Indonesian tax news
Highlight

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Arm's length nature of controlled transactions

- Transfer pricing audits focus on the application of ALP on controlled transactions.
- Taxpayers bear the burden of proof for the application of ALP
- There may be a chance to prepare TP documentation during a tax audit but the time would be very limited.
- The way S-153 factors common business practice seems to signal a contradictory message with the intention of the total benchmarking.

Amendment to the Indonesia-Malaysia tax treaty to take effect from 1 Sept. 2010

- The amendment to the Indonesia-Malaysia tax treaty will take effect from 1 September 2010.
- Withholding tax rates on dividends, interest, and royalties are reduced from 15% to 10%
- The most favored nation clause is no longer applicable for Malaysian companies engaging in oil and gas exploration and exploitation business in Indonesia
- Malaysian companies governed by the Labuan Offshore Business Activity Tax Act 1990 are denied of tax relief granted by the Indonesia-Malaysia tax treaty

Arm's length nature of controlled transactions

One burning question is always raised whenever a company engages in a transaction with a related party: Does the condition resulting from the transaction (price or profit) reflect the one that would obtain were it concluded between unrelated parties? In transfer pricing jargon, does the arm's length principle (ALP) prevail?

This is the very question behind the release of the transfer pricing audit guidance by the Director General of Tax (DGT) in 1993. It is also the question to be answered by taxpayers in their transfer pricing documentation required by GR 80/2007 and reiterated in disclosure requirement in corporate income tax returns (CITRs).

Now that transfer pricing (TP) documentation has become explicitly mandatory, the DGT indicated what measures they would take in a tax audit pertinent to it. These are outlined in DGT letter number S-153 published in early August supplementing the 1993 transfer pricing audit guidance.

Burden of proof

S-153 emphasizes that the burden of proof for the application of ALP lies primarily on taxpayers. This should be undertaken by filling out Form 3A/B of their CITRs properly. The form should portray the controlled transactions a taxpayer engaging in over the year along with the corresponding amounts and the transfer pricing methods used to apply the ALP. Needless to say the information should be drawn from the taxpayer's TP documentation.

It is therefore standard that a transfer pricing audit should start with the auditors' examination of Form 3A/B. A thorough study of the taxpayer's TP documentation, if it does have one, will subsequently follow.

If the taxpayer does not have any TP documentation, the tax auditors are authorized to apply the ALP by themselves. In this respect, they are bound to follow the same set of rules as that applicable for taxpayers for the preparation of TP documentation.

This approach is rather different from the DGT's stance presented by the head of the transfer pricing section in several public seminars on transfer pricing. The DGT stated in their presentations that taxpayers who failed to provide TP documentation during a tax audit would still be allowed to prepare one during a limited time. Only after it failed to produce TP documentation during this specified time would the tax auditors use their authority to apply the ALP by themselves. How long the time limit would be was not explicitly stated.

Common business practice

The application of ALP entails a comparison of the result and condition of a controlled transaction with the results and conditions of comparable uncontrolled transactions taking place in comparable circumstances. Most countries in the world adopt the 1995 *OECD Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations* (OECD Guidelines) as a basis to deal with this matter.

Despite not officially stated in any written regulations, the DGT declared in recent public seminars that the OECD Guidelines should also prevail in Indonesia if a tax treaty was in force. If not, the ALP should be applied in accordance with the 1993 DGT transfer pricing regulations.

Good understanding of common business practice (CBP) should be helpful in the application of ALP. This gives valuable information on how businesses would behave in response to business opportunities in diverse conditions. The total benchmarking developed by the DGT recently portrayed some aspects of CBP, especially the results of undertaking in terms of profitability ratios and some other ratios of activity.

The DGT emphasized in one circular letter that the total benchmarking should be used only as a supporting tool to educate taxpayers and to oversee their tax compliance, not a basis to make transfer pricing adjustment. However, the way S-153 factors in CBP seems not in line with the DGT's statement.

Amendment to the Indonesia-Malaysia tax treaty to take effect from 1 Sept. 2010

After in a wait of more than four years, the 2006 Protocol amending the Indonesia-Malaysia tax treaty finally came into force in July 2010 following the exchange of ratification documents between the governments of Malaysia and Indonesia on 15 July 2010.

The 2006 Protocol covers the following key changes:

- The maximum withholding tax rates on dividends, interest and royalties are reduced from 15% to 10%

- The branch profit tax of Malaysian companies engaging oil and gas exploration and exploitation business shall be determined in accordance with the relevant production sharing contracts concluded with the Indonesian government. The most favored nation clause is no longer applicable.

- The tax relief granted by the tax treaty is not available for Malaysian companies governed by the Labuan Offshore Business Activity Tax Act 1990.

Based on Article 7 of the new Protocol, the new provision should take effect on any amounts debited or credited on or after 1 September 2010.

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