Transfer Pricing Audits of Manufacturing Companies in Indonesia: Quo Vadis?

The author looks into approaches taken by the tax authorities during tax audits, and attempts to clarify transfer pricing issues in the manufacturing sector through an analysis of various Tax Court rulings.

1. Introduction

Transfer pricing issues are one area of focus in tax audits performed by the Directorate General of Taxes (DGT). Indeed, the DGT has stated that related-party transactions are one of the targets of tax audits, and manufacturing activity is one business sector that the DGT has been particularly focusing on. For the last few years, tax audits involving transfer pricing have intensified and the DGT has concentrated, among other things, on transfer pricing audits. An issue that arises in this context concerns how the tax authorities deal with transfer pricing issues arising from manufacturing activities.

This article considers the approaches taken by the tax authorities during tax audits, and attempts to clarify transfer pricing issues in the manufacturing sector through an analysis of various Tax Court rulings. The increasing number of transfer pricing disputes involves not only income tax, but also indirect tax (i.e. VAT).

2. Tax Audits and Tax Disputes

Tax audits are performed by the DGT to assess a taxpayer’s compliance with its tax obligations. The audited taxpayer must provide any books or records, documents and other necessary information related to earned income and business activities. After the tax audit, the DGT will issue a tax assessment letter, in response to which the taxpayer may file a tax objection. After a decision is issued regarding the tax objection, the taxpayer may file a tax appeal before the Tax Court. Judicial review by the Supreme Court is a further option if the taxpayer disagrees with the ruling on its tax appeal.

Under article 18(3) of the Income Tax Law (ITL), the DGT has the authority to redetermine the amount of income and deductions, as well as characterize debt as equity when calculating the amount of taxable income for a taxpayer having a special relationship with another taxpayer, in accordance with normal and reasonable business practice that is not influenced by the special relationship. A special relationship is deemed to exist if two taxpayers have a shareholding of 25% or more in each other; there is direct or indirect control of another taxpayer through, for example, management or technology; or if there is family relationship. The DGT recognizes five transfer pricing methods, namely the comparable uncontrolled price (CUP) method, the resale price method, the cost-plus method, the profit split method and the transactional net margin method (TNMM).

For intra-group services, financial arrangements and intangibles, a transfer pricing adjustment may be based on the arm’s length principle as stipulated in article 18(3) of the ITL, or based on article 6 or article 9 of the ITL regarding deductible expenses for income tax purposes.

For VAT purposes, if the sales price is influenced by a special relationship, that sales price must be calculated based on the reasonable market price at the time of delivery of the taxable goods or services. The definition of “special relationship” is similar to that under the ITL. Accordingly, the arm’s length principle also applies for VAT purposes, including cross-border intra-group transactions and cross-border sales and purchases.

The Tax Court has released information on the increasing number of tax disputes, including tax appeals and litigation, over the years. This information reveals a growing concern among taxpayers that the increasing number of tax disputes will cause more problems. Although there is no official number of transfer pricing cases before the Tax Court, undoubtedly transfer pricing disputes are on the rise in recent years, as is shown in Figure 1.

7. ID: Income Tax Law (ITL), art. 18(4) and its clarification (further definition of special relationship). National Legislation IBFD.
8. Art. 18(3) ITL and its clarification (regarding transfer pricing methods).
9. See e.g. ID: TC, PUT-45132/PP/M.XII/15/2013. In this case, the Tax Court held that the charge for intra-group services was not a deductible expense under art. 6 ITL.
11. Under art. 1(4) of DGT Regulation PER-32/PI/2011 of 11 November 2011, the arm’s length principle applies for VAT purposes in related-party transactions.
Taxpayers may pursue an APA in order to avoid transfer pricing disputes, and may use a mutual agreement procedure (MAP) to resolve double taxation in Indonesia, despite certain limitations (e.g. the requirement that a MAP application not be commenced if the taxpayer files an objection or appeal on the issue).\(^1\)

Tax Court rulings reveal how the DGT might interpret the application of the arm’s length principle under Indonesian transfer pricing rules, particularly as regards manufacturing activities. The main focus of this article is on cases where the DGT has successfully challenged taxpayers in transfer pricing disputes.

3. Tax Audit Guidance and Transfer Pricing Compliance

Regarding related-party transactions and tax audit guidance, the DGT has issued the following rules:

- DGT Circular S-153/PJ.04/2010 of 31 March 2010: tax audit manual regarding the fairness of related-party transactions;
- DGT Regulation PER-22/PJ/2013 of 1 July 2013: tax audit guidance for taxpayers in a special relationship; and

Taxpayers had been required to disclose information regarding related-party transactions in the annual corporate income tax return, including the names of related parties, types of transactions, values of transactions, transfer pricing methods and the reasons for using the selected transfer pricing methods.\(^1\) Taxpayers now must disclose financial transactions with related parties in the latest form of the income tax return.

