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Recent Developments in the Tax Dispute Process

Recently, the Director General of Tax (DGT) revoked Regulation No. PER-49/PJ/2009 regarding Procedures for Filing and Resolving Objections on Income Tax and VAT/Luxury Sales Tax Disputes. This has been replaced with Regulation No.PER-52/PJ/2010 (PER-52) which contains more detailed procedures and forms.

PER-52 does not change the objection process substantially, but taxpayers should be aware of the changes to the requirements concerning forms and some administrative changes, for example those concerning the withdrawal of an objection letter. They can only withdraw the objection letter before the DGT sends an invitation to attend a discussion on the objection. Previously, the deadline was the receiving date of such letter.

VAT on Trade Services – a benefit or place of performance principle?

The DGT issued new guidance on VAT treatment of trade services in the form of DGT Circular Letter No. 145/PJ/2010 (SE-145) on 22 December 2010. SE-145 revokes any contradictory circular letters, including DGT Circular Letter No. 08/PJ.52/1996 (SE-08).

In this circular, the DGT express the view that VAT imposition is based on both the place of performance and benefit principles. Should the trade service be performed and/or utilised inside the customs area, the service will be subject to VAT.

The only exception is if both the trade service provider and the recipient (either the buyer or the seller of the traded goods) are outside customs area.

Guidelines for implementing the CFC Rule

As stipulated in Law No.36/2008, Indonesian tax residents who own (individually or collectively) at least 50% of the shares in a qualifying controlled foreign corporation (CFC) are subject to the CFC rule. Recently, the DGT issued Regulation No.PER-59/PJ/2010 (PER-59) as an implementing regulation of the Minister of Finance (MoF) Regulation No.256/PMK.03/2008 regarding the CFC rule.

PER-59 provides further guidelines for the reporting of deemed dividends, tax calculation and foreign tax credit claims. In summary, the CFC rule and its associated guidelines stipulate the following:

- qualifying shareholders are deemed to receive dividends from their CFC in the fourth month after the annual corporate income tax return (CITR) filing deadline in the relevant country. If there is no deadline for annual CITR filing or no requirement to file annual CITRs, the dividends are deemed to be received in the seventh month after the end of tax year;
- these dividends are determined proportionately according to the shareholding percentage and must be based on the CFC's after tax profits;
- these dividends must be reported by the shareholders in the CITR for the respective year. The CFC's financial statements must be attached;
- the rule does not apply if the CFC has distributed dividends to the qualifying shareholders consistently with the CFC's formula before the designated months;
- any dividends (by whatever name and in whatever form) received by qualifying shareholders in excess of the deemed dividends or not constituting part of the deemed dividends must be reported in the shareholders' CITR for the year the dividends are distributed;
- dividends tax paid or withheld abroad are claimable as foreign tax credit for the qualifying shareholders for the year the tax is actually paid or withheld.

The new CFC rule applies to Indonesian investments in all foreign countries, the only situation in which the rule is not applicable is where the CFC's shares are listed with a recognized stock exchange.

New procedures for tax registration

The DGT has recently issued Regulation No.PER-62/PJ/2010 (PER-62) as the second amendment to DGT Regulation No.44/PJ/2008 (PER-44) regarding procedures for Tax ID/VAT-able Entrepreneur registration, change of data and transfer of taxpayer/VAT-able Entrepreneur.

Under the new regulation, the related Tax Service Office must carry out a field visit to check the accuracy of data stated in the tax registration/change of data/transfer forms and to ensure the existence and appropriateness of the business by gathering information on the place of business, its financial figures and assets.

Furthermore, PER-63 stipulates that the field visit should be carried out at a maximum of six months after the issuance of a Tax ID Number, Tax Registration Letter and/or VAT-able Entrepreneur Confirmation Letter. The deadline of six months is earlier than the provision in PER-44, which is one year.

Updates on Transfer Pricing Issues – Advance Pricing Agreement (APA)

As outlined in our Tax Flash No. 09/10 dated 22 September 2010, we were expecting further guidelines on Mutual Agreement Procedure (MAP) and Advance Pricing Agreements (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 to welcome the New Year.

What is an APA?

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.

Why do we need an 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.

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

The purposes of the pre-lodgement meeting are, among others to:

- a. discuss whether an APA is needed;
- b. provide an opportunity for the taxpayer to explain the proposed transfer pricing method;
- c. discuss the possibility of arranging an APA which involves another country's tax authority (i.e. a bilateral or multilateral APA);
- d. discuss the documentation and analysis prepared by the taxpayer;
- e. agree on a proposed timeline for negotiating the APA; and
- f. discuss other matters that are relevant to the formation and implementation of the APA.

A significant amount of work must be done by the taxpayer prior to the pre-lodgement meeting. The DGT provides Form APA-1 as a tool to request a pre-lodgement meeting. Form APA-1 must be supported with extensive supporting documents. The specific documents which must be attached to the request for a pre-lodgement meeting include:

- a. the taxpayer's articles of association;
- b. a detailed explanation of the taxpayer's business activities;
- c. a description of the taxpayer's corporate structure, including group, ownership, and organizational structures;
- d. detailed descriptions of the taxpayer's shareholders and the nature of transactions between the taxpayer and its shareholders;

- e. detailed descriptions of other related parties and the nature of transactions between the taxpayer and these other related parties;
- f. an explanation of the transactions proposed which will be covered by the APA;
- g. the taxpayer's proposed transfer method and transfer pricing documentation which supports the selection and application of this method (including functional analysis and comparability analysis);
- h. an explanation of conditions under which any changes could materially impact the appropriateness of the proposed transfer pricing method;
- i. a detailed explanation of the taxpayer's accounting system, production and decision making processes;
- j. detailed information on competitors which have the same or similar business activities or products along with an explanation of competitors' market shares and characteristics;
- k. copies of the taxpayer's income tax returns and audited financial statements for the past three years; and
- l. any other documents considered relevant by the taxpayer.

