Indonesian “Thin Capitalization” Rules

The Minister of Finance (“MoF”) on 9 September 2015 issued the long awaiting “thin capitalization” rules regarding finance expenses that can be deducted when calculating corporate income tax payable, in its regulation No. 169/PMK.010/2015.

In this regulation, the MoF has set a Debt to Equity Ratio (“DER”) maximum of **4:1**, effective for Fiscal Year 2016 onwards.

**Definitions for the DER calculation:**

1. Debt:
   a. Is the average of month end outstanding debt balances in a tax/fiscal year or part of a fiscal year,
   b. Includes short term and long term debt and interest bearing trade payables. (We believe that interest bearing loans from related parties are included in this definition of debt), and
   c. Excludes non-interest bearing related party loans.

2. Equity:
   a. Is the average of month end equity balances in a fiscal year or part of a fiscal year, determined in accordance with Indonesian Financial Accounting Standards, plus
   b. The average of month end outstanding debt balances in a tax/fiscal year or part of a fiscal year of non-interest bearing related party loans.

**Exemption from the “thin capitalization” rules applies to the following corporate taxpayers:**

1. Banks, including the Bank of Indonesia,
2. Financial institutions/leasing companies that engage in providing funds and/or capital goods,
3. Insurance and reinsurance companies, including Syuriah compliant insurance and reinsurance companies,
4. Oil and gas and mining companies under a Contract of Work, Production Sharing Contract and other agreements with the government that have specific provisions for DER (if such provisions do not exist, the taxpayer is not exempt from the 4:1 DER requirement),
5. Companies subject to a final tax regime, and
6. Companies engaged in infrastructure businesses.

**Finance expenses, subject to the DER calculation, include:**

1. Interest on loans,
2. Discount and premium on loans,
3. Additional expenses to acquire the loans (borrowing arrangements),
4. Finance charges in a financial lease transaction,
5. Costs related to obtaining loan repayment guarantees, and
6. Foreign exchange differences resulting from translating foreign currency loans, provided that such differences result in adjustments to interest expense and/or the other financial expenses above.

**Other important matters to be considered:**

- If the average month end equity balance in a tax/fiscal year or part of a fiscal year is zero or negative, no finance expenses are deductible in the corporate tax payable computation.
- Interest rates on related party loans must still be at arm’s length to be deductible.
- Foreign loans must be reported to the Director General of Taxes (DGT). (We expect the DGT to issue further implementing regulations on report timing, the form to be used and any mechanism to obtain a filing deferment.)

**KPMG comments:**

The new “thin capitalization” rules will increase many taxpayers’ burden and may become an additional barrier for new investors in Indonesia.

The effective tax rate may increase significantly for companies not meeting the 4:1 DER requirement and negatively impact their cash flows.

Consideration of recapitalization alternatives may be appropriate for companies not meeting the 4:1 DER requirement, especially if interest income from related party loans is taxable in another jurisdiction but the interest expense is not deductible in Indonesia.

In addition, for some foreign investors, there may be a limitation in their home country on deducting interest expense if the investment in and/or loans to Indonesia are funded by loans obtained at the shareholder’s level.

For new investments, it may be worth considering applying for other tax incentives, such as tax holiday or tax allowances.

**Contact us**

**KPMG Advisory Indonesia**

Abraham Pierre
Partner In Charge,
Tax Services
Abraham.Pierre@kpmg.co.id
Kpmg.com/id

**KPMG Advisory Indonesia**

33rd Floor Wisma GKBI
28, Jl. Jend. Sudirman
Jakarta 10210, Indonesia
**T:** +62 (0) 21 570 4888
**F:** +62 (0) 21 570 5888

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