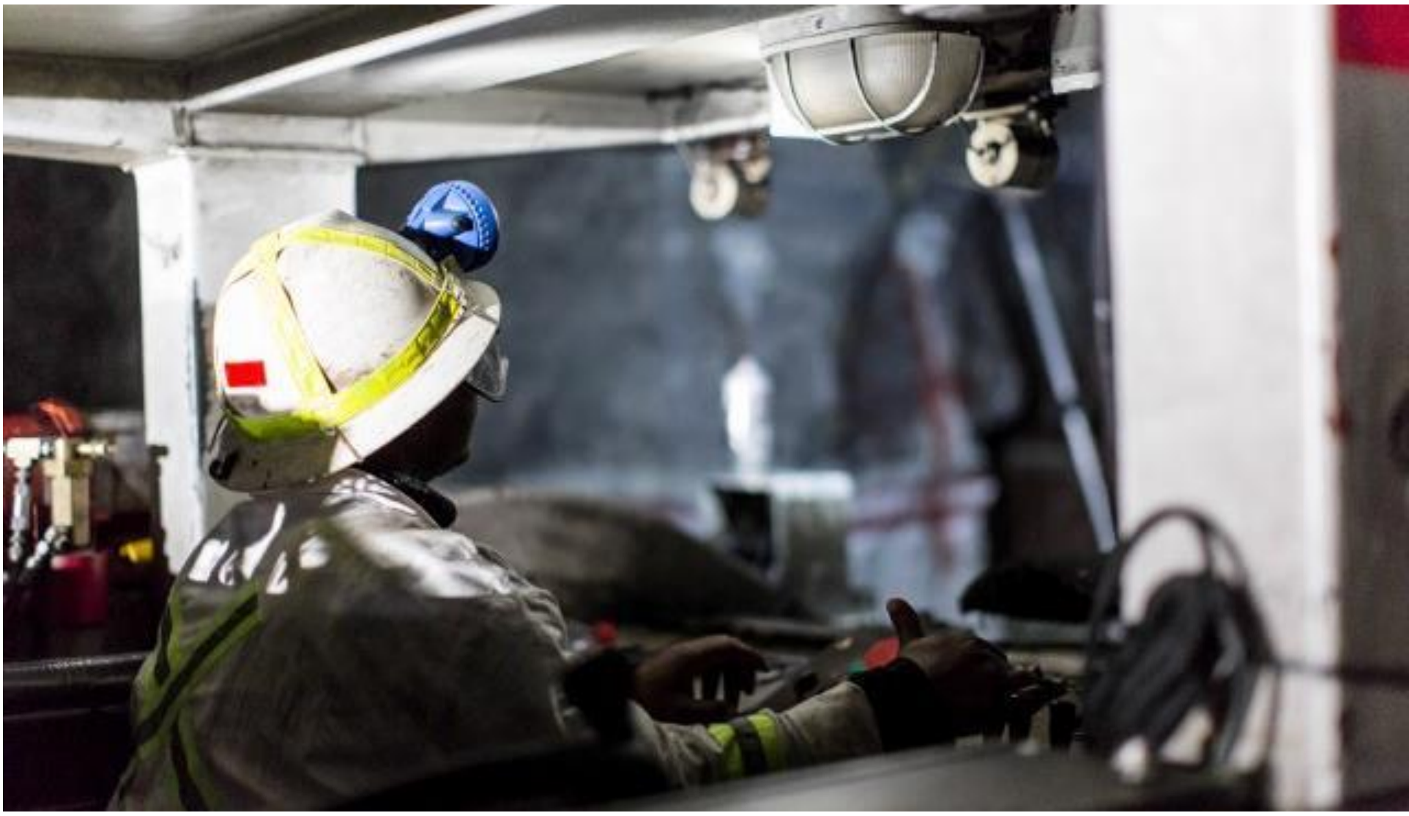
PwC Indonesia
Energy, Utilities & Resources NewsFlash



Updated Tax Holiday Regulations for Pioneer Industries

On 4 April 2018, the Minister of Finance ("MoF") issued Regulation No.35/PMK.010/2018 ("PMK-35") dealing with the revised Tax Holiday arrangements for investors in "Pioneer Industries". PMK-35 revokes MoF Regulation No.159/PMK.010/2015 as amended by MOF Regulation No.103/PMK.010/2016 (see our NewsFlash No.57 of October 2015 for comments on the previous regulations).

