



# REVISED REGULATION FOR THE IMPLEMENTATION OF THE ARMS LENGTH PRINCIPLE IN INDONESIA

## RSM INDONESIA CLIENT ALERT – 1 February 2024

Minister of Finance Regulation No. 172 regarding Application of Arm's Length Principle on Transaction Affected by Special Relationship was issued on 29 December 2023 ("MoFR-172"). MoFR-172 was mandated by Article 37 of Government Regulation No. 55 of 2022 (GR-55). It applies to any taxpayer conducting transaction affected by special relationship.

In addition to providing additional clarification and guidance, MoFR-172 combines the regulatory content of three previous Minister of Finance regulations: MoFR-213/2016, which regulates transfer pricing documentation; MoFR-49/2019, which oversees the administration of the Mutual Agreement Procedure ("MAP"), and MoFR-22/2020, which contains administrative regulations for the Advance Pricing Agreement ("APA") as well as the norm for applying the arms length principle ("ALP"). Therefore, these regulations are now revoked.

This Client Alert summarises MOFR-172 and highlights key points for taxpayers conducting transactions where there is a special relationship.

### **When is MoFR-172 effective?**

MoFR-172 is effective on 29 December 2023. However, the obligation to comply with MoFR-172 provision on documentation is effective for fiscal year 2024 and onwards.

### **What is the Arm's Length Principle?**

A principle which is applied in sound business practice as observed in Independent Transaction.

### **What is Transfer Pricing?**

Determination of price in transaction where the parties are in a special relationship.

## What are the significant updates on MoFR 172?

Main Issue		MOFR-172
1	Application of ALP	Provides more details on the activity/work to be performed in every stage of applying the ALP
2	TP Documentation (come in force for FY 2024 and onwards)	<ul style="list-style-type: none"> <li>a. Must be provided within one month after requested by the Director-General of Taxation (“DGT”) for tax audit or compliance supervision purposes.</li> <li>b. Country-by-Country Reporting (“CbCR”) threshold is determined based on consolidated revenue for the year preceding the reporting year</li> </ul>
3	Secondary adjustment	<ul style="list-style-type: none"> <li>a. Secondary adjustment arises both in tax audit process and compliance supervision</li> <li>b. Waived if taxpayer agrees on tax audit result and/or repatriation</li> <li>c. Applies in all types of special relationship</li> </ul>
4	Corresponding adjustment	Stipulate criteria and mechanisms for corresponding adjustment: <ul style="list-style-type: none"> <li>a. Taxpayers agree to the tax assessment letter</li> <li>b. Taxpayers do not lodge/commence tax litigation procedure</li> <li>c. Implemented through correction of annual income tax return, tax audit process, or correction of tax assessment letter</li> </ul>
5	VAT adjustment	<ul style="list-style-type: none"> <li>a. Reaffirm DGT authority to apply ALP for VAT</li> <li>b. Transfer pricing adjustment by DGT in selling price does not result any adjustment on Input VAT credit for the purchaser/user</li> </ul>
6	MAP	The Decision Letter of Mutual Agreement can be directly executed as the basis for tax refund or tax collection
7	APA	<ul style="list-style-type: none"> <li>a. Introducing Multilateral APA</li> <li>b. Removing administrative sanctions for taxpayers who implement the agreed APA</li> </ul>

## Definition of Special Relationship

A special relationship arises if there is dependence or attachment due to ownership, control, and/or familial relationship by blood or marriage.

## Application of ALP

The application of ALP requires comparing the conditions and price indicators between transactions affected by a special relationship and comparable independent transactions. It is conducted based on actual conditions, at the time the transfer price is determined, and following the stages per the table below:

ALP Stages		Activity
1	Identification of transaction affected by special relationship	No Significant changes from earlier guidelines.
2	Industrial analysis	Indicative suggestions are provided for performing analysis of: <ul style="list-style-type: none"> <li>a. Type of products or services provided.</li> <li>b. Industry and market characteristics.</li> <li>c. Competitor and business competition level.</li> <li>d. Efficiency level and location specific advantages.</li> <li>e. Economic circumstances that affect industry.</li> <li>f. Relevant regulation in the industry.</li> <li>g. Other factors which affect business performance in the industry.</li> </ul>

ALP Stages		Activity
3	Analysis on transaction condition/comparability factors.	No Significant changes from earlier guidelines.
4	Comparability analysis	<ul style="list-style-type: none"> <li>• Emphasize the application of reliable adjustments to promote the comparability between the otherwise tested party transaction and the comparable data.</li> <li>• Geographical compatibility is also suggested importance irrespective of the location of the tested party.</li> <li>• Comparability analysis where profit level indicators are applied should be applied using single year comparable data unless the use of multiple year data improves comparability. The burden of proof will be on Taxpayers to support that the use of multiple year data improves comparability as against the expected preference to single year data by the tax office otherwise.</li> </ul>
5	Transfer pricing method	<p>Additional guidance provided for application of Profit Split Method (“PSM”) at the level of gross profit or net operating profit, by using contribution or residual analysis.</p> <p>Further, the three additional methods in HPP law has been added to the existing 5 methods in earlier guidelines.</p>
6	Determination of arm’s length price	Arm’s length price can be in the form of an arm’s length point, or an arm’s length range which may be the full range (minimum or maximum value if only two comparable are available), or interquartile range (Quartile 1 to Quartile 3 from three or more comparable used).