Regarding transfer pricing documentation, the taxpayers must document each step of the process in the determination of the arm’s length price or profit.\(^1\) The absence of transfer pricing documentation cannot be used as the reason for not testing the application of the arm’s length principle as required by the regulations, as transfer pricing documentation is part of the bookkeeping requirement stipulated by tax law.\(^1\)


13. Attachment 3A of the annual corporate income tax return, regarding the disclosure of related-party transactions in the income tax return, as stipulated by DGT Regulation PER-19/PJ/2014 on the form of income tax returns.

14. Based on art. 3 of PER-32/PJ/2011, but it is exempted for transaction values below IDR 10 billion.

15. For example, in Tax Court case PUT-43695/PP/M.I/16/2013, the Court ruled that transfer pricing documentation is part of the bookkeeping requirement as stipulated under art. 28(1) and 29(3) GTL.
4. Transfer Pricing Disputes Related to Manufacturing Activities

For tax purposes, manufacturing activities could be classified as part of the processing sector, based on the business field classification issued by the DGT, according to the DGT Decree.\textsuperscript{16} The manufacturing sector has been the focus of transfer pricing audits for several years, as noted in the DGT’s annual plan and strategy for tax audits.\textsuperscript{17}

As a developing country, in practice, Indonesia may have a different interpretation of the arm’s length principle for manufacturing activities. The UN Practical Manual on Transfer Pricing for Developing Countries notes that individual countries may have their own viewpoints and experiences in applying the arm’s length principle.\textsuperscript{18}

In transfer pricing audits, the DGT analyses several things, including the use of intangibles, royalty payments, intra-group services, interest payments, the level of net profit as compared to that of other companies; and ongoing losses suffered over several years.\textsuperscript{19} Tax auditors must determine the taxpayer’s business characteristics, choose the transfer pricing method and apply the arm’s length principle.\textsuperscript{20}

Some of the issues discussed below are found not only in the manufacturing sector, and are likely to be quite relevant to other sectors as well. In practice, based on transfer pricing disputes of manufacturing companies in the form of tax appeals, the DGT appears to focus on the following issues.

4.1. Intangibles

In related-party transactions involving intangible property, it is necessary to ensure that such transaction in fact does take place; there is a commercial or economic benefit; and the value of the related-party transaction is similar to that in a transaction between unrelated parties by performing a comparability analysis and applying the appropriate transfer pricing method. For the comparability analysis, the DGT considers any geographic limitation on the use of the intangible property, exclusivity and the existence of intangible property rights.\textsuperscript{21}

During a tax audit, the DGT may request proof of the intangible property, such as an agreement; registration of intangible property; and benefits received from the use of intangible property. In a tax appeal, the court will require at least two items of evidence in this regard.\textsuperscript{22}

For ownership of intellectual property, it may be necessary to register at the Directorate General of Intellectual Property Rights, which is part of the Ministry of Law and Human Rights. Intangible property may include:

- brands (trademarks). Brands are acknowledged as intellectual property rights pursuant to Law 19 of 2002 on Intellectual Property Rights;\textsuperscript{23}
- know-how. Know-how that can be defined as a trade secret may be protected by Law 30 of 2000 on Trade Secrets.\textsuperscript{24} Thus, information provided to a taxpayer as a trade secret through a licence, is protected by law. Trade secrets are defined, under article 1 of the Law, as information that is not publicly known in the field of technology and/or business, has economic value because it is useful in business activities; and is kept secret by the owner of trade secret; and
- patents. Legal ownership of patents is acknowledged based on Law 14 of 2001 on Patents. A patent is defined as an exclusive right granted by the state to an inventor for an invention in the field of technology, where the inventor may use the invention by himself or herself, or give permission to others to use the patent.\textsuperscript{25}

The definition of intangible property can also be based on Indonesian accounting standards as stated in article 28 of the GTL.\textsuperscript{26} Indonesian Accounting Standard 19 may be used as a reference for bookkeeping related to intangible property,\textsuperscript{27} and taxpayers may justify royalty payments based on this accounting standard.\textsuperscript{28}

4.1.1. Royalty payments

In many cases, the DGT has challenged royalty payments and disallowed the deduction thereof, mainly because the DGT is of the opinion that there is no benefit received by the taxpayer, there is no existing intangible property and the royalties are deemed to be payments of disguised dividends. The taxpayer may need to ensure that such payments are made for royalties due to the use of intangibles, and not for intra-group services. Transfer pricing disputes involving royalty payments are generally brought before the Tax Court, and the DGT has lost many of those cases.\textsuperscript{29}

\textsuperscript{16} DGT Decree KEP 233/P/2012 on the classification of business for taxpayers, as last amended by KEP 321/P/2012.

\textsuperscript{17} DGT Circular SE-07/P/2012 on audit plan and strategy for 2012 (2 Mar. 2012), which stipulates that the focus of tax audits in 2012 includes the manufacturing sector and processing sector. See also DGT Circular SE-11/P/2013 of 26 Mar. 2013 on the audit plan and strategy for 2013 and SE-15/P/2014 of 21 Mar. 2014 on the audit plan and strategy for 2014 (which also stipulate the focus on transfer pricing audits).


\textsuperscript{19} Based on DGT Circular; SE-50/P/2012 of 13 Oct. 2013 on transfer pricing audit guidance.

\textsuperscript{20} See also DGT Regulation PER-22/P/2013 of 30 May 2013 on transfer pricing audit guidance.