PMK-35 allows for a "holiday" from the payment of Corporate Income Tax ("CIT") for a period of up to 20 years for businesses in Pioneer Industries. These industries extend to a number of key sectors of relevance to investors in the energy, utilities and resources space.

On 30 May 2018, the Capital Investment Board (*Badan Koordinasi PenanamanModal*/BKPM) issued Regulation No.5/2018 ("BKPM-5") to more formally identify businesses entitled to the PMK-35 concession.

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What Industries are now "Pioneer Industries"?

PMK-35 lists 17 "Pioneer Industry" classifications with BKPM-5 extending this detail via a sub-listing of 153 businesses. For further precision the sub-listing is by the general business classification code ("KBLI") as traditionally applied in BKPM licensing.

The 17 activities falling within the Pioneer Industry classification are as follows:
1) integrated upstream basic metals (which covers general smelting activities);
2) integrated oil and gas refining;
3) integrated petrochemicals arising from oil, gas or coal;
4) integrated inorganic basic chemicals;
5) integrated organic base chemicals derived from agricultural, plantation or forestry activities;
6) integrated pharmaceutical raw materials;
7) manufacturing of semi-conductors and other components integral to computers;
8) manufacturing of the main components of communication equipment integral to smartphones;
9) manufacturing of the main components of health equipment integral to irradiation, electro medical, or electrotherapy equipment;
10) manufacturing of the main components of industrial to electrical motors or internal combustion engines;
11) manufacturing of the main components used in motor vehicle production;
12) manufacturing of the main components integrated with robotics;
13) manufacturing of the main components of vessel production;
14) manufacturing of the main components of aircraft production;
15) manufacturing of the main components of locomotive production;
16) power plant machinery (including waste to power); and
17) economic infrastructure.

Of particular relevance to readers of this NewsFlash is that the "Pioneer Industry" classifications now formally extend to "economic infrastructure" with the relevant KBLI covering "road infrastructure" and "electricity infrastructure". This would appear therefore to mean that a high percentage of investment in the power generation sector will, in principle at least, attract this tax concession. This is obviously in addition to the various categories of oil and gas and mine-related processing activities which were already covered.

Interestingly PMK-35 also indicates that even investments not falling within the formal classifications may still be approved should the investment fulfil the remaining requirements.

New Investment Thresholds

Among the other major policy developments set out in PMK-35 are that:
a) the new minimum capital investment threshold has been reduced to IDR 500 billion (approx. US$35mn);
b) there is no longer a requirement for the investment to be via a new entity;
c) there is no longer a requirement for a percentage of the proposed investment to be pledged as a guarantee of investment realisation;
d) there is clarity that the incentive period starts from the fiscal year in which commercial production commences.

Updated Tax Holiday Periods

The new holiday periods, with a comparison to the prior positions, can be summarised as follows:

<table>
<tr><th>Provision</th><th>Old
(PMK 103)</th><th>New
(PMK 35)</th></tr>
<tr><td>Applicants</td><td>New Indonesian entities only</td><td>Any new “investment”</td></tr>
<tr><td>Reduction of CIT - %</td><td>10 – 100%</td><td>100% (single rate to nil)</td></tr>
<tr><td>Period of reduction</td><td>5 – 15 years
can be extended to 20 years</td><td><table>
<tr><th>No.</th><th>Period (Years)</th><th>Investment (in IDR)</th><th>US$ mn (approx.)*</th></tr>
<tr><td>1</td><td>5</td><td>500 bn up to < 1 T</td><td>35 - 70</td></tr>
<tr><td>2</td><td>7</td><td>1 T up to < 5 T</td><td>70 - 350</td></tr>
<tr><td>3</td><td>10</td><td>5 T up to < 15 T</td><td>350 - 1050</td></tr>
<tr><td>4</td><td>15</td><td>15 T up to < 30 T</td><td>1050 - 2100</td></tr>
<tr><td>5</td><td>20</td><td>≥ 30 T</td><td>>2100</td></tr>
</table></td></tr>
<tr><td>Transition</td><td>Not available</td><td>50% CIT reduction for the next 2 years</td></tr>
</table>

*US$1:IDR14,500

In general the new holiday periods are a simplified improvement on the prior position. This is in line with the Government’s aim of spurring further investment in infrastructure and capital intensive industries.

