



ANALYSIS OF INTEREST EXPENSE DEDUCTION IN TRANSFER PRICING DISPUTE IN INDONESIA

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Abstract

This study provides a comprehensive examination of interest expense disputes within the context of transfer pricing in Indonesia. Multinational enterprises frequently employ transfer pricing mechanisms to reduce their tax obligations, often leading to legal challenges in tax courts. The research employs a qualitative methodology, focusing on a detailed analysis of several tax court verdicts related to interest expense disputes. The primary dataset comprises appellate verdicts available from the official tax court repository. The study identifies key factors influencing the outcomes of such disputes, including the strength of the evidence presented, the consistency between recorded contracts and actual economic conditions, coherence between transfer pricing documentation and real-world practices, the legitimacy and rationality of the loan arrangements, utilization of reliable comparability data, and substantive arguments concerning the applicability of the Debt-to-Equity Ratio (DER) for assessing interest expense reasonableness. Furthermore, the research underscores crucial considerations for taxpayers, such as the role of DER in determining expense reasonableness, the regulatory framework governing interest-free loans, methodologies for applying the arm's length principle in interest expense transactions, and the importance of meticulous documentation in transfer pricing files (TP Documentation).

Keywords: Comparability analysis, DER, Interest expenses, Tax dispute, Transfer pricing

INTRODUCTION

Transfer pricing, mispricing, or abuse of transfer pricing practices are not new phenomena in the realm of taxation, including in Indonesia. In Asia-Pacific, 21 out of 33 countries have reported base erosion and profit shifting (BEPS) as a top priority in monitoring taxpayer compliance (ADB, 2020). In Indonesia, typical non-compliance schemes include profit shifting/transfer pricing, unpaid value-added tax (VAT) debt issues, and failure to submit tax returns as per regulations (ADB, 2016).

Transfer pricing (also referred to as intracompany pricing, intercorporate pricing, interdivisional pricing, or internal pricing) is defined as the prices charged for management control purposes over the transfer of goods and services between group members (Mangoting, 2000). This definition has since shifted to a pejorative meaning, where transfer pricing is associated with tax avoidance through BEPS practices (Kurniawan, 2015).

Transfer pricing disputes in Indonesia primarily involve tangible asset sales/purchases (32%), intra-group services (27%), transactions involving intangible assets (18%), intergroup loans (16%), cost allocations (3%), marketing/promotional costs (1%), and other transactions (3%) (KPMG, 2023). Court verdicts vary according to the nature of each case, with the tax authority (Directorate General of Taxation - DGT) achieving its highest success rate in cases related to information technology services (100%) and interest income (100%). Meanwhile, taxpayers won predominantly in disputes related to loan interest expenses (82%) and royalty-related transactions (81%) (Tax Prime, 2022). The following table presents the win rates of DGT and taxpayers in transfer pricing disputes from 2014 to 2019:

Table 1. Percentage of Corporate Income Tax Decisions in Tax Court 2014-2019

Dispute Type	Number of Verdicts	Rejected	Accepted	Partially Accepted
Royalty	21	14%	81%	5%
Interest expenses	22	18%	82%	0%
Technical services	14	64%	36%	0%
Management fee	6	67%	33%	0%



Dispute Type	Number of Verdicts	Rejected	Accepted	Partially Accepted
Marketing fee	3	67%	33%	0%
IT services	2	100%	0%	0%
Intra-group services	1	0%	0%	100%
Cost of goods sold (purchases and costs)	10	40%	50%	10%
Sales	27	26%	59%	15%
Other expenses	7	43%	57%	0%
Interest income	1	100%	0%	0%

Source: Tax Prime, 2022.

As indicated in Table 1, taxpayers achieved a win rate of 82% in disputes involving interest expense on loans, representing the highest win rate for taxpayers in transfer pricing cases. Followed by the taxpayer's win in royalty dispute (81%), sales dispute (59%) and other expense dispute (57%). Interest expenses and royalty disputes are two top disputes that taxpayers mostly win.

Previous research on interest expense adjustments has been extensive. Santoso (2022) found that interest expense adjustments may result in additional tax liabilities, specifically dividend taxes, when interest expenses are reclassified as dividends, a consequence of the explanatory notes to Article 4, paragraph 1 of the Income Tax Law (PPH Law). Loshita Sari & Nuryanah (2023) concluded that the implementation of Minister of Finance Regulation (PMK) No. 169/PMK.010/2015 has increased the number of disputes related to thin capitalization due to the application of a 4:1 debt-to-equity ratio, which is deemed inappropriate for specific business characteristics and unfair in practice. Ilmiawan & Mardiasmo (2023) suggested improvements to Government Regulation (PP) number 94/2010, which regulates interest-free loans, particularly in clarifying the cumulative conditions and defining shareholder loans, to prevent cost-shifting schemes and ensure consistency with the Income Tax Law.