\textsuperscript{22} Based on ID. Law 14 of 2002 on the Tax Court, art. 76. See e.g. arguments asserted in PUT-44616/PP/M.III/15/2013.

\textsuperscript{23} See e.g. PUT-37708/PP/M.XVI/15/2013 (taxpayer asserted that the brand, Panasonic, was registered at the Directorate General of Intellectual Property Rights under the Ministry of Law and Human Rights).

\textsuperscript{24} See e.g. PUT-45162/PP/M.XV/15/2013 (taxpayer asserted that know-how is actually a trade secret).

\textsuperscript{25} The definition is based on ID. Patent Law, art.1.

\textsuperscript{26} See clarification of art. 28(7) GTL (bookkeeping must be organized in a manner or system that is commonly used in Indonesia, for example based on Financial Accounting Standards, unless tax laws stipulate otherwise).

\textsuperscript{27} Commonly known as Pernyataan Standar Akuntansi Keuangan (PSAK).

\textsuperscript{28} In case PUT-49890/PP/M.V/15/2014, the taxpayer argued that the royalty payments were made according to the accounting standard and were disclosed in the audit report.

There are several cases in which the DGT successfully challenged royalty payments based on the arguments presented below.

4.1.1.1. Measurement of financial benefit of royalty payments

There are two relevant cases in this regard. Royalty payments paid despite the fact that dividends were not paid. The DGT asserted that even though the taxpayer, PT Sanken Indonesia, is owned by Sanken Electric Japan, and despite the fact that the legal form of these two entities is separate, substantially these two companies are one entity and should not be referred to as independent entities. Other arguments included the fact that the incorporation of the taxpayer in Indonesia was to produce and sell products with the Sanken brand; and there is no other party that has a particular interest or concern for the establishment other than Sanken Japan. The other shareholder, holding only 0.01% of the total number of shares, exists only to meet the requirement under article 7(1) of the Company Law which requires that a company be established by two or more persons. Sanken Japan will make every effort to support the success of Sanken Indonesia, and all benefits will be owned completely by Sanken Japan.

Since the company’s establishment in 1997, it has never formally paid any dividends that are subject to withholding tax. Based on the statement of changes in shareholders’ equity, the taxpayer has never paid any dividends even though there are retained earnings. The DGT asserted that the royalty payments should be seen as profit sharing, and thus actually as dividends. According to the DGT, the royalty payments could be more than the percentage of net profit compared to net sales; for example royalty payments in 2008 were 2.27% of sales while the business profit was only 1.5% of sales. The DGT also noted that, based on article 6(1)(a) of the ITL, the royalty payments should not be allowed as a deductible expense because the royalty payments are, in fact, disguised dividends.

In case PUT-38849/PP/M.I/15/2012, the Court stated that the arm’s length principle, as provided under article 18(3) of the ITL, concerns not only the value of a transaction, but also the transaction itself. The Court noted that the royalty payments could not contribute to the taxpayer’s profit, and an analysis of the sharing structure reveals that the taxpayer is an economic unity with a Japanese parent company, although they are different legal entities. Therefore, the Court concluded that because the royalty payments are like payments from the company to itself, no deduction was to be allowed for those payments.

Royalty payments paid despite a loss-making position. The DGT asserted that the royalty payments caused losses for the taxpayer, Fosroc Indonesia, for several years. Application of the TNMM revealed that the taxpayer’s profit margin was below the arm’s length profit of comparable companies. The DGT made a comparison by recalculating the taxpayer’s profit margin for several years without allowing a deduction for the royalty payments, and found that the recalculated profit margin could become arm’s length based on the arm’s length range from applying the TNMM.

In its decision in this case, PUT-44586/PP/M.XV/15/2013, the Tax Court accepted the argument of the DGT that the use of a patent and a brand did not give rise to any profit for the taxpayer, so that the taxpayer effectively became a cost centre of the parent company. Although the taxpayer could provide transfer pricing documentation, the DGT could prove that the royalty payments did not give rise to any benefit for the taxpayer to earn a profit.

4.1.1.2. Royalty payments must be related to the expected profit

In the Panasonic case, the DGT characterized the taxpayer as a contract manufacturer because almost all raw materials were purchased from Matsushita Group and the manufactured products were sold to Matsushita Group as well. The DGT believed that the TNMM could be used as the transfer pricing method, although the DGT argued that there is another approach to understanding the taxpayer’s losses through a recharge approach, noting that the amount of recharge for the taxpayer is less than the overall cost and expense.

The DGT also asserted that there are two options for royalty expenses in a contract-manufacturing context. Under the first option, the royalty expense is borne by the contract manufacturer and recharged as part of the sales price to the principal, while under the second option, the royalty expense is borne by the principal so that the contract manufacturer does not need to recharge it. For the DGT, in the manufacturing sector, taxpayers that are contract manufacturers should not bear the royalty expense.