Updated Application Process

These updated features include:

a) that an applicant can apply for the incentive:
   i) at the time of application for capital investment registration; or
   ii) within 1 year after the issuance of capital investment registration;
b) that, whilst a new entity is not required, the applicant should nevertheless be Indonesian incorporated (albeit with no limitation on the date of incorporation);
c) that, once a complete application has been received, BKPM is required to forward a (qualifying) proposal to the MoF for approval within 3 working days. The MoF should then decide on any application within 5 working days (note that we have already seen examples of in-principle BKPM approval including for power generation investment);
d) that BKPM can submit recommendations to the MoF up until 3 April 2023;
e) that the applicant should never have had a previous Tax Holiday application granted or rejected by the MoF;
f) that the investment is still required to satisfy the “debt to equity ratio” leverage limitations set out in MoF Regulation No.169/PMK.010/2015; and
g) that any domestic shareholders of the applicant must obtain a “tax clearance letter” (confirming the status of their tax compliance) from the Director General of Tax (“DGT”).

Re-evaluation of the Incentive

Enjoyment of the incentive remains subject to the review of any of the key qualification criteria (e.g. realisation of the committed investment threshold, actual investment alignment with the relevant industry classification, etc.). This review is made pursuant to an Indonesian Tax Office ("ITO") field audit carried out on a post MoF approval basis. If the ITO determines that any of the qualifying requirements have not been satisfied then the Tax Holiday period can be amended or revoked with any taxes not paid as a result of the non-compliance then becoming payable with penalties.

Conclusion

The revisions to the Tax Holiday regulation outlined in PMK-35 are generally being viewed positively and may (arguably for the first time for this incentive) operate to attract investment to Indonesia which might not have otherwise gone ahead. The notable improvements include:

a) the potential increase, in absolute tax savings, of the overall incentive especially for large capex projects;
b) the more precise outline of what investments should qualify and the ability to obtain early confirmation of this status; and
c) the reduction in the financial risk thresholds both in terms of the size of the absolute investment that needs to be committed to and the absence of upfront financial guarantees.

This new process is however still in its early days and many investors may still be reluctant to push forward with otherwise marginal projects. Some concern will no doubt exist around the potential for an incentive "drawback" which could arise from a post-investment ITO field audit. Nevertheless the incentive should certainly warrant a more detailed consideration for any investments in "Pioneer Industries" as defined.

We will keep readers updated on developments and welcome discussion with investors looking to further explore this opportunity.

We have moved!

Effective 20 August 2018 PwC Indonesia has moved to:

pwc

New location. New direction.
PwC Indonesia is now open for business at:
WTC 3, Jl. Jend. Sudirman Kav. 29-31,
Jakarta, Indonesia, 12920.

Our phone and fax numbers remain:

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We look forward to welcoming you to our new office.

New Taxation Rules for the Mineral Mining Sector

As readers may be aware Article 31D of the Income Tax Law allows the Government to issue special Income Tax rules for certain industries. As outlined in Energy, Utilities and Mining NewsFlashes Vol.39/2011, Vol.62/2017 and Vol.63/2018 specific tax rules have already been issued for the upstream oil and gas (or Production Sharing Contract ("PSC")) sector via GR-79, GR-27 and (now) GR-53.

The Government has now issued Regulation No.37 Year 2018 ("GR-37") to provide special rules in relation to both the tax and non-tax state revenue (*Penerimaan Negara Bukan Pajak/PNBP*) arrangements for the "mineral" mining sector. At the outset therefore, it should be noted that these rules do not extend to the coal mining sector. However, in May the Government announced that special rules for coal mining will also be issued in 2018.

GR-37 also provides different tax arrangements according to the type of mineral mining "concession" in question. This includes for Contracts of Work ("CoWs") where the CoW follows the prevailing tax regulations (i.e. for CoWs with no "*lex specialis*" principle). Concession holders must however comply with the withholding tax ("WHT") and related collection obligations outlined in GR-37 in all circumstances.

