Wake Up Call

# Claiming Tax Deductions for Borrowing Costs

*I have heard that there is a new regulation that is going to resolve the uncertainty regarding claiming tax deductions for borrowing costs. Is this true? When is it effective and how do I benefit from this?*

*Priscilla, Jakarta*

Until now claims for deductions relating to borrowing costs were subject to the general provisions of the Income Tax Law. That is, the costs should be necessary for gaining, collecting and/or maintaining taxable income. For related party transactions it was also necessary to consider whether the borrowings reflect arms-length arrangements or not. The Income Tax Law included a provision allowing the Minister of Finance to stipulate permissible debt-equity ratios; however, this was only briefly implemented in 1984, before being suspended on 8 March, 1985.

As a consequence there was a possibility that a tax auditor might arbitrarily adjust deductions for borrowing costs. Although such adjustments might be questionable the amount might not be sufficient to justify lodging an objection and taking the rejected objection to appeal in the Tax Court.

Minister of Finance Regulation No. 169/PMK.010/2015 dated 9 September, 2015 ("the D/E Regulation") partly addresses this by stipulating that a D/E ratio of up to 4:1 is permissible for the purposes of determining what borrowing costs can be deducted. It applies to most companies with specific exclusions (e.g. banks, insurance, infrastructure, and those subject to government agreements such as mining contracts of work that have a specified D/E ratio).

The D/E Regulation is effective for the 2016 Tax Year (e.g. from 1 January, 2016 for December year-end companies) and defines debt, equity and borrowing costs. Borrowing costs include arrangement costs and guarantee fees – not just interest; debt includes interest-bearing trade payables, and equity includes retained earnings plus non-interest bearing loans from related parties.

The D/E ratio is determined by the total of the average of the month-end balances for the relevant debt and equity accounts. If the ratio exceeds 4:1 then there is a proportionate adjustment to the deductible borrowing costs. That is, if the ratio was 5:1 then the maximum deduction is 4/5 or 80% of the total borrowing costs.

If the company has negative equity then no deduction is permitted. Therefore companies with negative equity or excessive D/E ratios may wish to analyse the implications of revising their capital structure.

Do note that the D/E Regulation only provides a maximum ratio. It is still possible that a tax auditor might argue that 4:1 is too high for the particular industry. Furthermore the company must also comply with the arms-length principle if there are borrowings from related parties.

Finally we note the D/E Regulation requires that private loans sourced from overseas must be reported to the Tax Office otherwise no deduction can be claimed for the borrowing cost. The mechanism for reporting will be stipulated by the Tax Office at a later date.

## KEY POINTS

- Claims for deductions relating to borrowing costs were subject to the general provisions of the Income Tax Law
- D/E ratio of up to 4:1 is permissible for the purposes of determining what borrowing costs can be deducted
- Companies with negative equity or excessive D/E ratios may wish to analyse the implications of revising their capital structure

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