In its ruling in case PUT-45162/PP/M.XV/15/2013, the Court concluded that the royalty payments could be allowed as a deductible expense. However, one judge issued a dissenting opinion that the royalty payments should be based on the arm’s length principle, under which an independent party would agree to pay royalties to the owner of the technology, as the technology user expects the profit from the sales of products manufactured using the technology. Additionally, the dissenting opinion stated that the royalty calculation should be based on the expected profit, but it is a fact that from the time the company was incorporated in 1991 until 2008, there was an accumulated deficit, and thus it would not be normal for such a taxpayer to pay royalties.

4.2. Intra-group services

The DGT takes the position that the arm’s length principle applies to intra-group services if the service has been rendered and the value of the rendered services is arm’s length. Services are deemed to be rendered if there is an...

30. Art. 26 ITL.
31. The DGT based its argument on the transfer pricing rule under art. 18(3) ITL and other articles regarding deductible expenses.
economic or commercial benefit that adds value to the services provided, but will be deemed not to have been rendered if (i) the services are rendered because the taxpayer is part of a corporate group or (ii) the services actually constitute shareholder activities, such as general shareholders meetings of the parent company or the reporting of the consolidated financial statement of the parent company.\textsuperscript{33} The DGT believes that the taxpayer must use a direct charging method, as the payment for the intra-group services must be based on the part of the service that is truly consumed.\textsuperscript{34} Therefore, the taxpayer, as the service recipient, might not be able to use a charging method based on the turnover (e.g. the company’s turnover), and the benefit of the intra-group services should be seen from the effect on the company’s profitability. Based on those arguments by the DGT, the Tax Court decided in case PUT-44586/PP/M.XV/15/2013 that no deduction is to be allowed for the expense of the intra-group services, as the services could not provide a direct benefit (as indicated by, among other things, the losses of the company for several years). The Court held that the management services and technical services rendered did not provide a direct benefit to the taxpayer, and that the taxpayer became a cost centre of the parent company due to the services.

The DGT will verify whether (i) the taxpayer has the internal capability to perform the functions provided through the intra-group services, (ii) the taxpayer truly needs the services and (iii) the intra-group services could provide a benefit as seen from the profits of the company. In the Tax Court’s ruling in PUT-45132/PP/M.XII/15/2013, the DGT prevailed in the charge of intra-group services by using the above-mentioned argument for intra-group services charged, in a situation where some services were centralized and provided by related parties and the services could be seen as a cost allocation. The Court held that the services did not provide a benefit to the taxpayer, the taxpayer who had the internal ability to perform those services and the services were performed abroad (e.g. marketing and purchasing services), although the biggest market was the domestic market and the suppliers are mostly domestic companies. The Court also took into account article 6 of the ITL and concluded that no deduction was to be allowed for the intra-group service expense.

4.3. Intra-group financial arrangements

Thin capitalization rules, through the use of a specified debt-to-equity ratio, are not the only way to check whether the arm’s length principle has been respected in related-party financial transactions.\textsuperscript{35} No debt-to-equity ratio for tax purposes has yet been issued, and the transfer pricing regulations do not specifically require the application of the arm’s length principle to intra-group financial arrangements.\textsuperscript{36}

Nevertheless, the DGT could assert that a non-arm’s length interest payment should be treated as a disguised dividend. To meet its burden of proof, the taxpayer may need to provide intra-group financial arrangements and proof of transfer of the loan funds to the taxpayer’s bank account. However, the interest expense must meet the criteria for a deductible expense under article 6(1)(a) of the ITL. The taxpayer also must show that the interest rate used is arm’s length.

Although there are various categories of intra-group financial arrangements (e.g. loans, credit guarantees, factoring and cross-border swaps), the current focus in tax audits by the DGT is mainly on intra-group loans, with regard to which the arm’s length nature of the financial arrangement must be supported as follows.

4.3.1. Review of the debt-to-equity ratio of the company

The DGT challenges interest payments by using the arm’s length ratio for thin capitalization through the benchmarking of the ratio although different rates apply to different industries. The arm’s length nature of the loan could be verified by analysing whether a third-party company would provide a loan in light of the taxpayer’s debt-to-equity ratio.

The benefit and economic value of the intra-group loan to enhance the taxpayer’s commercial position can be seen in the taxpayer’s financial condition after receiving the loan. An improvement in the financial condition, such as the taxpayer’s profit, could be seen as an indicator that the loan is actually necessary. Thus, if the taxpayer’s financial condition deteriorates, the DGT could conclude that the loan is of no benefit to the company.

4.3.2. Analysis of paid-up capital and liabilities

In normal business practice, if a company needs more funding, the shareholders can be asked to provide more capital through the issuance of more shares, rather than through the company’s seeking a loan. Thus, the arm’s length principle is regarded as inapplicable if the shareholder makes additional loans, although the shareholder has not fully made the loan based on the authorized capital in the founding documents of the company.

