

VAT on Sale & Leaseback

*A Change of the DGT's Interpretation?

For years leasing companies had been engaged in sale & leaseback (S&L) transactions without taking into account VAT. This was on the basis that leasing services (with option) by law are exempt from VAT, and the variation in S&L in essence does not change the very nature of the leasing service itself. The same spirit had been expressed by the director general of tax (DGT) in its general guideline (SE-10/PJ.42/1994) regarding this matter. Several DGT private "rulings" have also confirmed this understanding.

IN THIS ISSUE:

- **VAT on Sale & Leaseback Transactions.** The DGT has undertaken to recharacterize S&L transactions, giving rise to some taxable events. This may have a serious impact on the leasing industry.
- **Individual Income Tax: A Few Changes in the Withholding Guideline.** More focus on monthly compliance of Article 21/26 income tax obligations.
- **"Beneficial Owner" Principle: What Is the DGT's Position?** After 6 months, the DGT finally indicated in a public seminar its stance on this matter and where it will go.

VAT on S&L transactions last year. In a private letter No. S-813/PJ.53/2005 addressed to a taxpayer, for instance, the DGT considers that, from a VAT perspective, an S&L transaction consists of three types of "deliveries", namely:

- The delivery of the equipment (capital goods) under consideration upon the sale by the original owner to the leasing company. For the VAT treatment, the DGT refers to Article 16D of the VAT Law.
- The delivery of the title to the equipment by the leasing company to the lessee (upon the execution of the purchase option), which constitutes a taxable delivery and is subject to VAT.
- The delivery of the leasing service, which is not subject to VAT.

The DGT's stance differs from that expressed in SE 10 in which an S&L transaction was not included as "a transfer of goods from the lessee to the lessor" provided that the (capital) goods continued to be used by the lessee. On that basis several private rulings have been issued to taxpayers which confirmed that an S&L transaction should not be subject to VAT (e.g. S-2086/PJ.54/1998).

In contrast, the DGT pointed out in S-813 that the S&L exclusion from the meaning of "transfer of goods" had been based on MoF Decree 1441b/KMK.04/1989 about *Crediting Input Tax*, which was void by virtue of MoF Decree 296/KMK.04/1994. It further stated that the current regulation discussing the same subject (MoF Decree 575/KMK.04/2000) did not address the transfer of title in an S&L transaction.

Given the above background, the leasing industry was a bit shocked when the DGT undertook to seek

The current DGT stance is debatable. It is true that MoF Decree 1441b referred to by SE 10 is no longer applicable. However, as far as leasing contracts are concerned, there has never been any change in the legislative provisions in the VAT Law since its enactment in 1984. SE 10 itself, acknowledged as the general guideline on this subject, has never been cancelled. Hence, S-813 has caused only an ambiguity.

Implementation of the DGT's stance will have profound impact on the leasing industry. Leasing companies, so far regarded as non-taxable entities for VAT, will have to register with the tax office to be confirmed as taxable companies, unless they completely refrain from any S&L transactions.

It is also uncertain from what date the new VAT treatment should be applied. Retroactive application will inevitably result in serious complications.

Individual Income Tax

**A Few Changes in the Withholding Guideline*

People may work for a company as employees, consultants, or service providers and be compensated in the forms of salaries, fees, commissions, etc.

Companies are held responsible by law for settling (some part of) the tax due on such compensation by way of withholding. This matter is governed by Articles 21 and 26 of the Income Tax Law and accordingly is typically referred to as Article 21/26 income taxes. Basically any entities, including pension funds, foundations etc., which make payments to individuals may be subject to

Article 21/26 income tax obligations.

The DGT guideline about this matter (Kep-545/PJ/2000) has just been amended by virtue of DGT Regulation No. 15/PJ/2006 dated 23 February 2006 (Reg. 15).

One of the reasons for the amendment is to take into account the increase in the non-taxable income threshold ("PTKP") covered by MoF Regulation 137/PMK.03/2005 (See to TaxFlash No. 1/2006). In addition, Reg. 15 also sets out a few changes and a new requirement.

Reconciliation between monthly and annual calculations

The tax due for each individual must be calculated correctly and accounted for properly. Year-end recalculation and reconciliation with the monthly amounts must be made and any discrepancy for each individual must be settled and documented in a working paper, which must be kept for 10 years.

Please note that monthly tax payments based only on rough estimates are completely wrong. Potential overwithholding and overpayments may result from employees who resign within the current year due to the income "annualization" established in the standard tax calculation formula. The reconciliation working papers should take into account the settlements with such employees.

