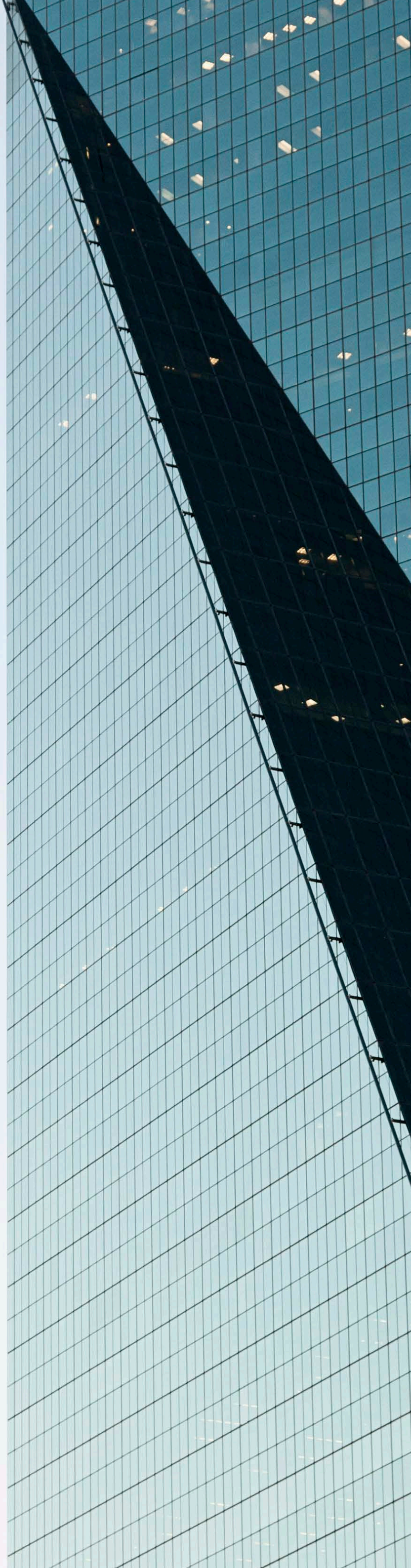
Transfer Pricing

Frequently Asked Questions (FAQ)
Tax, Transfer Pricing



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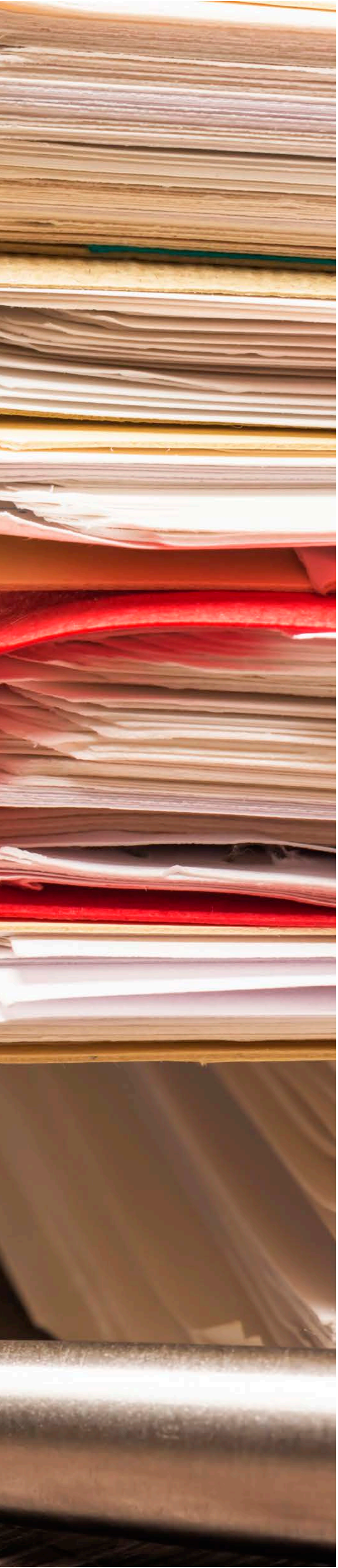


Transfer pricing - FAQ

Update January 2016

Ever since the first Indonesian transfer pricing regulations were issued in the fall of 2010, transfer pricing has been at the top of the agenda of both taxpayers and the Indonesian Tax Office (ITO).

This updated brochure aims to equip you with the knowledge needed to consider whether or not your business is compliant in this field and sufficiently prepared to withstand scrutiny. It is hoped that, by way of concise and insightful answers to some frequently asked questions, this document will put you in a position to assess your company's potential adjustment exposures and any needs to reassess your transfer pricing arrangements.

