Wake Up Call

How Should Business Manage Transfer Pricing Risk ?

In the last couple of years the Indonesia tax authority has shown their growing attention on Transfer Pricing matters. How do we, as a corporation prepare ourselves so that we do not have additional tax risk arising from transfer pricing examination by the tax authority?

Edwin W,Jakarta

RSM AAJ
Audit • Tax • Advisory

Transfer-pricing (TP) is the mechanism for setting the arm's length (market) price for goods and services between related parties. That is, TP is a legitimate (and legally required) process to

allocate profits between related parties based on their contributions to the group's business.

A company that engages in transactions with related parties must:

- Disclose these transactions in its Corporate Tax Return
- Prepare a formal TP Report for those transactions with an overseas related party that exceed IDR 10 billion per year, and
- Maintain documentation to support that any other transactions with overseas related parties that are IDR 10 billion or less per year are undertaken on an arm's length basis

The TP obligations also apply for transactions between domestic related parties where there is potential for the parties to take advantage of difference tax regimes.

In all cases the company should ensure they have copies of the invoices, purchase orders, agreements, etc. In addition if there are charges for intercompany services then a tax auditor might request additional evidence (e.g. timesheets, copies of reports, emails, evidence of manuals provided) to show that the services were delivered and the taxpayer received a benefit from these charges.

We always recommend that documentation is collated during the year – and not at the time of a tax audit - because it is difficult to provide the information within the tight tax audit deadlines. Do remember, the key is to avoid an adjustment being proposed. Once it is proposed then it is very difficult to prevent this becoming a formal tax audit result with corporate tax assessment consequences.

If it is necessary to prepare a TP Report then this should also be prepared in advance of any tax audit. Technically it should be prepared at the time of the related party transactions; practically, it will be prepared after year-end. The reason for this is that the financial databases that are used are only updated once companies submit their financials to the corporate registrar in their country (and the database companies can then access these financials).

When preparing the TP Report the taxpayer needs to understand the objective is to identify comparable products/services that are offered to third parties. If the taxpayer does not deal with third parties then it is necessary to benchmark the taxpayer's prices (or profit) against third party market data. This process requires an analysis of:

- the Group structure,
- the business and relevant sector (e.g. size, location, growth, competitors)
- the Functions performed, Assets utilised and Risks assumed by the company and the related party (known as a FAR analysis)

Based on this a financial database is then used to select potential comparable companies. Their financial results (e.g. net profit) are then compared to the taxpayer's. The comparison uses a range and it is acceptable to fall within the "inter-quartile" range. Or more simply, the taxpayer's position within the range is neither too high nor too low.

Do note that the TP process is not a science and it is possible that the tax auditors will disagree. A professionally prepared TP Report will, however, place the taxpayer in a far better position than if no document exists. Thus it is a form of insurance.

And a final thought. Make sure that the structure used for the TP process mirrors the actual operations and is not based on Head Office's assumptions. This will reduce the risk the tax auditor notes that the situation in the field is not consistent with the TP Report with potentially material consequences for the tax audit.

KEY POINTS

- That is, TP is a legitimate (and legally required) process to allocate profits between related parties based on their contributions to the group′s business.
- When preparing the TP Report the taxpayer needs to understand the objective is to identify comparable products/services that are offered to third parties.
- A professionally prepared TP Report will place the taxpayer in a far better position than if no document exists.

Irwan B Afiff MBA
Senior Managing Partner
irwan.afiff@rsmaaj.com

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