The analysis is based on the amount of authorized capital and the amount of paid-in capital. Under Company Law,\textsuperscript{37} 25% of the amount of authorized capital must be issued and fully paid by the shareholder. Based on this argument, the DGT has challenged the intra-group loans by

\begin{itemize}
\item[33.] Art. 14 PER-32. See also OECD Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations (2010) (OECD Transfer Pricing Guidelines), paras. 7.9 and 7.10, International Organizations’ Documentation IBFD\textsuperscript{1}.
\item[34.] Paras. 7.20-7.22 OECD Transfer Pricing Guidelines (regarding direct charging arrangements and related issues).
\item[35.] The official debt-to-equity ratio was stipulated in Ministry of Finance Decree 1002/KMK.04/1984 as 3:1, but it was revoked by Ministry of Finance Decree 254/KMK.01/1985.
\item[36.] Art. 18(1) ITL (for the legal basis of the debt-to-equity ratio for tax purposes).
\item[37.] Company Law refers to ID: Law 40 of 2007 on Limited Liability Companies.
\item[38.] Art. 33 Company Law.
\end{itemize}
a shareholder to the taxpayer, if the shareholder has not fully paid the overall authorized capital. The analysis will determine whether the loan provided is actually a loan or merely a payment for shares. The analysis may include a calculation of the difference between the amount of authorized capital (as stated in the founding documents) and the amount of capital based on issued shares. Further, there could be another calculation of the difference between the amount of an intra-group loan by shareholders and the above-mentioned difference. This difference is used as the basis for the arm’s length amount of interest expense paid to the shareholder, as shown in Figure 2.

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No deduction is allowed for the amount of interest expense that is determined not to be an interest payment on a loan.

In a different case, PUT-45132/PP/M.XII/15/2013, the Court held that the amount of authorized capital stated in the company’s founding documents relates to the ability of the shareholder to fully pay the capital to invest in the company. The Court also held that the issue, as stated by the taxpayer, that the issuance of additional shares relates to the ability of the shareholder to fully pay the capital to invest in the company. The Court ruled that, in light of the worsening financial condition and the need of the company for more capital from the shareholder, the shareholder loan must be treated as a disguised capital contribution. The interest on the shareholder loan, accordingly, was not a deductible expense under article 6 of the ITL.

4.4. Taxable profit

To determine the arm’s length profit, the taxpayer must choose the most appropriate transfer pricing method, and the arm’s length profit may be determined as a single point or within an arm’s length range. The calculation of the arm’s length profit is to be disclosed in the transfer pricing documentation, which is to include a comparability analysis, the selection of a transfer pricing method and the application of the arm’s length principle to related-party transactions.

A functional analysis should be done to determine the characteristics of the taxpayer, based not only on the legal form, but also on the economic substance. The DGT looks to the business substance of a manufacturing company to determine whether the company is a full-fledged manufacturer, a contract manufacturer or a toll manufacturer. Such a determination based on the substance could be used to assert that the taxable profit is not arm’s length and that a limited-risk company should not be in a loss-making position.

4.4.1. Limited-risk company

A limited-risk company can include a contract manufacturer and a toll manufacturer. For contract manufacturers, the most common disputes involve royalties or a contract manufacturer in a loss-making position, as described above. For toll manufacturers, there are specific problems. For example, the DGT has challenged a toll manufacturer that suffered losses, arguing that a limited-risk company in which various functions (i.e., purchase of materials, marketing and distribution) are performed by the company’s principal, should not suffer losses. The DGT’s assertion was supported by the fact that virtually all income was acquired from the principal.

Basically, there is a question regarding the transfer pricing method to be applied to toll manufacturers and how to determine an arm’s length profit for the toll manufacturer, specifically in that there are several difficulties that arise in determining an arm’s length profit. One of these difficulties is a shareholder to the taxpayer, if the shareholder has not fully paid the overall authorized capital. The analysis will determine whether the loan provided is actually a loan or merely a payment for shares. The analysis may include a calculation of the difference between the amount of authorized capital (as stated in the founding documents) and the amount of capital based on issued shares. Further, there could be another calculation of the difference between the amount of an intra-group loan by shareholders and the above-mentioned difference. This difference is used as the basis for the arm’s length amount of interest expense paid to the shareholder, as shown in Figure 2.

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In case PUT-38168/PP/M.VIII/15/2012, the Court held that the amount of authorized capital stated in the company’s founding documents relates to the ability of the shareholder to fully pay the capital to invest in the company. The Court also held that the issue, as stated by the taxpayer, that the issuance of additional shares relates to the ability of the shareholder to fully pay the capital to invest in the company. The Court ruled that, in light of the worsening financial condition and the need of the company for more capital from the shareholder, the shareholder loan must be treated as a disguised capital contribution. The interest on the shareholder loan, accordingly, was not a deductible expense under article 6 of the ITL.

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Basicall...
problems concerns the fact that there are few independent listed companies performing toll manufacturing.\textsuperscript{17}

During an audit of a loss-suffering toll manufacturer, the DGT rejected the argument that the losses were due to mismanagement or due to the use of additional materials in the toll manufacturing process. The DGT may also request details regarding the functions that the company’s management performs which may cause the losses.

The DGT might assert that the profit split method should be applied where the profit split percentage is based on the percentage of functions performed by the toll manufacturer. It is more appropriate if the company is a wholly owned subsidiary of the principal and most revenue is from the principal. Regarding the necessary proof, the taxpayer may be required to provide its own financial report and the principal’s financial report.