We recommend that you ensure that your overseas affiliates and/or shareholders are aware of the Indonesian TP issues and that you contact a transfer pricing professional if you believe that any matters need attention.

What is Transfer Pricing?

An unofficial translation of the definition provided in the 2010 Indonesian Transfer Pricing Regulations[1] is:

"…The determination of price in a transaction between parties having 'Special Relations'."

It is essentially the price related entities charge each other for goods, services or any other transactions (for example licensing of intangibles and intercompany loans). Commercial dealings between unrelated entities are generally subject to market forces and a mutually agreeable price is negotiated. However, within a Multi National Enterprise (MNE) or a group of entities under common ownership or control, conditions may differ and this may influence the pricing and the level of profits.

Tax systems in most countries apply the separate entity approach – within a multinational group each entity is treated (taxed) as a separate entity. In order for the tax to apply on the appropriate tax base, group entities must be taxed as if they were dealing with independent parties, free from the conditions arising from their special relationship which may lead to the distortion of prices.

The OECD and member countries recognized the potential impact and the effect it may have on global trade and investment. In efforts to reach a standardized approach to the problem, the OECD issued Transfer Pricing guidelines[2] in July 2010, which state that "Transfer prices are significant for both taxpayers and tax administrations because they determine in large part the income and expenses, and therefore taxable profits, of associated enterprises in different tax jurisdictions". The United Nations also issued a "Practical Manual on Transfer Pricing for Developing Countries" in 2013 which includes similar content.

The almost universally accepted standard to determine prices between related parties is the arm's length principle, under which related parties essentially must set their prices as if they were unrelated. If prices or conditions differ from those in comparable transactions between independent parties, tax authorities may adjust them accordingly.

As MNEs become increasingly global in their outlook, they attract increased attention from tax authorities around the world. The ITO is no exception and, while generally following the arm's length principle, the approach in Indonesia warrants special attention.

It should also be noted that certain domestic transactions also fall within the Transfer Pricing Regulations and the attention of the authorities.

[1] Practical Manual of Transfer Pricing for Developing Nations

[2] OECD Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations

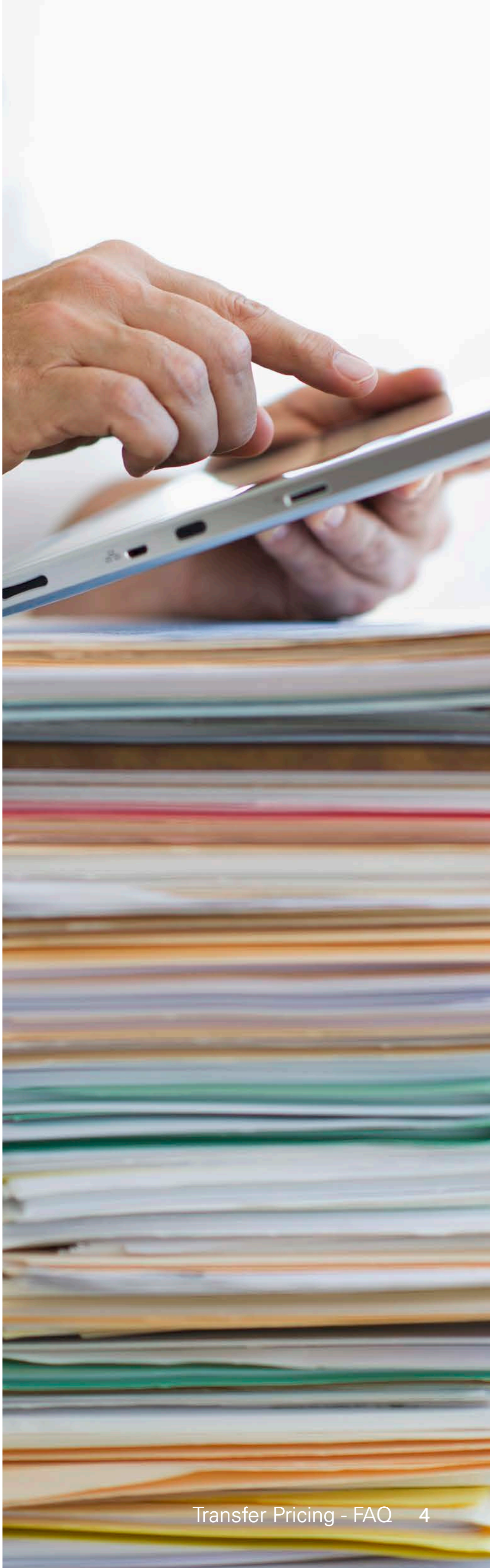
What are 'Special Relations'?

