Indonesia:
Thin capitalization rules reintroduced

Indonesia’s Minister of Finance (MOF) issued a regulation on 9 September 2015 (PMK-169) that reintroduces thin capitalization rules; the regulation applies as from fiscal year 2016. The new rules are aimed at curbing offshore loans and preventing excessive borrowing from related parties, and were issued specifically in response to a sharp increase in offshore loans by companies operating in Indonesia and the OECD’s base erosion and profit shifting (BEPS) initiative. 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, and included USD 169.7 billion of private sector external debt. The country’s foreign debt, according to Reuters’ data, is approximately 14% higher than it was a year ago, and the number of offshore loans has nearly doubled since 2010.

Thin capitalization rules originally issued in October 1984 disallowed the deductibility of borrowing costs for corporate income tax purposes if a debt-to-equity ratio of 3:1 was exceeded. In March 1985, the MOF deferred the implementation of the rules, based on its view that the rules would hamper the investment climate in Indonesia. Those measures have been revoked in light of the issuance of PMK-169. It also should be noted that a circular letter issued by the Directorate General of Tax (DGT) in 2013 on intercompany funding authorizes the MOF to determine the debt-to-equity ratio of companies for tax calculation purposes (although the circular letter is silent on what is considered a “reasonable” debt-to-equity ratio), and the circular letter is not expressly revoked by PMK-169.

PMK-169 provides a prescribed debt-to-equity ratio; definitions of debt and equity, as well as the cost of borrowing; exemptions for certain sectors; rules regarding foreign private debt; and other compliance requirements.

Debt-to-equity ratio and definitions

PMK-169 sets the debt-to-equity ratio at 4:1; any borrowing costs on debt that exceeds the ratio will not be tax deductible for corporate income tax purposes.

PMK-169 applies to related and third-party debt and to debt from domestic and foreign sources. However, it is silent on whether nondeductible borrowing costs can be carried forward or deducted in a subsequent tax year.

PMK-169 defines “debt” to include both short-term and long-term debt, as well as interest-bearing trade payables. The regulation, however, is unclear as to whether the imposition of a penalty for late payment of a trade payable would be considered an interest-bearing trade payable. PMK-169 relies on the prevailing principles of accounting or financial standards in relation to its definition of equity, and thus includes non-interest-bearing loans from a related party within the definition. The regulation also specifically provides that shareholder equity, share premiums, retained earnings and non-interest-bearing loans from related parties are considered equity for its purposes.

The calculation of debt or equity will be based on the following:
- The average debt or equity balance at the end of each month in the relevant tax year; or
- The average debt or equity balance at the end of each month of a portion of the relevant tax year.

PMK-169 emphasizes that, for taxpayers with zero or negative equity, the entire borrowing cost expense will be disallowed for income tax calculation purposes. Thus, taxpayers with negative retained earnings will need to be cautious, as this situation could reduce the amount of the deductible borrowing cost expense.

**Cost of borrowing**

PMK-169 defines “cost of borrowing” to include the following:

1. Interest;
2. Discounts and premiums in connection with the debt;
3. Additional costs incurred in relation to the arrangement of borrowings;
4. Finance charges on finance leases;
5. Guarantee fees; and
6. Foreign exchange differences arising from loans in foreign currencies (as long as the differences are adjustments to the interest expense and other borrowing costs referred to in items (2) through (4) above).

Taxpayers will need to take into account the exchange rate volatility with respect to foreign debt, in light of the fact that the Indonesian rupiah has been depreciating drastically over the past two years. If the rupiah continues to fall from its current level, a company’s borrowings could increase, which would affect the debt-to-equity ratio.

PMK-169 reiterates that, in addition to complying with the debt-to-equity ratio, a taxpayer must be able to demonstrate that related-party borrowing costs are on arm’s length terms.

**Exemptions**

The 4:1 debt-to-equity ratio is applicable to all taxpayers established or domiciled in Indonesia, except for certain entities that are subject to special rules:

- Banks;
- Financing institutions;
- Insurance and reinsurance companies;
- Mining, oil and gas enterprises that are subject to production-sharing agreements and contracts of work, or coal contracts of work, that specifically include a provision on the debt-to-equity ratio (if the contract is silent on the applicable ratio, or the contract has expired, the provisions under PMK-169 will prevail);
- Companies subject to final income tax; and
- Infrastructure companies.
Foreign private debt

In addition to complying with the prescribed debt-to-equity ratio under PMK-169, taxpayers with foreign private debt also must submit a report to the DGT that sets out the amount of the debt. Failure to comply will result in a disallowance of the borrowing costs associated with the foreign private debt. The DGT will issue a separate implementing regulation outlining the procedure for reporting foreign private debt.

Comments

The intention of the DGT with respect to its issuance of PMT-169 is clear: to limit the erosion of an Indonesian company’s tax base through the payment of excessive interest on related-party debt. Tightening up the thin capitalization rules is one way Indonesia can play its part in tackling the issues identified in the BEPS initiative.

The tighter rules also mean that the Indonesian tax authorities potentially will be able to collect more tax from companies whose debt-to-equity ratios exceed the prescribed limit. With BEPS as one underlying reason for the new rules, in addition to the DGT’s plan to make 2016 the year of tax law enforcement in Indonesia, the tax authorities may use PMK-169 to collect more tax revenue to support the current fiscal year’s increased budget.

PMK-169 is likely to have an impact on domestic and foreign companies doing business in Indonesia. The new regulation will require taxpayers to review existing funding arrangements to determine the proper characterization of borrowing costs for Indonesian tax purposes. Taxpayers should conduct a full review of their intercompany financing arrangements and prepare robust transfer pricing documentation to support the deductibility of such expenses.

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