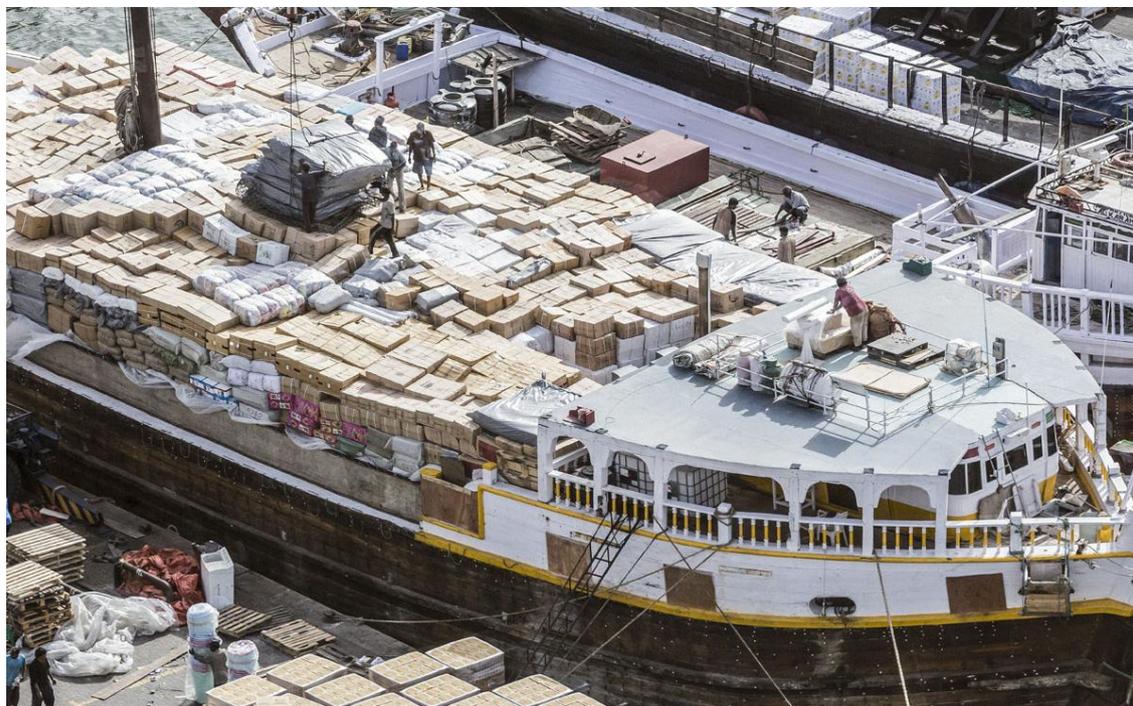


TaxFlash



New Transfer Pricing Audit Regulation

On 30 May 2013, the Directorate General of Tax (DGT) issued Regulation No.PER-22/PJ/2013 (PER-22) regarding tax audit procedures for taxpayers with related party transactions. PER-22 revokes DGT Decision No.KEP-01/PJ.07/1993 (KEP-01) regarding the same subject.

PER-22 is effective from 1 July 2013 and is applicable to prospective Tax Audit Instruction (SP2) and SP2 for which tax audit proceedings have not been concluded yet. Although not explicitly mentioned, tax audits that are currently in the finalisation stage and those to be finalised during 30 May – 30 June 2013 (for corporate tax overpayment audits with a June deadline), still refer to KEP-01 and S-153.¹

Below are some notable highlights of PER-22:

1. Taxpayers' transfer pricing documentation as the basis of review

In conducting a transfer pricing (TP) audit, tax auditors need to consider taxpayers' documents, which form the basis to apply the Arm's Length Principle (ALP). In this context, the primary document reviewed by the tax auditor will be the audited party's formal TP documentation. Other relevant supporting documents, such as inter-company agreements, export/import documents and invoices are also likely to be requested.

2. TP risk profiling

Tax auditors are required to conduct an initial analysis of the audited party's financial performance to assess whether there is any indication of profit shifting through TP. This analysis will be performed by comparing

¹ DGT Letter No.S-153/PJ.04/2010 (S-153) which outlined detailed procedures on Transfer Pricing (TP) audit

several financial ratios of the audited party with its industry peers. The financial ratios listed in PER-22 include among others, gross margin, return on sales and the Berry Ratio. However, there is no specific guidance in PER-22 regarding the circumstances under which the taxpayer may apply these ratios. In absence of specific guidance on this point, it is likely that these financial ratios will be applied in comparison to the comparable companies selected for the taxpayer.

3. Analysis of Functions, Assets and Risks (FAR) for both the audited party and the counter party

Taxpayers are expected to document FAR analysis for all parties involved in a tested transaction, including offshore counter parties. Support from taxpayers' counter parties will be required to produce adequate documentation to satisfy this requirement.

4. Selection of the tested party

PER-22 also requires selection of the tested party based on FAR analysis and reliable information/data collected during the tax audit process. This generally entails selecting the party with less complex functions and that does not own unique/valuable intangible property (the simpler entity). However, the tax auditors may select both of the transacting related parties as tested parties. This implies the intention of the tax auditors to analyse the profits generated in the supply chain in order to arrive at an arm's length conclusion for the tested party.

5. Rejection criteria

PER-22 also specifies that the tax auditors are expected to perform manual and web reviews to review the comparability of data selected by the audited party for benchmarking purposes. Taxpayers may want to consider using publicly listed comparables to facilitate an easy review of the comparables during a tax audit.