In Indonesia, a special relationship is defined as:

- Capital participation of 25% or greater (direct, indirect or shared);
- Control through management or technology; or
- Family relationships.

This definition differs from that in the OECD Model Tax Convention, that used in other countries and that used for financial statement disclosures under accounting standards. This can potentially cause issues on the other side of a transaction (the overseas counterparty the Indonesian taxpayer is transacting with) and with the scope of and approach taken to local documentation. Double taxation exposure is also a possibility.

The ITO is also considering to encompass definitions of related parties contained within Production Sharing Contracts (oil and gas) and Contracts of Work (mining) and to extend the definition to parties that are economically dependent on each other (for example, taxpayers with a single customer).



How to mirror arm's length price methodologies

In reality it is of course impossible to replicate exactly what would have happened if parties would have been unrelated. Hence the OECD Guidelines prescribe five Transfer Pricing methods to be considered for use as appropriate in particular cases. They are the:

- Comparable Uncontrolled Price (CUP) Method;
- Resale Price Method (RPM);
- Cost Plus Method (CPLM);
- Profit Split Method (PSM);and
- Transactional Net Margin Method (TNMM)

These methods are mentioned in the Indonesian Tax Law (ITL) and are described in the Transfer Pricing Regulations. Revised regulations will include further details regarding the application of these methodologies. The OECD also permits taxpayers to apply methods other than the above five methods, whereas the Indonesian Transfer Pricing Regulations do not contain such a provision.

Although virtually all jurisdictions embrace the OECD Transfer Pricing guidelines, there may be local differences in the approach taken. Therefore, taxpayers cannot rely on a "one size fits all" approach - the requirements of tax authorities in different countries need to be met.

What are the obligations for Indonesian taxpayers?

Since the introduction of the ITL in 1983, the ITO has been entitled to make Transfer Pricing adjustments[3]. Guidelines on the determination of such adjustments were issued to tax auditors in 1993 and disclosure of related party transactions has been required in corporate income tax returns since 2002.

It was not until 2007 that any specific reference was made to documentation, though no details of the requirements were provided.

Since 2009 taxpayers have been obliged to disclose additional details of their related party transactions in their annual tax returns and to declare that Transfer Pricing documentation is available.

The clearest guidance is found in the 2010 Indonesian Transfer Pricing Regulations, in which the ITO: confirms the applicability of the arm's length principle; outlines the basic requirements to determine that prices comply with it; and confirms the documentary requirements.

These regulations were updated in 2011 to make Indonesian Transfer Pricing Regulations more aligned with OECD Guidelines. It states that the "most appropriate method" should be applied.

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[3] Article 18 Paragraph (3) of the ITL

The five Transfer Pricing methods mentioned above are briefly described.

More details were provided by the ITO in the revised guidance given to its tax auditors in 2013. This guidance includes a template of a transfer pricing questionnaire that tax auditors can send to taxpayers to test their compliance with the arm's length principle.

Additional requirements are expected to be imposed as an impact of the global initiative to curb base erosion and profit shifting. The OECD recently published its final deliverables in connection to the Base Erosion and Profit Shifting ("BEPS") project. This project was launched by the OECD in 2013, with endorsement from G20 countries. This initiative was taken in an attempt to address the issues that arise due to lack of coordination between countries' tax systems. This, in turn, has created loopholes which have been seen by MNEs as opportunities to reduce their tax burden significantly.

Transfer pricing itself is one of the 15 key focus areas targeted by the OECD in the BEPS Project. The key transfer pricing areas in the BEPS project are aligning transfer pricing outcomes with value creation, together with transfer pricing documentation and country-by-country reporting. The latter focuses on transfer pricing documentation that consists of a master file, a local file and country-by-country reporting requirements, including revenues, profits, amount of taxes paid, as well as measures of economic activity. This requirement is expected to equip the tax authority with information that enables them to assess transfer pricing more effectively.

Although Indonesia is not a member of OECD, it is a member of G20 countries, hence, it also engages in the BEPS discussions. In the post-BEPS world, it seems evident that the adoption of country-by-country reporting is inevitable. The Directorate General of Taxation ("DGT") itself has informally expressed its intention to adopt a country-by-country reporting requirement. However, it is difficult to predict when the country-by-country reporting requirement will be formally implemented in Indonesia.

