

TaxFlash



SE-50: Circular on Transfer Pricing Audits

The Director General of Tax (“DGT”) recently issued a new Circular No.SE-50/PJ/2013 (“SE-50” or the “Circular”) effective 24 October 2013, to provide technical guidelines on transfer pricing audits. The legal basis of this Circular is DGT Regulation PER-22/PJ/2013 (“PER-22”) which was issued earlier this year in relation to the tax audit procedures for taxpayers with related party transactions. SE-50 revokes DGT Circular No.SE-04/PJ.07/1993 regarding guidance in handling transfer pricing cases.

The guidelines set out in this Circular are applicable for special or routine tax audits for taxpayers with the following criteria:

- a) Those who have been identified as carrying risk of tax avoidance using transfer pricing means, before a tax audit notification letter (“SP2”) has been issued; or
- b) Those who have been identified as carrying risk of tax avoidance using transfer pricing means, during an ongoing tax audit where the assigned tax audit team may revise its audit plan and program accordingly.

Whilst SE-50 aims to standardise the approach and nature of documents to be reviewed by tax auditors during the transfer pricing audit process, it essentially reemphasises the importance of maintaining a robust transfer pricing documentation in a timely manner to facilitate the tax audit process.

Below are some notable highlights of SE-50:

1. The three-step process

SE-50 outlines a three-step audit process for the tax auditor to review transfer pricing cases. The highlights of these three stages are summarized below:

- *Preparation stage:*
 - As an initial step, tax auditor is required to review the following documents pertaining to the taxpayer's related party transactions: Attachment V¹ of the Corporate Income Tax Return ("CITR"), related party disclosure forms and Attachment VIII² of the CITR. In case the taxpayer undergoing audit has not filled in and filed these documents, initial review is to be made based on review of the taxpayer's audited financial statements.
 - Thereafter, the tax auditor will assess the tax avoidance risk profile of the taxpayer based on the following criteria:
 - a. Materiality of the related party transaction(s) in proportion to the taxpayer's sales or net operating profit.
 - b. Transactions with counter party(ies) located in a lower tax rate jurisdiction.
 - c. Special transactions, such as transfer of intangibles (license), royalty payments, intra-group services, and interest expense.
 - d. Whether the net operating profit performance of the taxpayer is lower as compared to its industry peers.
 - e. Materiality of the related party transactions below the net operating profit line in proportion to the taxpayer's net operating profit, such as: interest expense, gain/loss on asset disposal, and foreign exchange gain/loss.
 - f. Non-routine related party transactions, such as business restructuring with or without intangibles and transfer of intangible property.
 - g. Taxpayers with perpetual losses.
- *Implementation stage*
 - After issuing the SP2, the tax auditor may request data/information using the forms/templates provided as an attachment to the PER-22. In case a transfer pricing documentation is available, the request for data/information may be tailored as appropriate.
 - The tax auditor is required to summon and seek explanation from the taxpayers, and document the explanation in a Minutes of Meeting (*Berita Acara Pemberian Keterangan Wajib Pajak Terkait Transaksi Afiliasi*) as provided by Attachment II of PER-22.
 - The tax auditor may use the Exchange of Information ("EOI") channel to clarify the special relationship with the taxpayer's counter party(ies) and/or to verify the related party transactions with its counter party(ies); for example, gathering the supply chain analysis data or obtaining the financial statement of the counter party.
 - Domestic related party transactions:

In case the taxpayer is engaged in domestic related party transactions with other taxpayers or permanent establishments in Indonesia, the tax auditor is required to confirm the following points with other tax offices with which the counter parties are registered:

 - a) Nature and value of the related party transactions.
 - b) That there are no tax avoidance arises from different tax rates as outlined in Article 2 of PER-32.
 - Functions, assets, and risks ("FAR") analysis:

In the implementation of SE-50, the tax auditor is required to review the functional profile of both the taxpayer and its counter party(ies) involved in the related party transaction(s) and characterise them, so that the tax auditor will be able to assess the return expected by each party and its transfer pricing risks involved. To describe the characterisation process of the taxpayer's related party transactions, SE-50 provides an

¹ List of shareholders/capital owners and total dividends distributed and List of directors and commissionaires

² Transcript of financial statement

example of a semi-conductor manufacturing company.

