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Highlight
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Transfer pricing under PMK 172/2023

Aiming for fair pricing with outright TPD

Tax relies on market forces for the pricing of virtually all types of business transactions. Market mechanism is believed to work well with transactions between independent parties: fair outcome is just taken for granted. Not so with transactions between parties of the same business group, deemed as being automatically consumed with a special relationship.

Minister of Finance (MOF) regulation Number PMK 172/2023 regarding transfer pricing (PMK 172) issued in late last year and took effect last month, like many other transfer pricing regulations, notionally aims to tackle the potential problem of unfair (non-arm's length) pricing resulting from the presence of a special relationship in transactions between parties of the same group (affiliated transactions). This is dealt with from three fronts: outright transfer pricing documentation (TPD), mutual assistance procedure (MAP), and advance pricing agreement (APA).

With outright TPD, taxpayers are left to demonstrate to the DGT that the pricing of their affiliated transactions are consistent with the arm's length principle (ALP). MAP, being a procedure required by most tax treaties in force, as far as transfer pricing is concerned, aims to tackle the transfer pricing disputes induced by the actions of the Director General of Taxation (DGT) or the tax authorities of the tax treaty partners. APA, another procedure derived from the tax treaties, aims to minimize transfer pricing disputes by the tax authorities agreeing in advance with the taxpayer on the pricing and many other aspects of the affiliated transactions.

What follows gives you highlights on several aspect of the TPD governed by PMK 172. Highlights on the other two fronts will be provided separately in due course.

What makes TPD to turn mandatory?

Whether or not a domestic taxpayer is required to prepare and maintain TPD for a fiscal year depends literally on its own level of activity of the prior year. Hitting the specified threshold (Table 1) in the prior year, under PMK 172, turns TPD – namely, Master File (MF) and Local File (LF) – mandatory in the current year. Size matters in most cases, but not with transactions conducted with an affiliate based in a country with income tax rate lower than Indonesia's.

Activity threshold beyond which TPD (MF and LF) turns mandatory 1

Prior year's activity indicator	IDR billion
Gross turnover	50
Affiliated transactions-tangible goods *)	20
Affiliated transactions-each of any others	5

*) Applicable only for transactions with parties based in countries with income tax rate not lower than Indonesia's. No threshold for those lower.

Taxpayers falling short of the threshold in the prior year is literally not required to prepare and maintain TPD. Yet, they are bound to apply the ALP to all affiliated transactions conducted in the current year. That said, and judging from the risk of tax auditors challenging the arm's length nature of the affiliated transactions along with the potentially ensuing transfer pricing adjustment, it would be wiser to decide whether or not to prepare TPD based on a more strategic consideration than just their position vis-à-vis the activity threshold.

As regards the country by country report (CBCR), another element of the TPD, it is the group's level of activity in the prior year which determines whether it is mandatory. And if it is, it is the group's ultimate holding company which is held responsible for the CBCR. At present, the threshold is set at IDR11 trillion of turnover, equivalent to EUR750 million.

All threshold are stated on a full-year (12-month) basis. If the financial statements under consideration cover an operation of less than 12 months, then, the amounts of the activity indicators should be annualized.

Covered transactions

Needless to say that TPD must cover all affiliated transactions conducted by a domestic taxpayer with an affiliate (affiliated transactions). It must also include transactions conducted with independent parties (independent transactions) to the extent they bear special relationship influence. The influence in this regard is reflected in the counter party to the (nominally) independent transaction and the price for the transaction being determined by an affiliate of the taxpayer.

The special relationship, in PMK 172's words, is essentially "a state of dependence or being bound together" of the taxpayer with or to another party. Such a state could stem from capital ownership or participation, control, or family relationship. The criteria for the three conditions are broadly similar to that stated in the income tax law. Pertaining to control-induced special relationship, though, PMK 172 adds the state at which parties are commercially or financially known to be of one and the same business group or declare as such.

Application of the arm's length principle (ALP)

Application of the ALP is the thrust of TPD. PMK 172 asserts it must be consummated based on the actual state of the covered transactions, at the same time as the transaction price determination or the occurrence of the transactions, and in accordance with the prescribed procedures.

To be arm's length, under PMK 172, means having the value of the Transfer Price indicator "to equal the value of the comparable Independent Transaction price indicator". Depending on the transfer pricing method adopted, the price indicator may be either the transaction price, the gross profits, or the net operating profits, either in an absolute amount or a ratio to a certain base.

Equality, and by implication being arm's length, may be represented by a single and the same point of the comparable Independent Transaction value or any point/value within a designated range. The former applies if no more than one comparable data is used to benchmark the transfer price. If two comparable data are used, the arm's length price indicator value is considered to lie anywhere within the minimum-maximum range of both comparables. If three or more are used, it is in the interquartile range of the comparables.