Given the complexity of these cases, this study seeks to analyze tax court verdicts related to interest expense disputes between taxpayers and the DGT, focusing specifically on the causes and factors that contributed to taxpayer victories or DGT losses. This study employs a qualitative approach with case studies. The primary data source is tax court appeal decisions, which are accessible via the official website and other online and offline data sources.

LITERATURE REVIEW

Agency Theory

Agency theory is widely recognized, especially in discussions involving agreements between capital owners and managers to manage a company. This often leads managers to engage in earnings management to safeguard their positions and meet the expectations of capital owners (Luayyi, 2012). An agency relationship arises when one or more individuals (the principal) hire another individual (the agent) to perform a service and delegate decision-making authority to the agent (Jensen & Meckling, 1979).

Capital owners delegate authority to managers to maximize company profits, which can include legal tax avoidance strategies. One way managers can engage in tax avoidance is through transfer pricing schemes. Managers representing the interests of capital owners are tasked with maximizing profits, including minimizing tax burdens through legitimate means, such as transfer pricing.



Tax and Tax Return (SPT)

Tax is defined as a compulsory contribution to the state owed by individuals or entities, which is imposed by law, without direct compensation and is used for the state's needs to achieve the greatest possible public welfare. This definition is outlined in the General Tax Provisions and Procedures Law (KUP). Several experts align their definitions of tax with this legal framework. For example, Prof. Dr. PJA Adriani defines *tax* as a compulsory contribution from the public to the state, which taxpayers owe according to general regulations without receiving direct compensation, and its purpose is to finance public expenditures. Similarly, Prof. Dr. H. Rochmat Soemitro describes the tax as a people's contribution to the state treasury, enforceable by law, without receiving any direct service in return, and used to cover public expenses (Purba, 2013). A slightly different definition is provided by Rosdiana & Irianto, (2012), who argue that the contemporary concept of taxation has shifted from "without direct compensation" to "with direct compensation," including transparency regarding the government's use of tax revenue.

Since the first tax reform in 1983, Indonesia's income tax system has operated on a self-assessment basis. Under this system, taxpayers are fully responsible for registering to obtain a Taxpayer Identification Number (NPWP), calculating the amount of tax owed, reconciling any underpayment or overpayment, paying the tax, and filing both monthly and annual Tax Returns (SPT). In practice, the SPT must be submitted accurately, clearly, and completely. "Accurate" means the SPT must contain truthful information reflecting the taxpayer's actual circumstances, which can be substantiated in terms of existence, substance, and fairness.

Taxpayers must report their income and expenses following the applicable regulations. Various articles in the Income Tax Law (PPH) specifically address income and allowable expenses, including Articles 4, 5, 6, 9, 11, and 11A. Article 18, Paragraph 3, also regulates the fairness of prices or profits in transactions with affiliated parties. One of the expenses deductible by taxpayers in calculating taxable income is any cost directly or indirectly related to business activities, such as the cost of raw materials, salaries, interest, rent, and royalties.

Tax Planning, Tax Avoidance, and Tax Evasion

Taxpayers may engage in tax planning, tax avoidance, or tax evasion as strategies to reduce their tax burden. Tax planning refers to the process of organizing a taxpayer's or a group of taxpayers' business activities in a manner that minimizes their tax liabilities, both in terms of income tax and other types of taxes, as long as such actions comply with existing legal provisions (Mangoting, 2000). Tax planning is a component of tax management, which is part of financial management, with the primary objective of maintaining adequate liquidity and profitability. Effective tax management allows taxpayers to fulfill their tax obligations accurately while minimizing the amount of tax payable, thus optimizing liquidity and profit.

Tax avoidance involves legally minimizing tax liabilities by utilizing provisions within tax regulations. While tax avoidance is lawful, it often attracts negative attention from tax authorities as it is not viewed favorably by the government (Oktavia et al., 2021). In contrast, tax evasion involves illegal actions, such as manipulating employee payroll records, underreporting income, or inflating expenses, which violate tax laws (Wahyuni, 2011). *Transfer pricing* is a common tax avoidance strategy used by multinational enterprises (MNEs). This involves shifting functions, assets, and risks (FAR) to group members in countries with lower tax rates, often through the transfer of intangible assets that are difficult to value (hard-to-value intangibles).