Below are some highlights from the FAR analysis sections in SE-50:

- Functional analysis

As mentioned above, SE-50 requires tax auditors to verify the functions performed by the taxpayers and its counter parties. Verification can be done by reviewing the taxpayer's organisational chart, the qualifications and capability of employees, audited financial statement, segmented financial statement, the group pricing policy, IP license agreement, and transfer pricing documentation. SE-50 lists a few examples of cases involving a trading intermediary, transfer of intangibles and intra-group services.

SE-50 also mentions that the tax auditor will also visit the taxpayer's premise and perform an interview process with the taxpayer's key personnel during their visit. It is doubtful whether the tax auditor will be able to perform this visit in many cases due to practical considerations.

- Asset analysis

The discussion on assets in SE-50 is primarily focused on intangible assets which are grouped into two categories: manufacturing intangibles and marketing intangibles. In confirming the existence of intangible assets, the circular provides a long list of steps that needs to be undertaken by tax auditors. These include among others, performing interviews with the taxpayer's research and development ("R&D") personnel to determine the market power of the intangibles and (when necessary) getting an expert opinion to determine patent value.

- Risk analysis

Tax auditors will review the risks assumed by the taxpayer based on the sale/purchase contract, bad debt write-

offs, foreign exchange losses, warranty expense and expenses relating to inventory obsolescence.

- Characterisation of the taxpayer:

SE-50 lists several types of characterisation which are in-line with those mentioned in PER-22; such as toll/contract/fully fledged manufacturer, limited risk/fully fledged distributor, commissionaire, commission agent, service providers, and "others".

SE-50 acknowledges that the tax auditor may encounter other types of characterisation as well. The tax auditor is required to determine the arm's length remuneration based on the taxpayer's functions performed, assets utilised and risks assumed.

- Creation or development of Intellectual Property ("IP") locally

SE-50 also expects the tax auditor to identify the taxpayer's contribution in creation, development, or protection of the intangible assets. The areas of focus are as follows:

- Whether the taxpayer incurred R&D or marketing expense,
- Whether the taxpayer performs activities related to R&D function,
- Whether the taxpayer performs marketing function,
- Whether the taxpayer borne R&D and/or market risks,
- Whether the taxpayer employs personnel with specific qualifications related to marketing, manufacturing, R&D, or other functions which determine the successfulness of the taxpayer's product,
- Whether there exists distribution channel and costumer list.

In one of the example presented in SE-50, the tax auditor can even request the resumes of the taxpayer's R&D personnel to determine the taxpayer's contribution to the development of intangible assets.

- *Reporting stage*

- The tax auditor must prepare its working paper based on the templates attached within the circular. The templates are largely similar with the Attachment II of PER-22.

In one of the templates, the tax auditor is required to confirm the taxpayer's transfer pricing position (e.g., functional characterisation, selection and application of transfer pricing method, comparability analysis, etc) and presents the tax auditor's own transfer pricing position to conclude the transfer pricing audit.

- Given the extensive level of the templates, and increasing number of transfer pricing disputes, detailed working papers and supporting documents must be maintained by the taxpayer to meet the tax auditor's expectation during a transfer pricing audit.

2. Transfer pricing methods

As a next step from the FAR analysis, SE-50 also provides some guidance to the tax auditor regarding selection of the most appropriate transfer pricing method to be applied for the related party transactions under review. SE-50 provides an explanation on each transfer pricing method, such as the Comparable Uncontrolled Price ("CUP"), Resale Price, Cost Plus, Transactional Net Margin Method ("TNMM"), and Profit Split methods. SE-50 also provides examples of how each method should be applied. Overall, the guidance is essentially in line with the OECD TP Guidelines.

In applying the TNMM, tax auditor needs to select the most appropriate Profit Level Indicator ("PLI") to be applied. SE-50 provides guidance that cost-based PLI is commonly applied for manufacturers, whereas sales-based PLI are more applicable for distributors. SE-50 states some of the commonly applied PLI ratios which are: Net Margin, Net Mark-up, and Return on Asset. The Circular also provides guidance on the search criteria, manual selection, the use of multiple years data, and also condition to apply transactional or aggregated analysis.

SE-50 also sets out that analysis on an aggregated basis may be appropriate where the transactions are closely linked or continuous in nature. Examples include the following:

- Transactions arising from contracts involving long-term supply of a commodity or services.
- Use of intangible property which is embedded in a product.
- Price determination of closely linked products.
- Instances where a company applies a portfolio-focused pricing policy by way of minimizing profit for one type product to maximize profit of a complementing product, e.g. pricing of printers and cartridges.