If the Transfer Price indicator value falls short of the arm's length point or the designated arm's range, the arm's length transfer price should be determined based on the comparable Independent Transfer price indicator values. In this respect, the arm's length point may be represented by either:

- A single arm's length point if one comparable is used for the benchmark;
- Any point within the designated range considered to be the most appropriate in terms of comparability; or
- The median of the designated range if neither of the other two options above can be specified.

TPD availability and filing

The TPD (MF and LF) for a fiscal year must be available by the end of the fourth month of the end of the year. Crucially, a summary thereon must be prepared along with an official statement about the date by which the TPD has been available and signed by a competent person of the taxpayer and attached to the corporate income tax return (CITR) submitted to the Tax Office.

The TPD needs not be attached to the CITR. Yet, if asked by the DGT –which could come off any time after the CITR filing– taxpayers are bound to deliver it within a maximum of a month of the request date. Missing the deadline may risk being deemed as not having any.

The CBCR for a fiscal year, if applicable, must be available by the end of the 12th month of the fiscal year end and must be attached to the CITR of the year upon filing –presumably of the ultimate holding company, which is registered as a domestic taxpayer and bound to submit the CBCR.

Secondary adjustments

The DGT may make a transfer pricing adjustment if they find, based on a tax audit, the transfer prices of the affiliated transactions not arm's length. The transfer pricing adjustment, being a primary adjustment to the taxpayer's taxable income, may lead to a secondary adjustment in the form of constructive dividends. This applies to transfer pricing adjustments related to either cross-border or within-border affiliated transactions.

The constructive dividends are to be taxed in accordance with the prevailing tax law and regulations. As such, if applied to a cross-border transaction, it will trigger Art. 26 withholding tax (WHT26) liability at 20% of the gross amount of the constructive dividend. WHT reduction or exemption may be applicable under certain tax treaties in force. Satisfaction of the administration procedures, though, need to be observed to get the tax treaty benefits.

Crucially, the DGT will forgo the secondary adjustment if the following conditions prevail:

- There is an increase and/or repayment of cash or cash equivalents [to the taxpayer bearing the primary transfer pricing adjustment] as much as the transfer pricing-induced difference (transformed into the transfer pricing adjustment); and/or
- The taxpayer agrees with the transfer pricing adjustment.

Corresponding adjustments

If a transfer pricing adjustment causes double taxation, PMK 172 states, "the domestic taxpayer which is the counter party [to the affiliated transaction bearing the transfer pricing adjustment] can make a corresponding adjustment". The rule applies in relation to any transfer pricing adjustments –namely, whether they are made by foreign tax authorities in relation to cross-border affiliated transactions or the DGT in relation to within-border affiliated transactions.

PMK 172 gives no clarification regarding the corresponding adjustment related to transfer pricing adjustments made by foreign tax authorities. Pertaining to transfer pricing adjustments in relation to within-borders affiliated transactions made by the DGT, PMK 172 provides as follows:

a. The corresponding adjustment can be made if the taxpayer bearing the transfer pricing adjustment agrees with the transfer pricing adjustment and take no legal action against it;

b. The corresponding adjustment can be consummated by either:
    - Revising the tax return of the counter party taxpayer. The counter party taxpayer can do it if their affected tax return has not yet been audited;
    - Issuing a tax assessment letter with the corresponding adjustment taken into account. This is to be done by the DGT pursuant to either:
        - The taxpayer revising the tax return to account for the corresponding adjustment; or
        - The taxpayer disclosing in a tax audit the incorrect tax return filling out [by missing the corresponding adjustment].

c. Revising the tax assessment letter with the transfer corresponding adjustment taken into account. This is to be done by the DGT *ex-officio* pursuant to the counter party taxpayer submitting a notification letter to the ITO regarding the corresponding adjustment it intends to make. This option can be consummated only the condition that the counter party taxpayer does not take any legal action pertaining to the corresponding adjustment.

Implication to VAT

Transfer pricing may also implicate in VAT. PMK 172 states, for instance, that the DGT may make an adjustment to the selling price or the compensation relating a special relationship-influenced transaction that falls short of the relevant "fair market price". The objective is to determine the fair (arm's length) VAT base for the transaction. This is to be done by reference to the "fair market price at the time of the taxable goods or taxable service deliveries".

Apart from the above, which implies a dedicated audit for VAT, a similar adjustment can be made by the DGT pursuant to a transfer pricing adjustment primarily dedicated for income tax. This is on the condition that the transfer pricing adjustment could be allocated to each transaction of taxable goods or taxable service delivery.

PMK 172 asserts that the selling price or compensation adjustments referred to above "do not implicate any adjustment to the input tax of the goods buyer-PKP or service recipient-PKP". It adds "the buyer PKP or service recipient PKP can persist with claiming the input tax stated in the tax invoices issued by the seller PKP or service providers PKP provided that the tax invoices comply with the relevant provisions for claiming input tax as a credit".

Please contact us to get more insight.

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