Affiliate Transaction, Transfer Pricing, and Arm's Length Principle

Multinational enterprises (MNEs) frequently engage in transactions with affiliated parties, also referred to as related parties. These affiliate transactions occur due to the failure of external markets, leading affiliated parties to internalize transactions, a phenomenon commonly



seen in multinational corporations (Darussalam et al., 2013). According to Article 18, paragraph (4) of the Income Tax Law (UU PPh), an affiliate relationship may arise due to shareholding or capital ownership exceeding 25%, control, or familial relationships by blood or marriage. Affiliate transactions refer to transactions conducted between parties with special relationships, as previously described. This definition has been expanded by the Ministry of Finance Regulation (PMK) No. 172/PMK.03/2023, introducing the concept of transactions influenced by unique relationships. These are independent transactions conducted by parties without a special relationship but influenced by a third party (who has a special relationship with one of the transacting parties), determining either the counterparty or the transaction price.

Furthermore, Article 18, paragraph (3) of the Income Tax Law (UU PPh) stipulates that in cases where taxpayers engage in affiliate transactions or transactions influenced by unique relationships, the price or profit from such transactions must adhere to the arm's length principle (ALP), ensuring fairness and regular business practices. This means that the price or profit arising from these transactions should be the same as those in transactions between independent parties. Such transactions may include the sale or purchase of tangible or intangible goods, services, loans, or transactions related to assets.

Transfer pricing refers to the pricing policy applied in transactions between parties with special relationships. As mentioned in the introduction, this concept has shifted toward a more negative connotation, with transfer pricing often being associated with tax avoidance through base erosion and profit shifting (BEPS). Transfer pricing is a matter of concern for governments, as it directly affects the amount of tax that taxpayers are required to pay (Septiani et al., 2021).

Taxpayers meeting specific criteria are required to substantiate the fairness of their affiliate transactions through documentation known as transfer pricing documentation (TP Doc). These criteria include taxpayers with annual gross revenue exceeding Rp50 billion, transactions involving the sale or purchase of tangible goods over Rp20 billion, or other transactions exceeding Rp5 billion, as stipulated in PMK No. 216/PMK.03/2016. In determining the appropriate price or profit, taxpayers must conduct a comparability analysis, which is central to the application of the ALP (OECD, 2022). In this analysis, taxpayers must select one or more prescribed methods, including the comparable uncontrolled price method, resale price method, cost-plus method, profit split method, transactional net margin method, comparable uncontrolled transaction method, tangible and intangible asset valuation, and business valuation method (Kemenkeu, 2022).

Debt, Equity, and Interest Expense

Companies typically have two funding options: equity or debt. Equity refers to the retained earnings used for further production, emphasizing value, purchasing power, or authority over capital assets (Riyanto, 1993). Equity does not necessarily take the form of money; it encompasses anything that can be utilized to generate goods or services. In contrast, debt represents the obligations a company owes to creditors (such as suppliers and banks) and other parties (including employees and the government) who possess claims on the company (Hery, 2016). Both equity and debt are presented on the balance sheet under liabilities.

Despite their similarities, debt and equity exhibit distinct characteristics. Debt must be repaid by a specified date (usually outlined in a contract), whereas equity is only returned upon liquidation. Interest on debt must be paid even if the borrower incurs losses, while dividends from equity are distributed only when there are profits or retained earnings. In the event of liquidation, creditors have the first claim on assets, while equity holders have the last claim. Furthermore, creditors do not have control over the company, whereas shareholders do (Helminen, 2010).



Interest expense encompasses the interest and other expenses incurred by an entity to borrow funds (IAI, 2011). These costs may include interest payments, financial expenses recognized in finance leases, and foreign exchange differences arising from loans in foreign currencies. According to PMK No. 169/PMK.010/2015, borrowing costs include interest on loans, premiums associated with loans, additional costs related to obtaining loans (arrangement of borrowings), financial expenses in finance leases, costs related to guarantees for debt repayment, and foreign exchange differences as long as these adjustments relate to interest and other costs.