Relevant Concession Holders

The tax and PNBP provisions outlined under GR-37 are applicable for the holders of:

a) a Mining Business Licence (*Izin Usaha Pertambangan*/"IUP") being a general licence to conduct mining business activities in a Mining Business Area;

b) a Special Mining Business Licence (*Izin Usaha Pertambangan Khusus*/"IUPK") being a licence to conduct mining activities in a State Reserve Area;

c) a People's Mining Licence (*Izin Pertambangan Rakyat*/"IPR") being a licence to conduct a mining business in an area of a limited size and investment (noting that IPRs are not available to foreign investors);

d) a Special Mining Business Licence for "Production Operations" ("IUPK-OP") being a mining business licence granted for this stage of activities (i.e. not just the actual mining but also construction, processing and/or refining, transportation and sales) within a State Reserve Area. The IUPK-OPs referred to in GR-37 are limited to those relating to the conversion of an "active" CoW into an IUPK-OP (which is obviously directly relevant to a number of historical concessions now being converted out of the CoW format); and

e) a CoW with tax provisions which follow the prevailing tax regulations (i.e. with no *lex specialis* provisions).

CoWs with *lex specialis* tax provisions are to be honoured until the end of the CoW period and so are not directly impacted by GR-37 (although most of these CoWs are being phased out in any case). However as indicated above, even these Contractors are still obliged to follow the WHT and/or collection obligations as outlined in GR-37.

GR-37 is dated and effective 2 August 2018. The Income Tax provisions are generally applicable from the 2019 tax year for IUP, IUPK, IPR and CoW holders.

Income Tax Treatment – Non-IUPK-OP Holders

General

In general, the Corporate Income Tax ("CIT") calculation, the applicable CIT rate, and the tax loss carry forward period should be determined according to the prevailing Income Tax regulations. Consequently, the *lex specialis* concept has now largely been discontinued for new concessions in the mining sector (although see the IUPK-OP discussion below). As such, the general adoption of the 5 year tax loss carry forward limit for the mining sector may be a disappointment for some investors.

Taxable Objects

Taxable "objects" are to comprise of:

a) income from operations; and

b) other income in whatever name or form.

Income from operations is to consist of income from the sale or transfer of mining production. The value of the output is to be based on one of the following prices determined at the time of the transfer transaction:

a) the market price of the "metal" mineral in question (e.g. aluminium as per the London Metal Exchange, zinc as per the Asian Metal Exchange, etc);
b) the market price of the "non-metal" mineral in question (e.g iron and steel as per the price published on an international or domestic commodity market);
c) the market price of the relevant "rock-like" material in question (e.g. as per the price published on an international or domestic commodity market); or
d) the actual selling price (but only if there is no market price reference).

Notwithstanding this, if the actual selling price is higher than the published market price, the actual selling price should be used. Taxpayers can otherwise use the actual selling price only if the discrepancy is within 3% of the relevant published market price.

This "valuation" approach to determine taxable value represents a significant departure from general Income Tax principles.

Allowable Deductions

Allowable and non-allowable deductions are generally as per the prevailing Income Tax regulations. Certain deductions however follow the rules set out in existing mine-specific regulations such as provisions for reclamation costs (which follows Minister of Finance ("MoF") Regulation No.219/PMK.011/2012) and donations (which follows GR No.93 Year 2010).

The debt to equity ratio is also in line with the prevailing Income Tax regulations (i.e. MoF Regulation No.169/PMK.010/2015) and therefore is currently a maximum 4:1 debt to equity ratio.

Specific Rules on Stripping Costs

Stripping activities are specifically dealt with. For stripping costs incurred prior to the start of Production Operations these should be capitalised and:

a) amortised proportionally over the concession period, or
b) amortised according to the unit of production method over the concession period.

Amortisation starts from the month that Production Operations are approved by the Minister of Energy and Mineral Resources ("MoEMR").

Stripping costs incurred during Production Operations, such as the cost of overburden removal, the opening of underground pits (including to find new reserves) etc should be deducted outright.