When a new employee joins a company during the current year, the company is required to take into account the employee's salary from his/her previous employer and the tax paid thereon to determine the correct Article 21 income tax for him/her. A potential problem may come up if the new employee and his/her previous employer refuse to "cooperate". Who should be held responsible for the shortfall of tax withholding

and tax payments due to the lack of the required data?

The requirement to produce and maintain such working papers is likely to compensate the removal of annual tax filing (Form 1721) as recommended in the proposed 2005 income tax law amendment, now under deliberation by the House.

Exclusion of Certain Individuals

Compensation to an individual who, in providing services, employs other individuals as his/her employees is excluded from the scope of Articles 21/26. Reg. 15 states that such compensation should be subject to Article 23 income tax.

We note that the tax rate for such compensation varies depending on the type of service as set out in Kep-170/PJ/2002.

Change in the basis of tax calculation

Under Kep 545, the tax due on compensation payable to non-employee commissioners must be calculated by applying Article 17 income tax rates (0%-35%) to each (monthly) individual payment. In Reg. 15, the same tax rates must be applied to the amounts (accumulated) during a calendar year. The same treatment is applicable for bonuses payable to ex-employees and pension withdrawals by individuals before commencement of the pension period.

Retroactive application

Reg. 15 must be applied retroactively from January 2006. Assuming the monthly Article 21/26 income tax returns have been filed on time, a revision would be required for the tax return for January 2006.

Tax overpayments resulting from the revision must be compensated against the following month(s)' tax

obligations. Tax underpayments, in contrast, must be immediately settled. Arguably, such underpayments should not trigger any interest penalty.

“Net” vs. “Gross-up” Methods

Article 7 of Kep 545 has been reworded in such a way so as to give rise to the question of whether the “gross-up” method must be applied to calculate Article 21/26 income tax for all net-of-tax compensation cases.

We noted that both the “net” and “gross-up” methods can still be used. Which method must be applied will depend on whether the employer (company) provides a “tax-borne” facility or a tax allowance.

To remove uncertainty, the option adopted must be stated clearly in employment contracts or any other relevant documents.

“Beneficial Owner” Principle: What is the DGT’s Position?

The issue of beneficial owner came up to the fore of Indonesian taxation in July 2005 when the DGT issued guideline No. SE-04/PJ.34/2005. In light of prevailing tax treaties, nothing is unusual in its assertion that treaty benefits for interest, royalties, and dividends are intended only for the beneficial owners of those income items. People, however, have been wondering how this principle would be applied.

SE-04 did not provide even a minimal hint about it. The term “beneficial owner” was only translated into the more “common” term of “actual owner”. No criteria was set for a company to qualify as a beneficial owner. While conduit companies were expressly disqualified, there was no discussion on the conditions that would render a company as being a mere “conduit”. Despite the lack of clarity, SE-04 required that payments of interest, dividends, and royalties to non-resident parties who were not beneficial owners be subject to withholding tax at 20% in accordance with Article 26 Income Tax Law. (See TaxFlash No. 3/2005).

The DGT’s clarification of these uncertainties has long been awaited. Yet, no further official guideline has been issued by the DGT to date.

A clue about the DGT’s stance and how the beneficial owner principle should be applied was recently revealed in a public seminar involving a speaker from the OECD which was attended by senior DGT officials.

Firstly, the DGT speaker tried to justify the issuance of SE-04 by referring to Article 3(2) of most tax treaties which calls for domestic tax laws to apply for any terms not defined in the relevant tax treaties. Apparently the DGT considered SE-04 to be part of the domestic tax law.

He further set out the following criteria under which a foreign company which received interest, dividends, or royalties from Indonesia would qualify as the beneficial owner:

- The income is subject to tax in the company’s country of residence; or

- The company has an active business operation (in its country); or
- The company has full power/control over the income to use it for its operations; or
- The company’s shares are traded on a recognized stock exchange.

In implementation, a company which claims treaty benefits would be required to present its certificate of beneficial ownership in addition to its certificate of residence.

It is questionable whether treaty country partners would accept the ITO’s rationale and, in particular, its quest for beneficial ownership certificates. It is also debatable that SE-04 constitutes part of the domestic tax law.

The uncertainty has not yet been fully settled. Nevertheless, the beneficial owner criteria set out by the DGT speaker should give you an idea of where the DGT is likely to go.

We will inform you if there are any further developments in this matter.

Please contact your regular PricewaterhouseCoopers adviser if you would like to discuss any of the issues raised herein or require further details.

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