



# Transfer pricing in Indonesia



**KPMG Indonesia**

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# Introduction

**It has been almost 30 years since Indonesia introduced some form of transfer pricing regulations, and it is therefore perhaps no surprise that transfer pricing has been at the forefront of the tax authorities' attention. In this publication we will provide an overview of the transfer pricing documentation requirements, specific topics related to the end of the pandemic, transfer pricing disputes, year-end adjustments and advance pricing agreements (APA). Needless to say, KPMG's transfer pricing experts would be more than happy to provide you with further information on any transfer pricing related topics, including those mentioned above.**

# Indonesian transfer pricing documentation requirements

When conducting business in Indonesia, it is essential to maintain your Transfer Pricing documentation, particularly if certain criteria are met. This may include exceeding a gross revenue of 50 billion Indonesian rupiah (IDR) from the prior year, participating in tangible goods transactions with related parties that surpass IDR 20 billion, or engaging in services, interest, licensing, or other related-party transactions that exceed IDR 5 billion.

Additionally, if a company engages in related-party transactions with parties residing in countries with a lower income tax rate than Indonesia's corporate income tax rate (which is 22 percent in 2023) during the current tax year, they will also need to prepare transfer pricing documentation. To ensure compliance with regulations and minimize potential risks, it is crucial to be mindful of these requirements.

There are three types of reports that need to be prepared: the Master File (MF), the Local File (LF), and the Country-by-Country Report (CbCR). According to Indonesian transfer pricing regulation PMK-213<sup>1</sup>, the MF and LF need to be available within four months after the end of the fiscal year and the CbCR must be submitted within twelve months after the end of the fiscal year.

Each of these reports contain different pieces of information. First, there is the MF, which is a top-level summary for the entire group of companies. This report contains information on the group's overall structure, business activities, intangible assets, financing activities, and gives a consolidated financial report.

Next, is the LF, which examines a specific group company in Indonesia. This report reveals detailed transfer pricing information such as the company's business activities, related party transactions, the application of the arm's-length principle for each transaction, financial information, and non-financial events that impact the company's financial results.

Finally, there is the CbCR. This report includes information such as business activities, turnover, profit (loss) before tax, prepaid tax, tax payable, capital, retained profit (loss), number of employees, and tangible assets. It allows the government to quickly scan and analyze important information about each entity in the group.

The requirements for transfer pricing documentation in Indonesia are generally similar to the OECD Guidelines, with some minor differences. For example, the Indonesian documentation requires more

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<sup>1</sup> Government Regulation No. 213/PMK.03/2016

information, especially for the MF and LF. It also needs to be prepared in the Indonesian language.

With our experience and expertise, we are able to assist our clients in determining whether transfer pricing documentation is required, and if so, provide assistance in preparing and completing all mandatory transfer pricing documents.

# Transfer pricing in the post-pandemic era

The COVID-19 pandemic has caused a multisectoral crisis that was sudden and unexpected. The pandemic has disrupted the economy and therefore has also impacted the tax transfer pricing policies adopted by multinational enterprises (MNEs). MNEs have been facing a decline in demand and often a decrease in company profits which constitute a critical risk from a transfer pricing perspective. Decline in revenue and losses are major triggers for transfer pricing audits. Therefore, it is necessary to anticipate potential questions and challenges from the Indonesian tax officer, which will evaluate the arm's-length principle of related-party transactions.

At the end of the year 2020, as a preventive measure, the Organization for Economic Co-operation and Development (OECD) released guidance on the transfer pricing implications of the COVID-19 pandemic,

which focused on the application of the arm's-length principle in the context of the pandemic. Unfortunately, Indonesia has not released specific guidance to auditors on how to deal with taxpayers impacted by COVID-19. This has led to an increase in inspections by the Indonesian Tax Office on taxpayers facing economic difficulties, which is expected to continue in the upcoming years.

MNEs need to carefully pay attention to possible preventive measures for post pandemic transfer pricing arrangements and their implications. MNEs will need to consider if any transfer pricing adjustments are needed, based on the existing policies. They will also need to review the impact of the pandemic by documenting the reasons for any exceptional business costs, while still being able to demonstrate the arm's-length principle in their intercompany transactions.

# Commonly challenged intra-group transactions

Intercompany transactions such as intra-group services and the transfer of intangibles are common for MNEs' operating in Indonesia, as most Indonesian entities are the recipients of intra-group services from their foreign affiliates and utilize intangibles owned by their related parties.