After calculating and determining the percentage of the functions for both the toll manufacturer and the principal, an additional calculation is made to determine the net profit allocated to the toll manufacturer based on the comparison between the toll manufacturer’s revenue and the principal’s cost of sales (which results in profit from the overall toll manufacturing activities).\textsuperscript{18} Subsequently, the net profit split for the toll manufacturer is calculated based on the percentage of the functions performed by the toll manufacturer and the profit from the overall toll manufacturing activities. The determination of the arm’s length profit for toll manufacturers can be illustrated as in Figure 3.\textsuperscript{19}

In case PUT-28868/PP/M.15/2011, the Tax Court accepted the argument of the DGT regarding the use of the profit split method for toll manufacturing, although the Court noted that there should be a further verification as to whether the principal still had to perform additional manufacturing and other activities on the products sent by the toll manufacturer. Ultimately, the Court accepted a portion of the adjustment made by the tax authorities.\textsuperscript{20}

\textbf{4.4.2. Transfer pricing methods}

As the taxpayer must use the most appropriate method,\textsuperscript{21} the taxpayer needs to consider the advantages and disadvantages of each method, the nature of the related-party transactions based on a functional analysis, the availability of reliable information needed to apply the selected method and the proportionality between related-party transactions and non-related-party transactions (including the reliability of adjustments made to eliminate any material effects of the differences).\textsuperscript{22}

The issue regarding the transfer pricing method also includes the method for a limited-risk entity engaged in manufacturing activities, i.e. a contract manufacturer. The characterization of a taxpayer based on its business model

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47. Para. 10.3.5.8. \textit{UN Practical Manual}.
48. There are no further details regarding how the tax authorities calculate the percentage of the functions performed by the toll manufacturer and the principal.
49. The figure is based on ruling PUT-28868/PP/M.15/2011.
50. In its decision, the Court further amended the adjustment after re-calculating the percentage of various functions (e.g. manufacturing, warehousing, purchasing, marketing and distribution) performed by the toll manufacturer and the principal. The Court also ruled on another dispute regarding purchase price variance for a toll manufacturer, concluding that the adjustment of purchase price variance by the tax authorities could not be accepted. The dispute concerned fiscal year 2003, during which the previous transfer pricing regulations still applied (i.e. DGT Circular SE-04/PJ.7/1993 and DGT Decision KEP-01/PJ.7/1993).
52. Art. 11(1) PER-32/PJ/2011. See also art. 11(8).
could lead to a company being characterized as a contract manufacturer – which will impact the determination of the arm’s length profit for the taxpayer.

Several cases are discussed below in which the tax authorities have taken specific approaches to the application of transfer pricing methods.

4.4.2.1. CUP method

It is appropriate to use the CUP method if (i) the goods or services have identical characteristics with their equivalents in comparable conditions or (ii) the conditions of the transactions between related parties and unrelated parties have a high degree of comparability and accurate adjustments can be made to eliminate the influence of the differences. The DGT could conclude that manufactured goods are actually semi-finished or finished goods, and decide whether internal comparables are available.

The Tax Court, in case PUT-50134/PP/M.I/15/2014, concluded that when the characteristics of the products manufactured or sold are relatively similar, they can be compared easily, and where there are sales to both related and non-related parties, the most appropriate method is the CUP method or at least the cost-plus method, and there is no reason to use the TNMM. The Court also noted that in order to use the CUP method, there must be a transfer pricing analysis of each transaction and of each country in terms of export sales, taking into account any differences in economic circumstances.

If the goods manufactured and sold are subject to VAT, transfer pricing rules also apply and the sales value for direct tax is to be used for VAT as well. In the case of export sales, the taxpayer may refer to internationally published market prices, and make adjustments for, for example, freight costs.

In case PUT-47123/PP/M.XVI/15/2013, the Court concluded that there was a need for independent verification of the information on the sales price of chemical products despite the fact that the taxpayer had provided transfer pricing documentation. The DGT noted that the taxpayer could not provide its pricing policy and did not explain the differences in sales price, and thus there should be an adjustment based on the arm’s length price. The Court ultimately decided in favour of the tax authorities.

4.4.2.2. Resale price method

Appropriate conditions for applying the resale price method include (i) a high degree of comparability between the related-party transaction and non-related-party transaction, particularly based on the analysis of functions, and (ii) the reseller not providing significant added value to the goods purchased and sold.

Export sales to a related party may trigger a transfer pricing audit, especially if the taxpayer suffers losses on the sales. The DGT may challenge the related-party transactions to the reseller and attempt to compare the related-party transactions with the non-related-party transactions – or even other related-party transactions. In the Toyota Motor Manufacturing Indonesia (TMMI) case, the DGT challenged the company, as TMMI had suffered losses on export sales of cars that the company manufactured, while the company did earn a profit on domestic sales of the same type of cars. Export sales were made to Toyota Motor Asia Pacific (TMAP), a related party domiciled in Singapore, which resold the cars to buyers in the other country. On the other hand, the cars were also sold on the domestic market through a related party, Toyota Astra Motor (TAM). For both domestic and export sales, market surveys, marketing and after-sale services were performed by related parties that purchased the cars.

