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Indonesia’s new armour – Thin Capitalization Rules

As a step towards curbing the burgeoning offshore loans and preventing excessive borrowing from related parties, the Indonesian Minister of Finance (MoF) reintroduced the Thin Capitalization Rules in Indonesia on 9 September 2015. Thin capitalization refers to the situation in which a company is financed through a relatively high level of debt compared to equity.

This regulation titled “Determination of Company’s Debt and Equity Ratio for Income Tax Calculation Purpose” is set out in the Indonesian Minister of Finance Regulation (PMK) Number 169/PMK.010/2015 (“PMK-169”).

The regulation was issued with the background of a sharp increase in offshore loans by companies operating in Indonesia. According to the latest data from Bank Indonesia, the country’s foreign debt stood at USD 304.3 billion at the end of the second quarter of 2015, including USD 169.7 billion of private sector external debt. This, according to Reuters data, is approximately 14 percent higher than a year ago, and almost twice the size of such loans in 2010.

Back in October 1984, the Minister of Finance, through decision Number 1002/KMK.04/1984, had issued a regulation that stipulated a debt-to-equity ratio (DER) of 3:1 as a legal basis for the determination of deduction for interest expenses as part of the corporate income tax calculation. Six months later, the Minister of Finance, through decision Number 254/KMK.04/1985 dated 8 March 1985, postponed the implementation of the regulation based on the view that the regulation could dampen the investment climate in Indonesia. The aforementioned regulations have now been revoked in light of the issuance of PMK-169.

Further, the Directorate General of Tax (DGT) had issued a circular letter SE-50/PJ/2013 (SE-50) dated 24 October 2013 regarding technical guidelines for audits of taxpayers with special relationships. Among various technical matters, SE-50 provided guidance on intercompany funding that included “Test the reasonableness of a Taxpayer’s DER” as one of the criteria to analyze the arm’s length basis of the interest rate on intercompany borrowings. The circular letter was, however, silent on what could be considered as a “reasonable” DER.

PMK-169, which is effective on 9 September 2015, provides detailed guidance on the scope of related parties, definition of debts and equity, prescribed threshold for DER, and other compliance requirements. This alert looks at some of the key features of PMK-169.

Debt-to-equity ratio of 4:1

The rule set out in this regulation essentially limits the amount of tax-deductible borrowing cost arising from the debt to a maximum DER of 4:1. This ratio will be effective from Fiscal Year 2016.

Any borrowing cost on debt which exceeds this ratio will not be tax deductible for corporate income tax purpose. For example, if the Taxpayer's DER is 6:1, two sixths of the borrowing cost will be non-deductible for income tax calculation. It is important to note that the rule applies to both related- and third-party debt, whether foreign or domestically availed.

The regulation is silent as to whether non-deductible interest expense can be carried forward and can be deducted in a later year.

Definition and calculation of debt and equity

A significant aspect of this regulation is the definition of debt and equity. Debt, as defined in this regulation, includes both short-term and long-term debts as well as interest-bearing trade payable. The regulation is however unclear on whether the imposition of penalty for late payment of trade payable would also be considered as "interest-bearing trade payable".

In relation to the definition of equity, PMK-169 relies on the prevailing principles of accounting or financial standards, extended to include any non-interest-bearing loan from related party. Through an example provided in this regulation, shareholders equity, share premium (*agio saham*), retained earnings, and non-interest-bearing loan from related party have all been considered as equity.

The calculation of the debt or equity itself will be based on the following:

a. The average debt or equity balance at the end of each month in the relevant fiscal year; or
b. The average debt or equity balance at the end of each month of a part of the relevant fiscal year.

Furthermore, the regulation emphasizes that for taxpayers who have zero or less than zero equity balance, the entire borrowing expense will be disallowed for income tax calculation purpose.

Considering this provision, taxpayers with negative retained earnings need to be cautious, as this situation could reduce the amount of deductible borrowing expenses.

Exemptions from this regulation

The permitted 4:1 DER is applicable for all Indonesian taxpayers established or domiciled in Indonesia, except for certain sectors which are guided by special rules, such as:

a. Banks;
b. Financing institutions;
c. Insurance and re-insurance companies;
d. Mining, oil and gas enterprises that are bound by Production Sharing Contract, Contract of Work or Coal Contract of Work which itself governs the DER. If the contract does not include a provision for the DER or the contract has expired, PMK-169 will prevail;
e. Companies subject to Final income tax; and
f. Infrastructure companies.

Impact on Cost of Borrowing

PMK-169 stipulates that if the taxpayer's DER exceeds the prescribed 4:1 threshold, the excess interest expenses will be non-deductible for income tax calculation. PMK-169 has defined cost of borrowing to include:

a. Interest;
b. Discount and premiums in connection with the debt;
c. Additional costs incurred in relation to the arrangement of borrowings;
d. Finance charges on lease financing;
e. Guarantee fee; and
f. Foreign exchange differences arising from loans in foreign currencies as long as the differences are adjustments to the interest expense and other expenses as referred to in b, c, d and e.

Taxpayers need to take into account exchange rate volatility with relation to foreign debts, especially given that the Indonesian Rupiah has been depreciating drastically over the past two years. If the Indonesian Rupiah continues to fall from the current levels, company borrowings could increase, in turn affecting their ratios.

Moreover, the regulation reiterates that in addition to the DER test laid out in PMK-169, any interest expense from related-party debt must also comply with arm's length principle in Indonesia, which includes the requirement to document the need for the debt, the existence test, and analyzing the arm's length basis of the applied interest rate.

Foreign private debt needs to be reported

Besides complying with the prescribed DER under PMK-169, taxpayers with foreign private debt also need to submit a report on the amount of the debt to the DGT. Failure to comply will result in a disallowance of the borrowing cost attributed to the foreign private debt.

The DGT will issue an implementing regulation separately for the procedure to report foreign private debt.

Conclusion

With the issuance of this regulation, the intention of the DGT is clear – to limit the erosion of an Indonesian company's tax base through the payment of "excessive interest" on debt from related parties. Tightening up the thin capitalization rules is one way Indonesia can play its part in tackling the taxation of multinationals and the global tax base erosion and profit-shifting (BEPS) problem. This could well be a step in that direction.

The tighter rules also mean that the tax office can potentially collect more tax due from companies with DER higher than the prescribed limit. No doubt with the backdrop of the BEPS as the underlying reason for these changes, tax offices may feel very bullish about this regulation as there is pressure to collect more tax revenues in light of the increased budget for the current fiscal year. This is also in line with the DGT's plan to make 2016 as the year of Tax Law Enforcement in Indonesia.

The regulation is likely to have an impact on both domestic and foreign companies doing business in the country. The new DER regulation will require taxpayers to review existing funding arrangements to determine the characterization of the relevant interest under the new DER rules for Indonesian tax purposes. It is advisable that the taxpayers conduct a full review of the intercompany financing arrangements through preparation of robust transfer pricing documentation to support deductibility of such expenses.

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