These rules are applicable even for taxpayers that hold more than one mining licence and simultaneously carry out both pre-Production Operations and Production Operations.

Overall the new stripping arrangements could operate such that pre-production spending may be recoverable (for tax) over a longer period. This could be problematic for projects with mine-lives significantly shorter than the relevant concession period. Recovery of post production spending is also effectively subject to the 5 year tax loss carry forward limit.

Specific Tax Rules for IUPK-OP Holders

CIT

In general the above rules apply equally to IUPK-OP holders but with a number of specific modifications as outlined below.

The CIT rate for IUPK-OP holders is set at 25% and is applicable for the fiscal year following the issue of the IUPK-OP until the end of the IUPK-OP period. In other words the CIT rate for IUPK-OP holders is fixed at 25% for the life of the IUPK-OP.

IUPK-OP holders also calculate fiscal depreciation and/or amortisation in accordance with the following:

a) for assets obtained <u>prior</u> to the issue of the IUPK-OP:
   - i) the depreciation/amortisation rules outlined in the original CoW (except for buildings) apply up until the end of the fiscal year when the IUPK-OP was issued;
   - ii) the prevailing depreciation/amortisation rules apply (except for buildings) for the fiscal years following the issue of the IUPK-OP with the depreciation/amortisation based upon the tax book value at the beginning of the fiscal year following the issue of the IUPK-OP;
   - iii) there is an entitlement to depreciate/amortise the residual tax book value of assets with useful lives which end in the fiscal year following the issue of the IUPK-OP; and
   - iv) the depreciation/amortisation rules outlined in the original CoW apply for existing buildings for the life of the IUPK-OP.

b) for assets obtained <u>after</u> the issue of the IUPK-OP these follow the prevailing depreciation/ amortisation rules;

c) if the IUPK-OP for some reason ends before the period set out in the IUPK-OP then the residual value may be deducted.

Other Taxes / PNBP obligations

GR-37 (and Law No.20 Year 1997 on PNBP) provides that the tax, PNBP and regional tax obligations are to follow the relevant regulations applicable at the time of issue of the IUPK-OP until the end of the IUPK-OP period:

a) for royalties and dead rent – as per the MoEMR regulations on the PNBP of mineral mining;

b) for environmental and forestry obligations – as per relevant PNBP regulations;

c) for State share due at 4% of net profit – as per the Mining Law and regulations;

d) for Regional Government share due at 6% of net profit – as per the Mining Law and regulations; and

e) for Land and Building Tax – as per relevant regulations.

The obligations under points (c) and (d) are applicable from the calendar year following the issue of the IUPK-OP. The net profit is determined after deducting CIT and based on the audited financial statements. These obligations are regarded as profit distributions and therefore are not deductible.

Importantly therefore, the State and Regional Government payment calculations appear to follow accounting profit rather than taxable income. In addition it is not likely that the payments will constitute "taxes" for foreign tax credit or other fiscal purposes and so any home country tax treatment should be considered carefully. Finally there will doubtless be scope for different calculation interpretations between the various Government bodies.

Land and Building Tax under point (e) is applicable from the tax year following the issue of IUPK-OP.

IUPK-OP holders are also subject to the following obligations based on prevailing regulations:

a) those more generally in relation to PNBP (i.e other than as set out in points (a), (b), and (c) above);
b) WHT remittance and/or collection;
c) Value Added Tax and/or Luxury-goods Sales Tax;
d) Stamp Duty;
e) Import Duty and Export Duty;
f) Excise Duty; and
g) Regional taxes and retributions.

The above is applicable to IUPK-OP licences issued up to 31 December 2019.

Administrative requirements

IUPK-OP holders may maintain bookkeeping in accordance with the language and currency agreed in the original CoW until the end of the tax year following the issue of the IUPK-OP. Bookkeeping in Indonesian language and IDR currency is mandatory thereafter unless a written notification on bookkeeping in a foreign language and currency (other than IDR) is submitted pursuant to the relevant tax regulations.