## Additional Requirement and Increased Burden to Prove the Benefits of Certain Transactions

During tax audits, the tax auditors regularly questioned the taxpayers to prove the benefit for the Indonesian taxpayer. MOFR-172 now formalises this practice by requiring the taxpayer to prove the benefits of the transaction affected by special relationship through Preliminary Stage, which means it must be documented in the local file. The benefits may be in the form of increasing sales, reducing costs, protecting commercial positions, or meeting the needs of other commercial activities, including activities to obtain, collect, and maintain income. The specific intragroup transactions that need proof of benefits at the Preliminary Stage are:

1. Intragroup services
2. The use or right to use intangible assets
3. Intragroup loan
4. Other financial transaction
5. Transfer of asset
6. Business restructuring
7. Cost contribution arrangement

## Implementation of ALP for Permanent Establishments

MOFR-172 requires domestic taxpayers that are Permanent Establishments to submit all data and information related to transactions carried out by the affiliated party abroad which are related to the business or activities of the Permanent Establishment in Indonesia. If this is not complied, the tax officer has been empowered to apply the arm’s length principle *Suo Moto* to adjust the PE’s income.

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## Transfer Pricing Documentation

- a. Country-by-Country Reporting (CbCR) applies for business groups with consolidated revenue in the previous fiscal year exceeding IDR 11 trillion (equivalent to EUR 750 million). This change has made the CbCR preparation consistent to the preparation of local and master file for which thresholds are provided and to be evaluated from the previous fiscal year.
- b. If the tax authority requests the full transfer pricing documentation for tax audit or compliance supervision purposes, taxpayers must provide these within a month of the request. Non-compliance could result in penalties from the tax authority.

## Primary Adjustment

The Directorate General of Taxes (DGT) is authorized to assess whether:

- a. taxpayers meet the requirement for transfer pricing documentation as regulated in MOFR-172
- b. taxpayers comply with ALP as regulated in MOFR-172

If the obligation is not met, DGT is authorized to recalculate income and deductions for the purposes of computing income tax (primary adjustment). Such recalculations shall be carried out based on the stages for application of ALP.

## Secondary Adjustment

The primary adjustment triggers a secondary adjustment, in which the adjustment conducted by DGT or taxpayers is treated as a dividend to the related party and taxed with the provisions of the Income Tax Law (withholding tax). It applies to all types of special relationships, irrespective of whether it is caused by ownership, control, or blood relation. However, MOFR-172 provides relaxation for secondary adjustments if the taxpayer agrees to the tax assessment letter and/or repatriates the funds.


## Domestic Corresponding adjustments

The corresponding adjustment guidance and process for transfer pricing between domestic related parties is provided. It requires written notification to DGT and will be executed by following the below steps:

- a. amendment of the annual corporate income tax return (CITR) if the counterpart has not been tax audited
- b. issuance of a tax assessment letter which considers the correction by DGT, if a tax audit for the counterpart has begun
- c. correction of tax assessment letter, if a tax assessment letter has been issued and the taxpayers agree with the result and do not commence tax litigation

## Value Added Tax (VAT) Adjustments

MOFR-172 reaffirms the DGT authority to apply ALP and make a transfer pricing adjustment for VAT when the selling price is lower than the market price. Furthermore, MOFR-172 confirms that the related party user of the tax invoice can still credit the tax invoice if it meets the requirements enacted in VAT Law. However, MOFR-172 stipulates that the transfer pricing adjustment on the selling price does not result in an adjustment of input tax for the related party user of the invoice.



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## Mutual Agreement Procedure (MAP) to Resolve Transfer Pricing Dispute

### MAP Process and Timeline

An MAP application can be submitted in parallel with the domestic tax litigation process, such as objection, appeal, application for reduction or cancellation of an incorrect tax assessment and judicial review to the Supreme Court. However, MAP does not defer the obligation for payment of tax payable, tax collection, and/or tax refund. Besides, there are no significant changes in the MAP regulations from the earlier guidance/regulations.

### Advance Pricing Agreement (APA) to Prevent Transfer Pricing Dispute

APA now provides increased benefit by firstly introduce Multilateral APA and waives administrative sanctions for taxpayers who implement the agreed-APA. Furthermore, no significant changes in administrative procedure from earlier guidelines/regulations.

## KEY TAKEAWAYS:

- The combination of primary, secondary, and VAT adjustment from the application of ALP in MOFR-172 may result in triple taxation. Taxpayers should prepare robust and thorough transfer pricing documentation to justify the ALP as a preventive measure.
- More robust contractual agreements and documentation must be internally maintained by taxpayers to facilitate reliable comparability adjustments and also to prove benefits tests for intra group services.
- Profit attribution reports should be emphasized to justify the ALP of transactions with an Indonesian PE.
- Relaxation for secondary adjustments benefits applies only at tax audit stage and does not provide cover for waive off at appeal stage. This could be a material consideration for companies in their litigation and tax audit strategy.
- Use of Domestic Corresponding adjustments can be explored between group companies in viable cases to prevent protracted disputes.
- For cross border transactions, MAP could be an alternative dispute resolution mechanism for the taxpayers in addition to any domestic remedy such as an objection and appeal.
- APA could be an optimal solution for high-value historically litigated transactions and/or complex transactions.

For further information please contact:

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