Interest costs are deductible expenses for taxpayers when calculating taxable income, as stipulated in Article 6 of the Income Tax Law. Thus, an increase in interest costs reduces taxable income, and conversely, a decrease results in higher taxes. However, taxpayers must adhere to several limitations when allocating these interest costs. First, interest costs must be incurred to obtain, collect, and maintain income (often referred to as the "3M principle"). Taxpayers can only deduct interest expenses related to income subject to income tax under Articles 25/29, meaning expenses associated with income taxed at a final rate or income not subject to tax are not deductible. Second, taxpayers must comply with a debt-to-equity ratio (DER) of 4:1 as stipulated in PMK No. 169/PMK.010/2015. If a taxpayer exceeds this ratio, they must adjust their interest costs to align with the 4:1 requirement. Third, interest-free loans from shareholders are permissible under Article 12 of Government Regulation No. 94/2010, provided certain conditions are met: (i) the loan originates from the shareholder's funds and not from other parties; (ii) the required capital from the lending shareholder has been fully contributed; (iii) the lending shareholder is not in a loss position, and (iv) the borrowing limited liability company is facing financial difficulties essential for its operation.

Fourth, interest costs associated with qualifying assets (per PSAK 26) must be capitalized into the asset's value and expensed through depreciation. Qualifying assets, such as buildings, factories, and machinery, require a significant amount of time to construct (IAI, 2011). Interest costs related to these assets are added to their value and expensed through depreciation. Fifth, interest costs incurred by taxpayers must adhere to the principles of fairness and business normativity according to Article 18, paragraph (3) of the Income Tax Law. Thus, if the previous four limitations are satisfied but the interest costs remain unreasonable, the Tax Director-General retains the authority to adjust these expenses. Consequently, in the context of transfer pricing, the interest charged to taxpayers must be justifiable.

Tax Audit and Dispute Resolution

As mentioned above, Indonesia implements a self-assessment system for tax obligations, granting taxpayers full authority to fulfill their responsibilities. This includes registering for a Taxpayer Identification Number (NPWP), calculating and reporting owed taxes, remitting payments to the state treasury, and submitting tax returns (SPT) following regulations (Rosdiana & Irianto, 2012). If a taxpayer fails to meet these obligations, the Directorate General of Taxes (DGT) may conduct a tax audit. A tax audit involves a series of activities to collect and analyze data, information, and evidence carried out objectively and professionally based on established auditing standards. The purpose is to assess compliance with tax obligations and to ensure adherence to tax regulations (DJP, 2021).

Taxpayers who disagree with the audit findings have three options for dispute resolution. The first stage involves submitting an objection to the Directorate General of Taxes following Article 25 of the Tax Administration Law (UU KUP). If the objection is rejected, the taxpayer may proceed to the next stage by appealing to the Tax Court. If the Tax Court's decision is still unsatisfactory, the taxpayer can initiate a third stage of dispute resolution by requesting a judicial review from the Tax Supreme Court.



METHODS

This study employs a qualitative research approach through case studies. The primary data sources for this research are derived from appellate court verdicts accessible via the official [website](#) of the Tax Court Secretariat. Additional data and information were gathered from various online and offline sources. The following table lists the court decisions that serve as the focus of this research:

Table 2. List of Appellate Verdicts

No	Verdict Number	Result
1	PUT-002248.15/2021/PP/M.XVIB Tahun 2023	Rejected
2	PUT-015814.15/2020/PP/M.VA Tahun 2022	Accepted
3	PUT-004286.15/2021/PP/M.VA Tahun 2023	Accepted
4	PUT-006271.15/2019/PP/M.VB Tahun 2021	Partially accepted
5	PUT-003457.12/2023/PP/M.XIVA Tahun 2024	Partially accepted
6	PUT-007262.15/2020/PP/M.VIIB Tahun 2024	Partially accepted
7	PUT-007892.15/2021/PP/M.IIB Tahun 2024	Partially accepted
8	PUT-009147.12/2020/PP/M.XIB Tahun 2022	Accepted

RESULTS AND DISCUSSION

Analysis of Factor Influencing Taxpayer Success and Failure

The outcomes of transfer pricing disputes related to interest expenses are determined by factors that can be categorized into two main groups: formal and material factors. Formal factors pertain to whether the formal procedures in tax audits, objections, and appeals have met the requisite standards. In contrast, material factors are related to non-formal elements that can significantly influence the results. The following material factors contribute to the success or failure of taxpayers in transfer pricing disputes concerning the allocation of interest expense:

Evidence of Transactions as Crucial Factors in Tax Disputes

Evidence of transactions plays a critical role in tax disputes, extending beyond issues related solely to interest expenses. Types of evidence that can be utilized in tax disputes include, but are not limited to, loan contracts, invoices, journals/ledgers, financial statements, and records of cash inflows or outflows. Such evidence supporting loan transactions can significantly influence judge decisions. In the court verdict number PUT-015814.15/2020/PP/M.VA of 2022, the appellant successfully demonstrated the existence of a loan contract explicitly stating that the loan was interest-free. While this contract was not the sole factor leading to the appellant's success, its clear stipulation of no interest played a pivotal role in the court's decision to grant the appeal in its entirety.