Are there instances where no Transfer Pricing documentation is required?

Fortunately, the answer can be yes.

First of all, for domestic related-party transactions, the revised regulations state that documentation is only required for transactions involving taxpayers that are subject to different tax profiles, such as:

- Taxpayers who are subject to different tax rates;
- Taxpayers who are subject to a different tax system (final tax); and/or
- Where transactions are subject to Luxury Goods Sales Tax.

It is also likely that taxpayers subject to reduced rates of corporate income tax (small and medium sized enterprises) will have reduced Transfer Pricing documentation requirements and, possibly, scrutiny of their related-party transactions by the ITO. Changes may also be made to the current "de minimis" limit of IDR 10 billion. Finally, so-called safe harbors may be introduced which taxpayers may apply without having to perform extensive economic analyzes.

Therefore a commercial decision must be made regarding the extent to which documentation should be prepared along with suggested situations where each may be applicable.

Why does the Transfer Pricing need to be controlled and monitored?

Transfer prices should be based on the economic circumstances. The accepted way to analyze them is to consider functions performed, risks assumed and assets used.

Businesses change and these changes should be reflected in Transfer Pricing policies. Be it an expansion of a distributor into manufacturing activities or the outsourcing of certain functions to related parties, Transfer Pricing policies should follow the changes in the circumstances.

It is prudent to plan ahead. Decreasing profit levels could attract the attention of the tax authorities, or even lead to automatic tax audits should the taxpayer be in a refund position. And it is not only corporate income tax that can be affected by changes in transfer prices. Consider the various withholding taxes, value added tax, luxury goods sales tax and even customs duties. All have their interaction with the prices charged between the parties involved.

How do the Indonesian Tax Authorities detect defective Transfer Pricing policies?

The reporting of continuous losses or low levels of corporate taxation and evidence of significant transactions with related parties are likely to attract the attention of the ITO and lead it to question a taxpayer's Transfer Pricing arrangements. Attention to such matters is now fairly widespread and many taxpayers have received questions and/or questionnaires from ITO Account Representatives or from tax auditors.

Alternative dispute resolution options

Traditionally, taxpayers who disagree with adjustments made during tax audits would follow the process of filing an objection and, if unsuccessful, lodge an appeal with the Tax Court. Many Transfer Pricing related cases are currently being considered by the Tax Court.

As the outcome of these procedures is uncertain, many taxpayers consider an available alternative: the Mutual Agreement Procedure (MAP). During a MAP the competent authorities of Indonesia and the country of residence of the counterparty of the transaction negotiate how to resolve Transfer Pricing issues. Although the outcome of the MAP may not fully provide the desired result for a taxpayer, at least the double taxation is eliminated.

In addition, taxpayers may also follow a more proactive approach to seek assurance that transactions will not be subject to future adjustment by making an application for an Advance Pricing Agreement (APA), which may only involve the Indonesian authorities (Unilateral APA) or may be between two or more authorities (Bilateral or Multilateral APA).

Details on procedures to execute a MAP and an APA were elaborated on in two regulations issued by the Indonesian Minister of Finance in 2014 and 2015, respectively. Currently, the ITO is processing and negotiating a number of APAs and MAPs.

How can KPMG Indonesia assist the taxpayer?

There are many situations where assistance may be beneficial for complying with regulations and defending positions.

KPMG Indonesia can add significant value to a client:

- contemplating new types of transactions;
- considering restructuring;
- entering into new markets;
- changing business strategy;
- seeking to ensure full compliance;
- defending its policies or positions;
- aiming for certainty against significant potential adjustments;
- desiring assurance that related party transaction pricing complies with the arm's length principle; and
- wanting confirmation that the required procedures are being followed.

KPMG Indonesia has a well-established and experienced team of dedicated professionals who can, acting alone or in cooperation with global and regional colleagues, assist businesses across the full range of Transfer Pricing issues, including:

- **Documentation and other compliance** – we assist clients to comply with the Indonesian transfer pricing documentation requirements, as well as other documentation requests from the ITO;
- **Planning** – we help clients plan sustainable transfer pricing policies, which should withstand any scrutiny from the ITO, including providing economic rationale for any changes in profit levels;
- **Implementation** – we advise clients on their existing and future policies, inter-company agreements and other tools to manage transfer pricing exposures; and
- **Dispute resolution** – we guide our clients through the processes in defending their transfer pricing policies, both through domestic litigation and competent authority processes, such as advance pricing agreements and mutual agreement procedures.

Contact us

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