KPMG Indonesia's experience in transfer pricing disputes over the past few years has revealed the transactions that are most frequently audited by the Indonesian Tax Authority, as outlined below:

Dispute	Percentage of cases
Sale or purchase of tangible assets	32%
Intra-group services	27%
Intangibles (know-how, royalty, trademarks, etc.)	18%
Intercompany loan	16%
Cost allocation	3%
Marketing/promotion remuneration/reimbursement	1%
Others	3%

In practice, the tax auditors often argue that services have not been rendered or that they provided no benefit to the recipient. In this respect, it is very important to collect contemporaneous documents to provide proof that the services were indeed rendered and beneficial. Any reports, memos, training records, and qualifications to provide such services, will be invaluable in helping to substantiate the service charges. The level of mark-up on costs is typically not a major point of contention.

As for the intangible transactions, the issues are similar to those mentioned above, in particular registrations, patents and know-how reports, and the tangible benefits of intangibles must be made available upon request by the tax auditors.

Hence, we advise taxpayers to prepare and maintain detailed documentation for their intra-group services and intangible transactions to help manage their transfer pricing exposure.

# Comparability

The comparability analysis is at the core of the application of the arm's-length principle. Its main function is to compare the conditions and economically relevant circumstances of the controlled transaction with those of the independent entities' transactions.

The OECD guidelines indicate that product differences are less significant when conducting a comparability analysis and recommend considering the broader business functions affecting the prices. However, Indonesian tax auditors will often challenge the validity of a comparability analysis based on the argument that the characteristics of the products are not similar enough.



# The dispute process

The Indonesian Tax Office (ITO) is known to be very aggressive in relation to tax audits for taxpayers. When a taxpayer requests a tax refund, the ITO will automatically audit their accounts and will usually make any tax corrections necessary to reduce the tax refund. The dispute process in Indonesia usually follows the steps below:

- tax audit;
- tax objection;
- tax appeal; and
- judicial review.

The ITO will start with a tax audit in order to determine the tax correction. The ITO is generally more aggressive with transfer pricing, as making a transfer pricing correction is generally less time consuming and results in a significantly higher tax correction. Transfer pricing is not an exact science, and therefore it is more difficult for taxpayers to defend their transfer pricing assessments. The ITO will issue a tax assessment letter at the end of the tax audit after they have determined the tax adjustment.

If the taxpayer decides to reject the ITO's finding, the taxpayer may proceed with the objection process. Tax objections are handled by a higher-level branch of the tax office. Generally, tax objections will not result in a reversal of the ITO's correction. However, this stage is required before moving on to the next step, which is a tax appeal.

Tax appeals are conducted in a tax court and overseen by tax judges. The tax judges hear arguments from both the taxpayer and the ITO. There are usually many hearings, and many documents will be requested by the judges in order to assess the transfer pricing arrangements of the taxpayer.

If the results of the tax appeal process are unsatisfactory for the taxpayer, the taxpayer can then submit the case to the supreme court.

KPMG can assist clients in every step of the dispute process, in order to increase the likelihood of a favorable outcome.



# Year-end adjustments

Taxpayers often set their transfer pricing policies in advance based on the Transactional Net Margin method which examines the profitability of a company by comparing it with similar companies through the performance of a benchmarking analysis. This is usually a practice for limited or no-risk companies that should be sheltered from risk materializing, but conversely are also not entitled to any excess profitability. This advanced planning complies with the Indonesian adherence to the ex-ante concept which more or less states that transfer prices should be set in advance to comply with the arm's-length principle. The core concept is often based on setting a target return and/or a return within a certain arm's length range that is supported by a proper economic analysis prepared before or during the related-party transaction (again, in adherence to the ex-ante concept).

While it is possible to budget and model transfer pricing policies in agreements and spreadsheets, in the real world a taxpayer often has less control over the actual results at the end of the year. Therefore, it may be necessary to adjust profitability levels to achieve the target or target range. This may be in the form of an upward adjustment if profitability levels are too low (a so-called "true up") or, conversely, downward if profits are higher than they should have been based on the transfer pricing policy.

From a transfer pricing point of view, it is of course essential that these year-end adjustments are supported by robust agreements and written transfer pricing policies. Also, it can be detrimental if the year-end adjustment is included in the annual audited financial statements as a mere tax adjustment. In particular, any downward adjustments are often subject to scrutiny from the tax office, even though these adjustments are performed in strict adherence to transfer pricing policies.

