TaxPrime Newsletter

Secondary Adjustment:
Background and Implementation in Indonesia

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Background: Why do Fiscal Adjustments Occur?

Fiscal adjustments in transfer pricing can be applied to affiliated transactions that do not comply with the Arm's Length Principle (ALP). The aim is to ensure that the transactions reflect conditions similar to those between unrelated parties which, as a logical consequence, would result in taxation consistent with the independent commercial conduct. These adjustments include three main types: primary adjustment, corresponding adjustment, and secondary adjustment. A primary adjustment is made by tax authorities (primary adjustment) or independently by the taxpayer (compensating adjustment) to adjust transfer prices that do not align with the ALP. A corresponding adjustment is necessary to eliminate double taxation that may arise from a primary adjustment. A secondary adjustment represents additional tax consequences resulting from the primary adjustment. These adjustments are crucially made to ensure tax fairness and prevent tax avoidance schemes.

As explained in the OECD Transfer Pricing Guidelines 2022, the use of the ALP represents an international consensus for regulating transfer pricing practices because it provides an estimate that closely approximates the way transactions occur in an open market among affiliate companies. Generally, the ALP results in an appropriate distribution of revenue or profit among MNE group members, making it more acceptable to tax authorities because, in the words of the BEPS 8-10 2015 Final Report, it aligns transfer pricing outcomes with value creation.

To follow up on primary adjustments, countries may apply secondary adjustments according to their domestic regulations. While the primary adjustment reconciles the difference between the reassessed taxable profit and the profit originally recorded by the taxpayer, taxing the difference, the secondary adjustment treats the excess profit from the primary adjustment as if it had been transferred in another form, subjecting it to appropriate withholding tax.

Therefore, recalibrating the economic reality of the taxpayer engaging in transactions with its affiliates that do not comply with the ALP.

Developments in Domestic Regulations Governing Secondary Adjustments

The regulations on secondary adjustments in Indonesia have undergone several changes. These changes reflect the government's efforts to align domestic tax policy with international practices. The regulatory changes can be summarized as follows:

2010	2013	2014	2020	2021	2023
DGR-69/2010 regarding the Transfer Pricing Agreements (Advance Pricing Agreements)	DGR-22/2013 regarding the Guidelines for Audits of Taxpayers with Special Relationships	MOFR-240/2014 regarding the Procedures for Implementing the Mutual Agreement Procedure	MoFR-22/2020 regarding the Procedures for Implementing Transfer Pricing Agreements (Advance Pricing Agreements)	The Income Tax Law as last amended by Law No. 7 of 2021 concerning the Harmonization of Tax Regulations	MOFR-172/2023 regarding the Application of the Arm's Length Principle on Transactions Affected by Special Relationships

In addition to these regulations, secondary adjustments have also been briefly outlined in SE-50/PJ/2013, which provides technical guidance for audits of taxpayers with related-party relationships.

The latest regulation, Minister of Finance Regulation Number 172 of 2023 (MoFR-172/2023) as well as Government Regulation Number 55 of 2022, clarify the position of the Directorate General of Taxes

(DGT) regarding secondary adjustments. Article 37, paragraph (1) of MoFR-172/2023 states that the difference in transaction value that does not comply with the ALP is considered an indirect profit distribution to the Affiliate, treated as a dividend, and subject to income tax according to tax regulations.[1] This clarification follows the Harmonization of Tax Regulation Law, which slightly altered the wording in the explanation of Article 18, paragraph (3) of the Income Tax Law, providing a more direct and clear legal foundation, likely drawn from MoFR-22/2020.

The treatment of secondary adjustments adopts a dividend approach consistent with paragraph 4.68 of the OECD Transfer Pricing Guidelines 2022. This approach states that secondary transactions generally take the form of constructive dividends, constructive equity contributions, or constructive loans. Additionally, and interestingly, the DGT can now cancel the imposition of secondary adjustments on transfer pricing adjustments, a provision not included in previous regulations. However, other countries may have different views on secondary adjustments.

Comparison of Other Countries' Approaches to Secondary Adjustment

Although secondary adjustments have been implemented in many countries, each country has a different approach to regulating and executing these adjustments.

Country	Legal Rules Regarding Secondary Adjustment	Treatment of Secondary Adjustment
Indonesia	• MoFR-172/2023 • Article 18 of Income Tax Law No. 36 of 2008 • Fourth Amendment to Law No. 7 of 1983 • Article 22 of MoFR No. 22 of 2020	The difference between the value of a transaction affected by a special relationship that does not comply with the ALP and the value of a transaction affected by a special relationship that complies with the ALP constitutes an indirect profit distribution to the affiliated party, treated as a dividend.
India	• Income Tax Act 1961 • Transfer Pricing Regulations • Rule 10CB of the Income-tax Rules, 1962 • Section 92CE of the Income-tax Act, 1961	India has enacted laws regarding secondary adjustments, effective from the fiscal year 2016-17. Detailed provisions are outlined in Section 92CE of the Income Tax Act, 1961 and Rule 10CB of the Income-tax Rules, 1962.
Canada	• Sub-Section 247(12)-(13) of the ITA (LIR). • TPM-02R (version française) Secondary transfer pricing adjustments, repatriation and Part XIII tax assessments	Sub-Section 247(12) of the ITA provides for a secondary adjustment on all transfer pricing adjustments. Broadly, the amount adjusted is deemed by this provision to be a dividend and withholding tax is applicable according to the relevant treaty rates. Sub-Section 247(13) provides that relief from secondary adjustments is available in certain circumstances.

