

TaxFlash

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The FITR was reapplied to construction service companies in 2008 after being abandoned for more than a decade. Fifteen months have elapsed since the FITR regulation came into force. Nevertheless some transitional issues are still pending.
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The Director General of Tax (DGT) has developed a benchmark to serve as a preliminary diagnostic tool to probe areas with potential irregularities. Companies below the benchmark will typically receive a Clarification Order Letter (COL) from the DGT. The response to it along with the clarification given by the taxpayer in the counselling session will determine whether or not an audit will be conducted on the taxpayer.

Transition to the final income tax regime



Fifteen months ago the government issued Government Regulation (GR) 51/2008 to re-implement the final income tax regime (FITR) for construction services after being abandoned for more than a decade. Some confusion still abounds, for a number of reasons.

First, there is a lack of clarity in the transitional provision. Most companies, if not all, adopt an accrual basis accounting for both tax and commercial purposes. Hence, construction service income for commercial purposes will accrue in parallel with that for tax. In contrast,

the FITR calls for cash-basis accounting. Certain parts of a particular project may have been accrued as income in one year with the corresponding tax obligations settled in accordance with the then prevailing regulations. However, payments are only received in another year, when the FITR is now in force. On a literal reading of the FITR regulations, this may lead to double taxation.

The retrospective application of the FITR is another issue of concern. GR 51 was only issued in June 2008 followed by the implementing regulation, Minister of Finance (MoF) Reg. 187/2008, issued in November 2008. Nevertheless, its scope of application extended back to contracts with customers signed on or after 1 January 2008. Additional administrative work is therefore required for contracts signed during January-June 2008. During this time those contracts were governed by Article 23 of the income tax law which calls for withholding tax (WHT) 23 at the rates of 2% or 4% depending on the type of services. The FITR, on the other hand, would impose a different tax rate structure (2%, 3%, 4%, and 6%). As a result, companies are required not only to reopen their past tax affairs. They must also arrange overbooking WHT 23 into their final tax figures and settle their withholding shortfall, if any.

Last but not least is the ultimate change in the FITR scope of application, in early June 2009. In GR 40/2009 the government excluded contracts signed before 1 August 2008 from the FITR scope of application. MoF Reg. 153/2009 was subsequently issued in late September serving as an implementing regulation. The government may have managed to remove the retrospective feature of GR 51/2008 by these regulations. However, as GR 40 was only issued in June 2009, another retrospective application issue has come up.

Companies may have overbooked WHT 23 into their final tax figures as mandated by GR 51 and MoF 187 and settled the withholding shortfalls. They may have even filed the 2008 corporate income tax returns (CITRs). In light of GR 40 and MoF 153, they will have to restore the final tax documents into WHT 23, reclaim refunds for the withholding shortfall settlements, and possibly revise their 2008 CITR.

Given the above developments, these are measures that construction service companies may need to take:

1. Identify all contracts with customers prevailing in 2008 and set 1 August 2008 as the cut-off date. These may include contracts signed before or during 2008.
2. Determine whether or not WHT 23 for contracts signed before the cut-off date has been overbooked into final income tax. If it has not been done, leave it as it is. However, if overbooking has been done, take the necessary actions to restore it into WHT 23 in accordance with GR 40/2009 and MoF Reg. 153/2009.
3. Determine whether or not additional payments of final income tax have been made together or in relation to the overbooking request to final income tax referred to in Step 2. Please note that the final income tax rates for certain categories of construction services are higher than WHT 23. Take the necessary action to apply for a refund if such additional payments have been made. In this respect, a simple procedure should apply for the refund given that the additional payments are specified as “tax that should never have been due”.
4. Determine whether or not a revision of the 2008 CITR is required. If the overbooking referred to in Step 2 has been done, the 2008 CITR would have understated tax credit by as much as the WHT 23 overbooked into final tax. In this respect, a revision of the 2008 CITR would be required after the final tax has been restored into WHT 23.
5. Revise the 2008 CITR if required and claim the restored WHT 23 as a tax credit.

Benchmarking: how low can you go?

A tax audit is an unpleasant process for most, if not all, companies. The timing of some tax audits can be accurately predicted. For instance, if you file an overpaid CITR now, the DGT will respond to it with a tax audit in the next three to six months. Filing a loss CITR may also trigger a tax audit; however the timing of such is harder to predict. There are still situations when you get a surprise audit.

It must be in the interest of taxpayers to know in advance that a tax audit will be coming, in a predictable time frame. The DGT indicated recently their preliminary steps, the taxpayer's response to which will determine whether or not an audit will be conducted.

These steps rely on so-called “benchmarking”. As the name implies, this is a type of standard against which taxpayers' performance can be compared. The benchmarking covers several parameters classified into four types of ratio:

- Operating performance ratios (e.g. operating profit margin, pretax profit margin, corporate tax to turnover ratio, etc.)
- VAT ratio (annual creditable input tax compared to annual turnover)
- Input ratio (eg. salary to turnover ratio, interest to turnover ratio, etc.)
- Non-operating ratio (non-operating income to sales ratio)

As set out by the DGT in SE-96/PJ/2009, benchmarking is intended as a preliminary diagnostic tool to flag up areas of potential irregularities. A taxpayer with performance below the benchmark will typically receive a Clarification Order Letter (COL) from the DGT. A COL is a type of order to a taxpayer to clarify alleged irregularities.

A counselling session has been specified as an official forum for the taxpayer to clarify to the DGT whether or not the alleged irregularities do exist. If the taxpayer and the DGT agree after counselling that the alleged irregularities do not exist, the case would typically be closed and therefore no further action would be required. However, if the taxpayer acknowledges the existence of irregularities, they would be required to rectify their tax returns within a specified time limit. The case would be closed if the taxpayer complies with this undertaking. However, if they fail to take the required action, the DGT may proceed to conduct a tax audit.

The benchmarking has been based on internal DGT data (i.e. tax returns and corresponding financial statements submitted to the DGT) and at present covers only the years 2005-2007. At the present time, the DGT has managed only to provide benchmarking for only 20 business lines out of more than 1500. These include cigarettes, pulp and papers, pharmaceutical, plastic packaging, automotive, etc. Benchmarking for other business lines will be introduced in due course.

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