However, true ups also need careful planning. Even if one can expect less controversy on the corporate tax side – although practical experience shows us that this is not always the case – there are some other Indonesian issues that should be taken into account, such as indirect taxes and customs duties. The same is true for true-downs (for the lack of a better term) which may also trigger withholding tax issues.

A prudent policy may therefore aim to monitor profitability levels during the year, and, if possible, adjust actual pricing on a continuous basis to achieve the budgeted targets.

# APA as a potential solution to avoid transfer pricing disputes

Tax disputes in Indonesia are particularly prevalent and the outcomes of such disputes are extremely uncertain. Therefore, taxpayers are constantly looking for ways to mitigate their tax risk.

APA is one approach that is becoming more popular in helping to manage transfer pricing risks.

APA is essentially a binding agreement between the tax administration(s) and the taxpayer that makes the tax treatment of relevant intercompany transactions clear for both the tax administration(s) and the taxpayer for a certain period of time.

Indonesian APA may involve the Indonesian authorities only (unilateral APA) or two or more authorities (bilateral or multilateral APA) and are concluded for five years<sup>2</sup>.

Although APAs have been around for more than 30 years in other part of the world (Apple Computer Corporation secured the first APA in the United States in 1991), the use of APA in Indonesia is much more recent. The ITO has been authorized to negotiate agreements since 2000<sup>3</sup>, but it took many more years to clarify the

modalities of the applications and therefore very few taxpayers applied. Only in 2016 did we see the first successfully completed APA in Indonesia.

Recently, we have observed the ITO's willingness to encourage APAs. In 2020, the ITO issued an update to APA regulations<sup>4</sup> which makes it more attractive to taxpayers. The main positive changes for the taxpayer are:

- Simplification of the application process which saves a significant amount of time
- Extension of the validity of the APA (from three or four years to five years)
- It has become easier to extend the APA for one consecutive period
- It is possible to apply for a rollback under certain conditions, and
- Annual compliance has been simplified.

The advantage of concluding an APA is clear. The taxpayer will obtain a long period of certainty on the application of transfer pricing policies, and it will considerably reduce both the time spent and the costs related to a tax audit, and any disputes with the tax authorities. Taxpayers experiencing

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<sup>2</sup> As of the date of this publication

<sup>3</sup> *Undang-undang Nomor 17 Tahun 2000, Pasal 18 ayat (3a)*

<sup>4</sup> PMK No. 22/PMK.03/2020

frequent tax disputes and large transfer pricing corrections will particularly benefit from an APA.

However, taxpayers need to be aware of several limitations as well. First, the benefits of an APA obviously depend on a successful conclusion with the ITO, which is relatively uncertain. Second, the time spent between the application and final completion of the APA can be significant, especially for bilateral APAs which require the taxpayer to reach an agreement with another tax jurisdiction. The fees for an external consultant assisting with the application process should also be considered. Finally, a lot of information will need to be disclosed to the ITO and the transactions will be scrutinized. Although in theory the documentation during the APA process cannot be used by the ITO for the purposes of a tax audit or tax investigation, we can not guarantee that in practice this is always the case.

We should also mention that the APA does not apply to newly established companies, as regulations require the taxpayer to have been in business for at least three years and to have filed tax returns and prepared transfer pricing documentation during that time prior to filing for an APA.

One last constraint is that the proposal for determining the transfer price in the APA application should not result in an operating

profit smaller than that reported in the tax return for the previous three fiscal years.

Due to the limitations discussed above, the APA program in Indonesia has not yet received a high degree of interest. According to the figures disclosed by the ITO<sup>5</sup>, only 103 APA applications (unilateral and bilateral APAs) have been received since the beginning of the program, of which 52 have been closed and 51 are still being processed. On the positive side we can observe an increase in applications since 2021 and the time to complete the APA has improved.

The APA program is gaining traction despite a few remaining constraints. Taxpayers that are facing a tax audit every year have started to show interest. The cost of concluding an APA should be compared with the accumulated cost of tax disputes over the years. Over the long term, an APA has the potential to significantly reduce transfer pricing compliance costs for many taxpayers.

From our recent consultations, we have observed that the international section of the ITO is willing to enter into discussions with taxpayers. We are optimistic that we will see more and more successful APAs in 2023 and beyond and therefore we are more comfortable recommending our clients consider APAs as a viable option to mitigate their tax risk.

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<sup>5</sup> APA MAP | Direktorat Jenderal Pajak, APA and MAP statistics pre-2016 to 2022, visited 31 March 2023.

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