Similarly, in the tax court verdict number PUT-004286.15/2021/PP/M.VA of 2023, the appellant provided evidence through journals and cash inflows related to the loan repayment, which countered allegations that these funds were derived from sales. The presence of this journal and cash flow evidence was critical, resulting in the full approval of the appeal. Furthermore, in ruling number PUT-006271.15/2019/PP/M.VB of 2021, the appellant effectively argued that the receivables testing conducted by the respondent was inaccurate. The appellant demonstrated that not all receivables were from sales within the same year; some were repayments of prior years' receivables that had already been recognized as revenue on an accrual basis. This evidence rendered the respondent's corrections based on receivables testing invalid and thus unsustainable.

Consistency Between Accounting Records, Contracts, and Reality

Taxpayers must ensure consistency between their accounting records, contracts, and actual conditions in the field. This aligns with the principles applied in transfer pricing analysis concerning contracts and conduct. The agreements stipulated in contracts should reflect reality



and vice versa. This consistency reassures judges that what is documented in contracts and accounting records is genuinely implemented and that actual practices align with the terms of the contracts and accounting entries.

In the tax court verdict number PUT-002248.15/2021/PP/M.XVIB of 2023, the appellant claimed that the loan was essentially a reimbursement for expenses initially paid by the creditor. However, the appellant needed to substantiate this claim, as an examination revealed that the reimbursable expense account was unrelated to the argument presented. Consequently, the court denied the appeal. In contrast, in verdict number PUT-015814.15/2020/PP/M.VA of 2022, the appellant successfully demonstrated that the interest-free loan from an affiliate was necessary solely for the purpose of saving the business. This was substantiated by financial reports indicating that without the loan, the appellant would continue to incur losses and face bankruptcy. Therefore, despite the loan not adhering to Article 12 of Government Regulation No. 94 of 2010 regarding interest-free loans, the court concluded that this loan did not result in any loss to the state, as evidenced by the absence of records indicating interest expenses or income for both the creditor and debtor.

Consistency Between Reality and Transfer Pricing Documentation

In addition to aligning with accounting records, actual conditions must correspond to what is outlined in transfer pricing documentation (TP Doc), particularly local documentation. In the tax court verdict number PUT-002248.15/2021/PP/M.XVIB of 2023, although the appellant claimed that an 8% interest rate met the principles of fairness and industry norms, the TP Doc stated that the arm's length interest rate derived from the comparable analysis was 11%. As a result, the court rejected the appeal. A similar situation occurred in tax court verdict number PUT-003457.12/2023/PP/M.XIVA of 2024, where the interest expenses charged by the appellant did not align with those specified in the TP Doc.

While TP Docs are typically prepared after the fiscal year concludes, they must be developed using an ex-ante principle, indicating that the arm's length prices documented should be based on data and information available at the time of the transaction, as stipulated in Article 3, paragraph (1) of PMK No. 213/PMK.03/2016. Therefore, taxpayers must ensure that the results of comparable analyses presented in the TP Doc accurately reflect reality circumstances.

The Loan Transactions are Common and Logic

The structure of a transaction plays a crucial role in understanding its rationale and the flow of goods and funds involved. Consequently, a well-designed transaction scheme can be a determining factor in a taxpayer's success or failure in transfer pricing disputes. Beyond being fair, a transaction must also be common and logical, following the principles outlined in Article 18, paragraph (3) of the Income Tax Law.

In the tax court verdict number PUT-004286.15/2021/PP/M.VA of 2023, the appellant successfully demonstrated that, in the relevant transaction, their position as the buyer rendered it illogical for cash inflows from receivables to be corrected as business turnover that the seller should have recognized. Based on this reasoning, the court fully granted the taxpayer's appeal. In contrast, in the verdict number PUT-007892.15/2021/PP/M.IIB of 2024, the appellant argued that the cash pooling system is a commonly used mechanism within corporate groups, making inter-company borrowing and lending a standard practice. Furthermore, when the respondent corrected the interest expenses within the cash pooling system, the appellant questioned why the interest income that had already been received and reported on the annual income tax return was not adjusted negatively, rendering the correction of interest expenses inconsistent. Based on these arguments, the court partially granted the taxpayer's appeal.