The pre-lodgement documentation requirements are substantial and are more comprehensive than many other countries. However, the documents that must be submitted are broadly consistent with the transfer pricing documentation that taxpayers should maintain for compliance purposes anyway.

The detailed pre-lodgement application requirements indicate that the pre-lodgement phase is likely to be one of the most critical stages of the APA process. It will be important for Taxpayers to ensure that their APA requests satisfy the requirements set out by the DGT. Furthermore, taxpayers must be prepared to share extensive data with the DGT to request an APA. The regulation states that this information will be treated as confidential and will not be used in any future tax audit.

The DGT has three months to respond to a pre-lodgement meeting request. Should the DGT reject the request, the DGT must inform taxpayer in writing. The taxpayer has the opportunity to submit a new request should the DGT reject the taxpayer's first pre-lodgement meeting request.

The regulation does not state what selection criteria will be applied by the DGT in deciding whether to accept APA requests.

If the DGT approves the taxpayer's request for a pre-lodgement meeting, then a meeting schedule will be agreed between the DGT and Taxpayer. It is possible for more than one pre-lodgement meeting to be held before the filing of a formal APA request.

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

Following completion of the pre-lodgement meeting(s), the taxpayer will progress to the next stage, i.e. filing a formal APA request to the DGT using Form APA-2. Form APA-2 needs to be completed and filed with the following attachments.

- a. a summary of the pre-lodgement meeting;
- b. a detailed explanation of the transfer pricing method proposed by the taxpayer and documentation that explains the reasons for selecting this method;
- c. a detailed explanation of the conditions that are used as the basis for determination of the transfer pricing method;
- d. a detailed explanation and documentation to show that the proposed transfer pricing selection method is in accordance with the arm's length principle;
- e. a detailed description of the critical assumption analysis.

An APA should include a set of critical assumptions. The critical assumptions represent specific conditions that are considered to be critical to the taxpayer's business operations and/or related party transactions, such that any change in them would have a material impact on the suitability of the selected transfer pricing method or the way it would need to be applied. The DGT regulation suggests that the following critical assumptions (among others) should be considered:

- a. changes to tax laws and regulations;
- b. changes to tax rates and customs duty;
- c. changes to industry regulations;

- d. force majeur events;
- e. new competitors who impact market price structure significantly;
- f. new government regulations which impact the taxpayer's business activities significantly;
- g. economic conditions which impact sales volume, production units, or market share significantly;
- h. changes to the taxpayer's business activities such as company restructuring;
- i. significant changes in relevant foreign exchange rates.

The number of critical assumptions suggested by the DGT is greater than the number of critical assumptions typically included in APAs in other countries.

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

In this step, the DGT and taxpayer will discuss certain topics, including:

- a. the scope of transactions and tax year of the APA;
- b. a comparability analysis, through the selection and determination of comparable data;
- c. an appropriate transfer pricing selection method;
- d. conditions and factors that impact the transfer pricing selection method;
- e. the need to have an APA with other countries/jurisdictions.

Based on experience overseas in countries with well established APA programs, the discussions and negotiations between the DGT and taxpayer would be expected to take place over several months or, possibly, years. For bilateral and multilateral APAs, the discussion process will also involve the foreign taxpayer and tax authority.

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

Should both parties, i.e. the DGT and the taxpayer, have come to an agreement, the DGT and the taxpayer will compile a formal APA agreement. The agreement should include the following information, at minimum:

- a. the name, tax ID number, and address of the taxpayer and related party company (or companies) covered by the APA;
- b. the scope of transactions covered;
- c. the scope of tax years covered;
- d. general provisions of the APA;
- e. agreed transfer pricing selection method(s);
- f. factors that impact critical assumptions in relation to the implementation of transfer pricing selection method(s);
- g. the range of arm's length prices or profits for each type of goods/services or transaction;
- h. obligations relating to the implementation of APA and compliance reporting;
- i. legal consequences of the APA;
- j. confidentiality of information;
- k. limitation and reconsideration;
- l. problem solving mechanisms.

The agreement must be executed within twenty working days after the APA discussion is agreed and signed by the DGT and the taxpayer.

The taxpayer may cancel the APA request in writing at any point in the process before the APA letter is issued by the DGT.

Step 5 : The implementation and evaluation of the APA

A taxpayer who has entered into an APA must submit an Annual Compliance Report (ACR) to the DGT four months after the end of the fiscal year. The ACR must contain at least the following items:

- a. the compliance of the taxpayer with the transfer pricing method as described in the APA;
- b. a detailed explanation concerning the accuracy and consistency of the transfer pricing method application;
- c. a detailed explanation of the accuracy of factors that may impact on critical assumptions in applying the selected transfer pricing method.

Circumstances under which the DGT might reconsider or cancel an APA

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

- a. if the taxpayer does not comply with the APA;
- b. if the taxpayer delivers incorrect data/information to the DGT;
- c. if the taxpayer does not submit an ACR or the submitted ACR is not in accordance with the prevailing provisions;
- d. if a critical assumption is breached;
- e. if errors are found in the APA;
- f. 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.

How long is the APA valid?

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:

- a. the tax year has not been audited;
- b. the taxpayer has not filed an objection or appeal for the respective tax year;
- c. 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.

Does an APA have any impact on the tax audit process?

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. The practice overseas in 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.

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