In the TMMI case, the taxpayer asserted that losses could arise because the sales price that was based on the contract and certain exchange rates affected the decrease in the actual sales price. It also argued that (i) the losses were due to the fixed cost that was based on the sales target and (ii) the lower price was used to attract customers abroad for new cars, while on the domestic market, the brand image for the new cars was already established. The taxpayer noted that the price differences were due not only to product specification, but to other factors such as market demand.

The DGT asserted in the TMMI case that, during the tax audit, the taxpayer did not submit supporting documents regarding the differences in car specifications for both domestic and export sales, as well as documents regarding the influence on losses from export sales, and the taxpayer did not provide an explanation of its market penetration strategy and the influence thereof on losses from export sales.

In PUT-54375/PP/M.XA/15/2014, the Court accepted the DGT’s argument that although the resale price method could be used for this transaction, ultimately the cost-plus method should be used for the related-party transactions – especially for export sales. The Court adjusted the transfer pricing correction originally made by the DGT, as the Court did not fully agree with the arguments of the DGT. The Court held that the sales price for exports was not arm’s length and that there must be additional profit to reach an arm’s length sales price.

53. Art. 11(9) PER-32.
54. The arguments regarding types of goods and internal comparables are used by the DGT as disclosed in ruling PUT-30134/PP/M.I/15/2014.
55. The taxpayer won the case, as the Court decided that the DGT could not provide strong arguments in support of its transfer pricing adjustment using operating profit. Furthermore, the Court noted that the sales price in related-party transactions was higher than that in non-related-party transactions.
56. Art. 11(10) PER-32.
58. The DGT noted that the resale price method could not be used, as there were no data. The DGT also observed that the taxpayer stated in its tax return that the cost-plus method was used as the chosen transfer pricing method.
4.4.2.3. Cost-plus method

This can be an appropriate transfer pricing method where semi-finished products are sold to related parties; there is joint-facility agreement or long-term buy-and-supply agreement; or there is a rendering of services. One practical challenge in applying the cost-plus method arises where the taxpayer sells its manufactured products to both related parties and third parties and the gross profit margin will be compared, as (i) there are differences in the functions performed and (ii) for sales to related parties, some functions may be performed by the related parties. Further analysis may be needed if both parties are domestic or foreign companies, as the functions, assets and risks may be different.

In case PUT-27663/PP/M.XIII/15/2010, the DGT asserted that because the price of export sales to related parties is less than the price of export sales for non-related parties, the cost-plus method was to be used. The taxpayer stated that the different prices were applied because the taxpayer had to bear advertising, promotion and freight expenses for sales to non-related parties, but not for related-party transactions with its parent company in Japan. The DGT applied the following steps to determine the arm’s length consideration for sales to related parties:

- separate sales to related parties and non-related parties;
- calculate the gross profit margin for both related and non-related parties;
- adjust the gross profit margin based on the differences and calculate the adjusted gross profit margin; and
- calculate the arm’s length consideration for sales to related parties.

The Tax Court accepted some parts of the transfer pricing adjustment to sales.

In the Sharp Electronics case, the DGT challenged the taxpayer and applied the cost-plus method (rejecting the TNMM applied by the taxpayer). The tax authorities compared export sales to related-party sales and exports, as well as domestic sales to non-related parties. The DGT made adjustments to the actual expense for marketing and advertising, as well as to the allocation of bad debt expense and after-sale services. In its ruling in case PUT-48154/PP/M.XV/15/2013, the Court accepted the DGT's argument and the tax authorities prevailed in the case. However, in a dissenting opinion, a judge stated that the transfer pricing adjustment should be reduced, as the DGT used comparisons between export sales prices to related parties and domestic sales prices to independent parties which bore different risks.

4.4.2.4. Transactional net margin method

The DGT stipulates appropriate conditions for the use of the TNMM, namely where one of the parties to a related-party transaction makes a special contribution or one of the parties engages in complex transactions and has transactions that are related to one another.

Regarding comparables needed for purposes of applying the TNMM, the DGT may use foreign comparables from different regions (e.g. the Far East and Central Asia, Oceania and ASEAN) in its database searches for comparables. It is likely that the DGT will use domestic comparables, such as various reports from specific industries that provide the average profit margin of the particular industry.

In case PUT-22248/PP/M.X/15/2010, the DGT argued that a report titled "Packaging and Paper and Cardboard Box Manufacturing in Indonesia" could be used as a benchmark for calculating the arm’s length profit. However, the Tax Court concluded that foreign comparables found in the search for comparables, along with the profit margin, in the database, must be used instead. In a different ruling, in case PUT-43906/PP/M.XIV/15/2013, the DGT used an industry report from an independent party to benchmark the taxpayer’s profit margin; the DGT ultimately prevailed in the case.

4.5. Indirect taxation

The arm’s length principle for VAT applies not only to sales and purchase of goods, but also to intra-group services (including the use of intangibles in cross-border related-party transactions). Transfer pricing issues related to VAT include the following.

Sales. Although export sales are subject to 0% VAT, the information on the VAT invoice is crucial because the sales price must be arm’s length and arm’s length. Otherwise, the DGT may challenge the VAT invoices, deeming them to be invalid and subject to a tax penalty. The arm’s length value of export sales for VAT purposes depends on the arm’s length price for income tax purposes.