Use of Credible Comparable Data

The OECD Transfer Pricing Guidelines state that comparable analysis is at the heart of the arm's length principle. Within this analysis, the selection of comparables plays a crucial



role, and therefore, the credibility of these comparables in transfer pricing studies must be carefully considered. In the tax court verdict number PUT-007262.15/2020/PP/M.VIIIB of 2024, the appellant argued that the selected comparables had business characteristics that did not align with those of the appellant, as evidenced by independent comparability information. Consequently, the court recalculated the appropriateness of the interest expenses using alternative methods.

In contrast, in verdict number PUT-009147.12/2020/PP/M.XIB of 2022, the appellant used data from reputable international rating agencies such as S&P and Moody's. This credible information convinced the court that the interest expenses incurred were reasonable, leading to the full approval of the appellant's appeal. However, the credibility of comparable data is not the sole determinant of the appellant's success, as seen in other tax court verdicts where similar data from the same sources did not result in favorable outcomes. Nonetheless, the use of credible comparables can bolster the arguments presented by the appellant and enhance the court's confidence in their rationale.

Strong Argumentation for the Use of Debt-to-Equity Ratio (DER) in Interest Expense Arm's Length Analysis

The Minister of Finance Regulation No. 169/PMK.010/2015 concerning the debt-to-equity ratio (DER) came into effect in the 2016 tax year. However, several tax court rulings have applied the DER in assessing the reasonableness of interest expenses charged by taxpayers for tax years before 2016. In the tax court verdict number PUT-007262.15/2020/PP/M.VIIIB of 2024, the court determined reasonable interest expenses using DER analysis, as did the ruling number PUT-006271.15/2019/PP/M.VB of 2021. A key argument supporting the use of DER in these rulings is that the DER analysis aligns with the OECD Thin Capitalization Rules established in 1987, specifically Section 2, which adopts a General Anti-Abuse Approach.

This reasoning effectively convinced the court that, although DER is regulated under Article 18, paragraph (1) of the Income Tax Law, the DER analysis remains consistent with the substance of Article 18, paragraph (3) of the same law. Consequently, the corrections made by the tax authorities were upheld, and the taxpayer's appeal was partially granted. This demonstrates that the application of DER, even before formal regulation, can be justified within the broader context of tax compliance and fairness principles.

Demonstrating That Interest Expenses Are Costs Incurred to Generate, Collect, and Maintain Income

As outlined in Articles 6 and 9 of the Income Tax Law, deductible expenses from gross income must be related to expenditures incurred to generate, collect, and maintain income—commonly referred to as the "3M expenses." Therefore, the appellant must prove that the interest expenses qualify as such. In the tax court verdict number PUT-007892.15/2021/PP/M.IIB of 2024, the appellant successfully demonstrated that the borrowing transactions were undertaken to enhance the cash flow flexibility of the corporate group rather than for the sole purpose of profit generation. Based on this reasoning, the court partially granted the taxpayer's appeal, affirming that the interest expenses were indeed legitimate costs associated with income generation and maintenance.

Challenges and Legal Aspects Related to Interest Expense Allocation

Use of Debt-to-Equity Ratio (DER)

The application of the Debt-to-Equity Ratio (DER) as a method for determining the reasonableness of interest expenses is frequently contested, mainly for tax years before 2016. Although Minister of Finance Decree No. 1002/KMK.04/1984 established a maximum DER of 3:1 for taxpayers; this policy was suspended indefinitely by Minister of Finance Decree No. 254/KMK.01/1985. In 2015, the Minister of Finance issued Regulation No. 169/PMK.010/2015, which allowed a maximum DER of 4:1 for taxpayers starting from the



2016 tax year. This regulation is legally based on Article 18, paragraph (1) of the Income Tax Law, rather than Article 18, paragraph (3). Consequently, the appellants have questioned the use of DER to assess the reasonableness of interest expenses. According to Article 18, paragraph (3) of the Income Tax Law, the Director General of Taxes uses methods such as Comparable Uncontrolled Price (CUP), Resale Price Method (RPM), Cost Plus Method (CPM), and others like Profit Split Method (PSM), Transactional Net Margin Method (TNMM), Comparable Uncontrolled Transaction Method (CUT), tangible and intangible asset valuation, and business valuation methods to determine the arm's length nature of transactions.