Obligation to Withhold and/or Collect Income Taxes

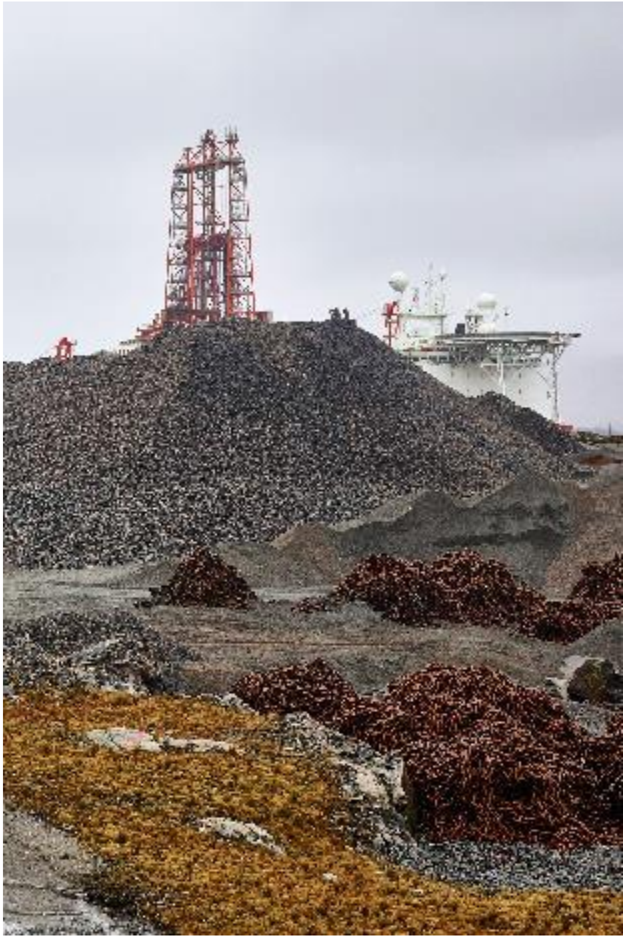
As indicated, concession holders, including CoWs with *lex specialis* Income Tax provisions, must comply with the WHT remittance and/or collection obligations as per the prevailing Income Tax regulations.

Tax and/or PNBP Rights and Obligations

GR-37 provides that mining concession holders may cooperate with other mining concession holders, and parties other than the mining concession holders.

The tax rights and obligations for the mining concession holders who enter into such cooperation arrangements remain with the respective mining concession holders. Provisions regarding tax rights and obligations related to cooperation arrangements will be set out in a separate MoF regulation.

Provisions regarding the imposition, collection and settlement of PNBP for the mining concession holders should also be in accordance with the prevailing PNBP Law and its implementing regulations.



Transitional Provisions

GR-37 provides the following transitional provisions:

a) that (as indicated above) CoWs with *lex specialis* Income Tax provisions will be honoured until the end of the relevant contract period (i.e. the tax provisions stipulated in the CoW will continue to apply – although the number of these CoWs is diminishing);

b) that for IUPK-OP holders any outstanding tax and PNBP obligations arising prior to the issue of IUPK-OP should be settled according to the provisions of the original CoW and/or regulations applicable to that CoW.

Conclusion

GR-37 represents a step forward in the establishment of industry-relevant tax rules for the mineral mining sector. Much of the regulation is however still quite generic with, at least at this stage, a limited focus on the fiscal needs of the industry. For instance, the absence of any tax loss carry forward concessions may add planning difficulty particularly where long exploration periods, often funded with debt, are expected.

Apart from IUPK-OPs there is also no fiscal recognition of the potentially significant issues associated with downstream processing. This is noting that such processing will often be a key feature of investment in the mineral mining sector.

Other challenges/uncertainties which may arise include:-

a) there may be more than one published market price for a given mineral. Clarity will ultimately be needed on which published market price should be used;

b) as indicated, the obligation for IUPK-OP holders to make “share” payments to the State and Regional Governments was mandated in the Mining Law of 2009. The “sharing” obligation is however categorised as PNBP for the State share and Other Revenue for the Regional Government share which, under general tax principles, should also be deductible. However, GR-37 views the obligations as a profit distribution and therefore as non-deductible. This outcome effectively adds to the overall fiscal burden.

We will endeavour to keep readers up to date on GR-37 as more real world experience arises.

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