For export sales, the Notification of Exported Goods (Pembayaran Berita Hsan Ekspor Barang, PEB) is treated as the standard VAT invoice. If the export value reported is not arm’s length, the DGT may challenge the VAT invoices, deeming them to be invalid and subject to a tax penalty. The arm’s length price through the CUP method.

59. Art. 11(11) PER-32
60. Art. 11(13) PER-32
62. In this dispute, the DGT based its argument on the fact that the transfer pricing audit guidance, KEP-01/PJ.7/1993, stipulates that third-party information may be used as comparables.
63. Art. 2(3) VAT Law.
64. For further details on the issue of transfer pricing for VAT, see A. Adie, Indirect Tax and Transfer Pricing Issues in Supply Chain Management and Inbound Business Restructurings, 18 Asia Pac. Tax Bull. 2 (2012), Journals IBFD
65. Art. 13(5) and (9) VAT Law (regarding formal and material requirements for VAT invoices).
66. DGT Regulation PER-10/PJ/2010 on certain documents used as standard VAT invoices.

Exported / Printed on 1 Jan. 2020 by danny@dannydarussalam.com.
In case PUT-47129/PP/M.XVI/16/2013, the Court accepted the argument of the DGT that the 10% rate VAT is to apply if the arm’s length sales value is not used on the PEB and invoices for export sales.\(^6^8\) The Court also held that there must be a further check of the freight cost on the comparable price, and the taxpayer must provide its pricing policy for export sales.

**Purchase.** Transfer pricing issues can arise with regard to the import of purchased goods because there is no harmonized valuation of imported goods between the DGT and the Customs Authority.\(^6^9\) Thus, the tax authorities and customs authorities may determine different valuations for the import price.\(^7^0\)

**Intra-group services.** Intra-group services could be subject to VAT in which output VAT is charged under the reverse charge mechanism, and will also be input VAT creditable for the VAT calculation; furthermore the consideration for intra-group services must be arm’s length.\(^7^1\) The taxpayer may not credit the input VAT from intra-group services if the DGT decides that no deduction is allowed for the intra-group services based on articles 6(1) and 18(3) of the ITL.\(^7^2\) Under the VAT Law, input VAT is not creditable if the taxable goods or services do not have a direct relationship with business activities through production, distribution, marketing and management.\(^7^3\)

In cross-border situations, toll manufacturing services are subject to VAT at 0% if certain requirements are met,\(^7^4\) while trading services are subject to VAT at 10% in certain situations.\(^7^5\)

**Intangibles.** In many cases, the tax auditor will assert that input VAT on royalty payments which is charged under the reverse charge mechanism (similar to intra-group services, above), is not creditable for VAT purposes, as the royalty payments are regarded as disguised dividend payments.\(^7^6\) Accordingly, the resolution of a transfer pricing dispute involving royalty payments and VAT clearly depends on the resolution of the same dispute for income tax purposes. Therefore, if the Court decides that the royalty payments are arm’s length transactions and are to be allowed as a deductible expense, input VAT on the royalty payments would be creditable for output VAT.\(^7^7\)

### 5. Conclusion

In recent years, the DGT has performed transfer pricing audits of taxpayers, especially in the manufacturing sector, and has prevailed in some transfer pricing disputes and tax appeals with regard to intangibles, transfer pricing methods, profitability and intra-group services, for both direct and indirect taxation.

In some cases, the DGT may have a different interpretation of how the arm’s length principle should be applied, for instance, in the case of a limited-risk entity as regards the transfer pricing method; intra-group financing as regards the direct charge method; royalty payments as regards the expected profit from the royalty payments; or intra-group financing as regards the relationship between authorized capital and interest expense.

Tax disputes and tax appeals before the Tax Court have indicated that manufacturing companies might benefit from proper planning to deal with the transfer pricing challenges in Indonesia before such issues rise to the level of a tax dispute.

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68. In this case, the DGT used the international market price from icis.com for comparables of Ethylene prices.
69. Arts. 2 and 3 Law 17 of 2006 on Customs.
70. The taxpayer may file an appeal to the Tax Court in response to the decision of objection to the assessment made by the Customs Authority.
71. Art. 2(1) VAT Law (regarding the use of market prices or arm’s length amounts for related-party transaction for VAT purposes).
72. See e.g. Tax Court, PUT-43696/PP/M.I/16/2013 regarding transfer pricing adjustments for input VAT on intra-group services, e.g. technical assistance fees, and royalties could not be accepted, as those payments were determined to be deductible expenses and accordingly the input VAT thereon should be creditable.
73. Art. 9(8)(b) VAT Law and its clarification.
74. Art. 7(2) VAT Law; Ministry of Finance Regulation 30/PMK.03/2011 of 28 Feb 2011.
76. Art. 4(1)(g) VAT Law on the definition of intangible property (which includes intellectual property).
77. See e.g. Tax Court, PUT-44011/PP/M.XI/16/2013 (a transfer pricing adjustment for input VAT on royalty payments was not accepted, as the Court held that the royalty payments were a deductible expense).