However, in several verdicts, judges have opined that the application of DER aligns with Article 18, paragraph (3), arguing that when taxpayers engage in transactions with related parties, the Director General of Taxes is authorized to reassess the reported expenses or income in the annual tax return. The referenced framework employs the OECD Thin Capitalization 1987 Report Section 2, which outlines two approaches for determining thin capitalization rules: the fixed ratio approach, which considers all taxpayer debts, and the general anti-abuse approach, which focuses only on loans from related parties. Furthermore, judges have stated that if the interest expenses of non-affiliated taxpayers are calculated based on the 4:1 DER rule, it is only fair for this rule to also apply to taxpayers making interest payments to affiliates. This upholds the principle of fairness in the application of tax regulations.

Based on the discussion, several conclusions can be drawn: (i) the 4:1 DER applies to all taxpayers, whether they are paying interest to affiliates or independent parties; (ii) DER is used to determine the reasonableness of interest expenses reported on the annual income tax return, and (iii) DER can be applied regardless of the purpose of loans obtained by the taxpayer from affiliated entities.

Interest-Free Loans

Shareholders often provide loans to their subsidiaries without charging interest. While this practice is not always aimed at avoiding tax liabilities, Article 12 of Government Regulation No. 94 of 2010 imposes restrictions on interest-free loans. According to this regulation, interest-free loans are permissible if they meet the following criteria: (i) the loaned funds must belong to the shareholders, not derived from borrowed money; (ii) shareholders must have contributed the total amount of capital required; (iii) shareholders must not be in a loss position; and (iv) the subsidiary receiving the loan must be facing financial difficulties, and the loan is solely intended to ensure the continuity of the subsidiary's operations.

Although these conditions are cumulative, in several verdicts, judges have granted taxpayers' appeals even when one of the cumulative criteria was not met. For instance, in tax court verdict number PUT-015814.15/2020/PP/M.VA of 2022, the respondent could demonstrate that the lender was in a loss position, thus necessitating a correction of interest expenses according to the provisions of Government Regulation No. 94 of 2010. However, the appellant proved that the loan was exclusively for salvaging the taxpayer's business and that the loan did not result in a loss for the state, as evidenced by the absence of recorded interest expenses or income during the loan period. Based on this reasoning, the court fully granted the taxpayer's appeal.

Application of the Arm's Length Principle (PKKU)

The application of PKKU in transfer pricing disputes concerning interest expenses often revolves around methodological issues: Which methods can be employed to assess the reasonableness of interest expenses? Can the Debt-to-Equity Ratio (DER) be utilized to evaluate this reasonableness? Is using benchmark data from credit rating agencies valid enough? Alternatively, is historical data from the Central Bureau of Statistics (BPS) or Bank Indonesia also valid?



Out of the eight research objects analyzed, two employed DER to assess reasonableness, while another two used external benchmark data (such as from BPS, S&P, and Moody's). Based on the reviewed verdicts, judges did not contest the methods used, whether it was DER or external comparisons. DER can be applied directly by implementing a 4:1 comparison or by seeking external benchmarks to determine a reasonable DER. Meanwhile, Minister of Finance Regulation No. 172/PMK.03/2023 regarding the Implementation of the Arm's Length Principle in Transactions Affected by Related Party Relationships states in Article 9, paragraph (8) that for loan transactions, the taxpayer or tax examiner may use the Comparable Uncontrolled Transaction (CUT) method to determine the reasonableness of interest expense allocations.

The CUT method is fundamentally similar to the Comparable Uncontrolled Price (CUP) method, where the analysis for assessing the reasonableness of interest expenses is conducted using internal or external comparables. Internal comparables come from the taxpayer itself, especially when the taxpayer has both affiliated loans and loans from independent parties. External comparables derive from independent loan transactions executed by reliable, comparable companies.

Transfer Pricing Documentation (TP Doc)

Minister of Finance Regulation No. 213/PMK.03/2016 stipulates that taxpayers with gross revenue exceeding IDR 50 billion in the previous tax year, who engage in affiliated transactions involving interest payments over IDR 5 billion, or who pay interest to affiliated parties in countries or jurisdictions with lower income tax rates than Indonesia, are required to prepare and maintain TP Doc in the form of a master file and local file. This documentation is mandated under Article 28 of the Income Tax General Provisions and Procedures Law (UU KUP). The TP Doc must be based on data and information available at the time the transaction occurs (the ex-ante principle), rather than on data and information after the transaction has taken place (the ex-post principle). Additionally, the TP Doc must be retained in Indonesia for a minimum of 10 years.

