Indonesia’s Director General of Taxation (the DGT) has issued DGT Regulation No. 25/PJ/2017 (PER-25) providing implementing regulations on Indonesia’s thin capitalization rules by applying a 4:1 debt-to-equity ratio (DER). The primary rules for DER are contained in Minister of Finance Regulation No. 169/PMK.010/2015 (PMK-169).1 PER-25 provides some clarity on the implementation of thin capitalization rules in Indonesia and includes an obligation to report the DER calculation and private overseas loan details to the DGT as part of the company’s income tax return.

This DER rule is applicable for fiscal years beginning in 2016. However, the requirement to attach the DER calculation and any private overseas loan report is effective for the 2017 fiscal year tax return and thereafter. The annual reporting of the DER calculation and any private overseas loans must use the specified forms attached to PER-25.

This Alert summarizes key aspects of PER-25.
General approach
Consistent with PMK-169, PER-25 applies to broadly defined borrowing costs, including interest, premiums, discounts, guarantee fees, other costs incurred in arranging the borrowing, financing costs on borrowing, and foreign exchange gains and losses related to the borrowing. Banks, insurers and other specific industries remain outside the thin capitalization rules.

Debt and equity balances will be calculated using the average of the month-end balances. The term “debt” includes short- and long-term debts and interest bearing trade payables. The term “equity” is the amount shown on financial statements but is increased by intercompany interest-free loans. Under the DER regulations, any borrowing costs in excess of liability over the 4:1 DER will be permanently disallowed as a deductible expense.

PER-25 provides a number of examples, demonstrating the application of the DER and adjustments for other matters in the regulation, e.g., borrowing for nondeductible purposes.

Thin capitalization limits are in addition to general deduction rules
PER-25 clarifies that deductible interest expenses permitted under the DER rules must also satisfy the conditions of deductibility under Articles 6 and 9 of the Income Tax Law.

DER rule and the application of arm’s-length principle for related party debt
In the event a company has an intercompany borrowing from a related party, in addition to the thin capitalization regime, the interest expense must meet the arm’s-length principle.

An example demonstrates both a reduction in deductible interest pursuant to the 4:1 DER and a reduction in the rate of interest on the intercompany loan under the arm’s-length principle. Interest expenses in excess of the 4:1 DER will be recast as a dividend to the lender at the time of the actual interest payment or at the time of maturity.

Requirements to submit an annual DER calculation and private overseas loan reports
PER-25 sets out implementing rules on the PMK-169 requirement by requiring an attachment of a DER calculation in the specified form to the company’s corporate income tax return. Failure to submit the DER calculation attachment results in potential penalties, since the annual corporate income tax return is considered incomplete.

If a company has any private cross-border borrowings, it must also submit the private overseas loan report using the standard form as an attachment to its annual corporate income tax return. Failure to submit the private overseas loan report with its annual corporate income tax return would cause the return to be incomplete and the interest expense on the private overseas loans would become nondeductible.

Endnote
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EYG no. 01568-181Gbl
1508-1600216 NY
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