulawesi
2. Agro-based natural resources manufacturing	15143-17111	Celebes, outside Java
3. Carton and paper-made packaging materials	21020	Outside Java
4. Plastic-made products and packaging materials	25205	Outside Java
5. Cement, chalk, and gypsum	26411	Papua, Celebes, Nusa Tenggara
6. Furniture (wood, rattan, bamboo)	36101,36102	Outside Java
7. Crustacean, mollusca, and sea fish catching and processing	05011-15129	Certain beaches of Java, Sumatra, Maluku, Papua, and Bali before the Indian Ocean

**Figure 8**  
Examples of Agricultural Products Designated as Strategic Goods

- Cocoa
- Coffee
- Palm
- Sugar palm
- Cashew fruit
- Black/white pepper
- Nutmeg
- Clove
- Rubber
- Tea
- Tobacco
- Sugar cane
- Cotton
- Quinine
- Vanilla

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