Taxand

Indonesia’s new Thin Capitalisation rules

Thin Capitalisation refers to a condition where a company is financed with a high level of debt compared to the equity (highly leveraged). Multinational companies are often structured through this arrangement whereby they get advantage by having the lender in a very low tax rate country (as they receive interest income) and the borrower in a country where interest cost can be deducted for income tax purposes. This structure can be made in a way to shift profit to the lower income tax rate countries. The financing of MNCs in Indonesia through debt more than equity has become a big concern in Indonesia. To overcome this issue, on September 9, 2015, the Minister of Finance issued a regulation through MoF regulation number 169/PMK.010/2015 (PMK-169) regarding the determination of ratio of debt to equity for income tax calculation purposes. This thin Capitalisation rule has set a 4 to 1 debt to equity ratio in limiting the deductibility of interest expense when calculating the income tax liability. This regulation is effective starting in fiscal year 2016.

Historically, in October 1984, the Minister of Finance issued a decision number 1002/KMK.04/1984, which stipulated a debt-to-equity ratio (DER) of 3:1 as a determination of interest expenses deduction for income tax calculation purposes. However, within six month period, the Minister of Finance issued another decision Number 254/KMK.04/1985 dated 8 March 1985 which postponed the implementation of the regulation with consideration that the regulation could diminish the investment growth in Indonesia. After 31 years of postponement, the Minister of Finance issued PMK-169 to revoke the old decision and reissued a new DER of 4:1.

The definition of debt and equity

The significance of this regulation other than the ratio itself is the definition of debt and equity. For the purpose of this rule, debt is defined as long term and short term debts, including interest bearing trade payable. The equity definition follows the applicable financial accounting standards and non-interest bearing loans from related parties.

The calculation of DER 4:1 is based on:
a) average of debt and equity balance at the end of each month in the relevant tax year; or
b) average of debt and equity balance at the end of each month in the relevant part of tax year.

Who are exempted from this regulation?

a) banks
b) financial institutions
c) insurance and re-insurance companies
d) oil and gas mining, general mining, and other mining companies which are bound to production sharing contract, contract of work, or Coal Contract of Work whereby the contract stipulates the provisions on limitation of debt to equity ratio
e) Companies which are subject to final income tax
f) Infrastructure Companies

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What is deductible?

In the event that amount of debt to equity ratio of Taxpayer exceeds the ratio of 4:1, the costs of loan that can be deducted in calculating taxable income is limited to the cost of loan that correspond to 4:1 DER. The costs of loan as which can be calculated related to borrowing of funds include:
a) loan interest
b) loan discount and premium
c) additional costs relating to arrangement of borrowings
d) financial changes in lease financing
e) guarantee fee
f) foreign exchange differences arising from loans in foreign currencies as long as the exchange rate differences are adjustment to interest expenses and costs as referred in b, c, d, and e

In case taxpayers have intercompany loans, they also need to comply with the Arm's Length principle as referred to in Article 18 paragraph (3) Income Tax Law number 36 year 2008.

In case taxpayers have zero or negative equity, all borrowing costs shall not be taken into account in calculating the taxable income

What does this Thin Capitalisation regulation means for Indonesia?

1. Currently, Indonesian Tax Office is getting more aggressive in increasing its tax revenues. This regulation might assist them in getting bigger tax adjustments.
2. Increase the taxpayer's tax burden as it basically adds more non-deductible expense items to the bucket list to calculate the tax liability. It means the effective corporate tax rate increases as well.
3. Existing financing arrangements should be reviewed to mitigate the impact of the said regulation.
4. Loss-making companies with negative equity should consider fresh capital injection or debt-to equity conversion. Whilst converting a shareholder loan to a non-interest bearing loan for the purposes of meeting the required DER may be considered an option, specific conditions as Government Regulation No. 54/2010 should be complied with.

Taxand's Take

Multinational Companies should prepare a robust transfer pricing documentation related to their intercompany loan arrangement to be able to equip themselves when challenged regarding the deductibility of the loan interest expense.

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