PMK 172 of 2023 states that all taxpayers engaging in affiliated transactions must apply the arm's length principle and business norms following Article 18, paragraph (3) of the Income Tax Law. However, only those taxpayers meeting the criteria outlined in PMK 213/2016, particularly those with affiliated transactions involving interest expenses, are required to create a TP Doc. Although taxpayers may have prepared TP Doc, this does not automatically imply that the transactions comply with the arm's length principles. This is evident from several analyzed appeal verdicts where judges upheld corrections regarding interest expenses, even when the appellant had created and submitted a TP Doc. Such situations arise when the reasonableness of the interest rates, as claimed by the appellant, differs from that outlined in the TP Doc; judges may eliminate comparables used in the benchmarking analysis due to issues such as inappropriate levels of independence or differing business characteristics from the appellant; or because the TP Doc was not prepared according to the ex-ante principle.

Implications for Transfer Pricing Practices in Indonesia

The appeals verdicts analyzed in this study have several implications for both taxpayers and tax authorities. First, both parties must tighten oversight of inter-company debt transactions. The analyzed verdicts show outcomes favoring both the Director General of Taxes (DGT) and the appellants. Therefore, taxpayers should be aware of the factors that lead to the success of disputes for either party. Enhanced oversight may include the preparation of transaction documentation, such as contracts, invoices, bookkeeping records, financial statements, and transfer pricing documentation, ensuring that these documents accurately reflect actual practices.

Second, taxpayers should start their analysis with the Debt-to-Equity Ratio (DER). It can be concluded that DER applies to all corporate taxpayers, whether they pay interest to



affiliates or not. Thus, the 4:1 DER can serve as an initial filter to determine if the interest expense incurred by the taxpayer is deductible from gross income according to the Income Tax Law. If the 4:1 DER criterion is met, further analysis of the arm's length nature of the interest expense should be conducted following Article 18, paragraph (3) of the Income Tax Law, utilizing the Comparable Uncontrolled Transaction (CUT) method. Taxpayers can rely on either internal or external comparables for this analysis. In this context, the 4:1 DER serves as a preliminary analysis before assessing the arm's length nature of the interest expense.

Third, there may be a shift in the financing structure of multinational enterprises (MNEs). Specific rulings regarding interest expenses that favored the DGT could encourage MNEs to reduce reliance on intra-group loans, prompting them to seek safer funding structures such as cash pooling systems or interest-free loans compliant with Government Regulation 94/2010. Fourth, regulatory changes may be necessary. The implementation of the 4:1 DER policy may need to be reviewed in light of the increasing number of disputes in tax courts concerning interest expenses. The government should consider alternative schemes to minimize tax avoidance related to thin capitalization, such as safe harbors or a percentage of interest expense relative to the total revenue or total expenses of the taxpayer.

CONCLUSION

Factors contributing to the success or failure of taxpayers in the transfer pricing dispute related to interest expense in Indonesia include the presence of supporting transaction evidence, alignment between bookkeeping records and contracts, consistency between actual practices and transfer pricing documentation, the logical nature of loan transactions, the use of credible comparables, robust arguments regarding DER in the analysis of interest expense reasonableness, and evidence demonstrating that interest expenses are incurred to obtain, collect, and maintain income.

Additionally, there are several challenges and legal aspects to consider in transfer pricing disputes involving interest expenses, including the audit of DER by appellants in determining the reasonableness of interest expenses, regulations surrounding interest-free loans under Government Regulation 94/2010, the suitability of various methods for applying the arm's length principle to related-party transactions involving interest, and the limitations of transfer pricing documentation in ensuring the DGT does not recalculate interest expenses owed to affiliates.

Recommendations

The author recommends that taxpayers maintain thorough documentation, including contracts, invoices, bookkeeping records, financial statements, and relevant transfer pricing documentation related to interest-bearing affiliate transactions. Furthermore, taxpayers should ensure consistency between documentation and actual practices and utilize DER as an initial filter in assessing the reasonableness of interest expenses. Meanwhile, the government, as the regulator, should provide more explicit guidelines regarding the methods taxpayers can employ to calculate arm's length interest rates, such as through regular publications.

Limitations

This study is limited to the appeal as mentioned above verdicts, and the circumstances encountered in practice may differ from those described herein. Therefore, future research should broaden its scope to explore additional possibilities in transfer pricing disputes involving interest expenses.

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