3. Intra-group services ("IGS")

The guidelines in the Circular on intra-group services transactions are generally in line with Chapter 7 of the OECD Transfer Pricing Guidelines and the Indonesia Transfer Pricing regulation.

Consistent with OECD Chapter 5, the following activities are not chargeable to the service recipient:

- Shareholder activity
- Duplicative services
- Services that provide incidental benefit
- Passive association
- On-call services which are not significant and can be easily obtained from third parties without an agreement in place.

In testing the arm's length nature of IGS transactions, the tax auditor is required to undertake the following steps:

- Review the appropriateness of the service charge. In the example provided in SE-50, the appropriate basis of charging management service fees would be the actual costs to perform services and not the turnover.
- Review the cost components and assess their appropriateness in relation to the services performed and the economic benefits for the taxpayer.
- Review the charging method (direct or indirect method).
- Review the appropriateness of allocation keys applied in case of indirect charging.

4. Intangibles

In line with the OECD Transfer Pricing Guidelines, the following factors need to be considered in determining the arm's length nature of transactions involving intangibles:

- Protection and time span
- Exclusivity

- c) Geographical coverage
- d) Useful life of the intangibles
- e) Rights to develop, revise, and improve
- f) The existence of other types of intangibles or services that is embedded in the transfer or use of an intangible
- g) The existence of sublicensing rights to third parties
- h) Other factors that can economically affect the license value of intangibles

Where the taxpayer is the licensee, the tax auditor needs to examine the followings:

- a) Whether payment of royalty will result in a reasonable return that is commensurate with the amount of royalty paid. This can be determined based on financial analysis of such transaction.
- b) Whether the payment will provide economic benefits to the licensee.

5. Interest on loan

In testing the arm's length nature of interest paid, SE-50 provides the following verification steps that need to be performed:

- a) Necessity of loan: nature and purpose (which is assessed based on working capital analysis), market condition at the time the indebtedness arose, principal amount and loan tenor, availability of guarantee/security and ability of the borrower to service the debt (which is assessed based on interest coverage ratio).
- b) The loan actually takes place: reviewing the loan agreement, verifying there is an incoming cash flow or repayment of principal and/or interest).
- c) Perform reasonableness test on the taxpayer's debt to equity ratio ("DER"): this would be done by a DER comparison of the taxpayer vis-à-vis similar companies.
- d) Test the fairness of interest rate: for example by adding appropriate credit premium on the market interest rate (e.g. SIBOR, LIBOR, JIBOR).

6. What this means for the taxpayers?

The key takeaways from SE-50 for the taxpayers are summarised below:

- Taxpayers should perform a self-review as to whether they satisfy any of the criteria listed for posing 'high tax avoidance risk' and prepare in advance for the tax audit.

- Taxpayers with perpetual losses should maintain a robust documentation to provide commercial reasons for losses, as the auditor will identify loss-making companies as having high tax avoidance risk.
- The Circular also puts some onus on the tax auditors to seek information regarding overseas counter-party using the EOI mechanism. Hopefully, this will provide some practical relief to the local taxpayer in those cases where the taxpayer cannot provide data from the overseas counter party.
- The FAR analysis in the TP Documentation ("TPD") should be more robust (and will need a higher degree of localisation) as the tax auditors are expected to perform a more detailed review of the size and capability of the local team. The taxpayers must assess whether there is any apparent or real duplication of functions vis-à-vis its related parties based on which the auditor can deny the deductibility of the IGS charges.
- The auditor may also focus on whether the Indonesian taxpayer contributed to the development/protection of an intellectual property. This may pose potential risk for local companies who not only make royalty payments to related party(ies) but also incur significant R&D or marketing expense.
- Another concern is that based on the Circular, the tax auditors may get into valuation issues for patents, IPO, even in those cases which do not involve transfer of any intangible but only involve royalty payment. Based on the SE-50, the auditor may ask the taxpayer to produce a valuation study for their global brand or technology IP to defend the royalty payment.
- In absence of any DER regulation in Indonesia, it is currently uncertain as to how the auditor will determine the reasonable level of the DER for the related-party borrower.

For readers who are anticipating tax audit, doing nothing is not an option anymore. With the issue of SE-50 and the Indonesian Tax Office's increased focus on transfer pricing, early preparation in the right direction are critical, especially for taxpayers who fall in the tax avoidance risk profile. A robust TPD will help minimize tax auditor's queries/ detailed questionnaires during audit and help turn around a response to the auditor in a shorter time.

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

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