Among others, a few points listed by PER-22 as the criteria to reject a potential comparable include the following:

- a) A potential comparable performs different functions than the tested party
- b) It operates in a very different industry
- c) There are indications that a potential comparable would not be a reliable benchmark

Further, since PER-22 does not restrict the use of regional comparables as such, it is likely that the tax auditor will not insist on use of local comparables only. However, it remains to be seen whether the tax auditor will only accept comparables within the same industry as PER-22 emphasises on the use of appropriate industry codes in performing search for comparable companies.

6. Use of multiple year data

A positive feature of PER-22 is that it explicitly provides for use of multiple year data in economic analysis. This will lead to application of a consistent approach by the tax auditors for the selected comparables though it is not clear whether the same approach will be applied to the tested party results as well.

7. Transactional or aggregated approach

PER-22 also clarifies that the related party transactions may be analysed on an aggregated basis particularly where the transactions are closely linked or interconnected.

8. Primary adjustment, secondary adjustment and corresponding adjustment

The concepts of "correlative adjustment" and "primary adjustment" were first introduced in PER-43² and then reiterated in PER-32.³ Following these regulations, PER-22 adds the concept of "secondary adjustment" which is defined as the resulting adjustment after a primary adjustment. It may be noted that the concept of secondary adjustment is also discussed in the OECD Transfer Pricing Guidelines.⁴

PER-22 mentions that a corresponding adjustment will be made for a primary and secondary adjustment based on the prevailing regulation. The DGT is yet to issue an implementing regulation on the mechanism to apply for these adjustments.

² DGT Regulation No.PER-43/PJ./2010 was the first comprehensive TP guideline for Indonesian taxpayers

³ DGT Regulation No.PER-32/PJ./2011 which amended PER-43

⁴ Refer Para 4.66-4.75 in Chapter IV- Administrative Approaches in the OECD Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations, July 2010

9. The median point as basis of correction

PER-22 also seems to remove the ambiguity on the computation of transfer pricing adjustment in case the results of the tested party are not within the inter-quartile range.

It provides an illustration on this point using the Transactional Net Margin Method (TNMM). Based on the example, it is mentioned that if a taxpayer's TNMM result is below the inter-quartile range, correction will be made by reference to the median point.

This illustration provides more certainty to the taxpayers that in case their results under the TNMM approach are below the inter-quartile range determined by the tax auditor, the adjustment will not be made to the upper quartile point of the range, which had occurred in some past tax audit cases.

10. Points attributable to each functions under the Contribution Profit Split Method

PER-22 mentions that under the Contribution Profit Split Method, it is important to consider the value associated with the activities performed by the respective parties based on facts and circumstances.

In an example on the Contribution Profit Split Method in PER-22, there are weights assigned to each transacting party based on various functions to arrive at the profit split percentage between the two related parties. However, since PER-22 does not provide specific guidance as to how these weights will be validated, the taxpayers must prepare a robust analysis and document its reasoning for the weights so that its profit split analysis is defensible before the tax auditor.

11. Cost base of the service provider

Besides the "service is actually rendered" test and the "benefits received" test, PER-22 requires confirmation of the actual amount of costs incurred to provide the service before determining what would be the arm's length mark-up. This will require taxpayers to maintain supporting evidence for the cost base.

12. Other methods for transactions involving intangibles

Besides the five specified arm's length methods, PER-22 allows the use of valuation methods for the

application of ALP in related party transactions involving intangibles. The valuation methods mentioned which PER-22 refers to as "other methods" are:

- a) Income-based Approach
- b) Cost-based Approach
- c) Market-based Approach

As a next step, to mitigate any practical issues, the DGT should also modify the Special Attachment Form 3A on related party disclosures to be filed with the Annual Corporate Income Tax Return (CITR) as the electronic form only allows selection among the specified five arm's length methods, namely, the Comparable Uncontrolled Price (CUP) method, the Resale Price Method (RPM), the Cost Plus Method (CPM), the Profit Split Method (PSM) and the TNMM.

Furthermore, while one would recognise these as valuation methods, it would be helpful for taxpayers to receive more guidance from the DGT on the application of these methods as this is not included in PER-22.

13. Mandatory use of the CUP method for interest

The new regulation also prescribes that only the CUP method can be used in the application of ALP for loan or guarantee fee transactions.

For interest transactions, taxpayers must first satisfy the following conditions before the tax auditors would review the fairness of the interest charged using the CUP method:

- The necessity to obtain loan
- The loan transaction actually takes place
- Reasonableness of debt to equity ratio ("DER")

In absence of any DER guidelines, it is likely that the taxpayers will be able to fulfil the DER test only after the Minister of Finance issues its guidelines on thin capitalisation.

14. Comprehensive forms to complete

As part of TP audit procedures, taxpayers will be required to complete several detailed forms. These forms include comparability analysis, FAR analysis, information relating to the audited party's business environment, supply chain management analysis, segmented financial data from transactions with related party and those with independent parties and

a signed statement letter by the company's board of management confirming the accuracy of the information provided.

Completion of these forms is expected to be made within seven working days. With a limited timeline, taxpayers who are anticipating tax audit may want to prepare these extensive forms in advance.

With the centralisation of tax office for mining, oil and gas taxpayers, the tax office may introduce a version of the forms/questionnaires specific to mining, oil and gas taxpayers given that the forms attached to PER-22 are designed for manufacturing and distribution taxpayers.

The tax auditor may also ask the taxpayers under audit to present on their business environment/ industry, nature of their relationships and transactions with related parties, TP method selected and application of the selected method.

In anticipating the tax auditors' expectation during TP audit, Taxpayers may want to examine some areas in the existing TP documentation which are not reflective of PER-22.

Please feel free to contact either your regular PwC contacts or any of the individuals mentioned below in case you have any questions on the above.

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