[1] MoFR-172/2023 regarding the Application of the Arm's Length Principle on Transactions Affected by Special Relationships.

Country	Legal Rules Regarding Secondary Adjustment	Treatment of Secondary Adjustment
South Korea	• Article 13 of the Act of Adjustment of International Taxes • Articles 22 and 23 of the Enforcement Decree Of The Act of Adjustment of International Taxes	If it is not verified that the amount to be included in the profit of a domestic company has been returned by the foreign affiliated party to the domestic company as stipulated by the Presidential Regulation, that amount must be treated as a dividend to, or adjusted as an investment in, the foreign affiliated party.
France	Le Bulletin Officiel des Finances Publiques BOI-INT-DG-20-30-10-20170201 §630 of the 1st of February 2017 on Mutual agreement procedures.	France makes secondary adjustments when the conditions exposed in the doctrine are met. In application of our domestic legislation, when the adjustment is carried out by the French tax authorities and is considered to constitute a deemed distributed profit, subject to the stipulations of the bilateral tax treaty, a withholding tax may be levied at the conventional rate on the deemed distributed profit. However, if the company agrees to repatriate the sums considered to constitute a transfer of profits within 90 days of receipt of the proposal, the notified withholding tax will not be maintained.
United States	Treas. Reg. §1.482-1(g)(3) and Rev. Proc. 99-32	Treas. Reg. §1.482-1(g)(3) provides that conforming adjustments may include treatment as a dividend or capital contribution (as appropriate). In addition, Rev. Proc. 99-32 provides an elective method to treat a conforming adjustment as a loan.

It can be seen from the samples above that countries have different views and approaches in regulating the implementation of secondary adjustments. Indonesia, India, Canada, South Korea, France, and the United States have adopted secondary adjustments, while Malaysia, Singapore, Japan, China, and Australia do not have specific regulations related to secondary adjustments, but require the most appropriate and reliable method based on the OECD Transfer Pricing Guidelines.

The differences in the existence and application of regulations regarding secondary adjustments among countries can create burdensome consequences for taxpayers and their business groups. Double taxation can occur unless another country provides a tax credit or relief for the additional tax liability resulting from secondary adjustments. If the secondary adjustment takes the form of constructive dividends, the multiplication of tax burdens imposed may not be reduced because the domestic laws of the counteracting country might not recognize any income occurring. In this context, a significant question may arise as to whether the reclassification of a transaction as a dividend under domestic law is consistent with its classification under a legally binding tax treaty. This leads to further questions about whether the tax treaty might actually disallow secondary adjustment taxation in certain cases. This issue leads to uncertainty and complexity for taxpayers in fulfilling their tax obligations.

Secondary Adjustment Exception: The Role of Repatriation

MoFR-172/2023 does not restrict the types of transactions subject to domestic fiscal adjustments due to primary adjustments. However, Article 37 paragraph (4) provides an exemption from the application of secondary adjustments. This exemption applies if there is an addition or repatriation of cash equivalents for the difference in the value of affiliated transactions that exceed the transaction value in accordance with the arm's length principle before a tax assessment letter is issued, and/or the taxpayer agrees to the transfer pricing determination by the DGT.

This exception is commendable as it provides fairness or balance to avoid double taxation between two jurisdictions. However, it is important to note that this exception is conditional upon the taxpayer's agreement to the transfer pricing adjustments by the tax authority and the short repatriation deadline (before the Notice of Tax Assessment is issued).

The Significance of the Impact of Secondary Adjustments

The potential impact of this adjustment, including an increased tax burden that can reduce profitability and create administrative complexity, cannot be overlooked. For example, consider a company with a turnover of 400 billion IDR in 2024 and a profit of 150 billion IDR that pays royalties to its affiliate amounting to 3% of the turnover (12 billion IDR). Initially, the company would bear a tax burden of 33 billion IDR on its profit. If a primary adjustment is applied to the royalties, the company's profit is recalculated without the royalty expense, resulting in a profit of 153 billion IDR and an additional tax of 660 million IDR. Furthermore, a secondary adjustment of 20% on royalties reclassified as dividends would increase the company's tax burden by an additional 2.4 billion IDR. Consequently, the total tax burden would rise by 3 billion IDR.

Therefore, a company engaging in affiliated transactions must be proactive in anticipating and minimizing the risk of secondary adjustments that can hinder business growth. Preparing comprehensive and accurate transfer pricing documentation (TP Doc) will enhance transparency and compliance with tax regulations. Moreover, a deep understanding and thorough discussion of applicable provisions and risk mitigation strategies are highly recommended. These steps help the company achieve legal certainty and avoid potential disputes with tax authorities.

Secondary Adjustment Prevention Strategy: The Importance of Comprehensive Transfer Pricing Documentation

To avoid secondary adjustments, the main step is to prevent the occurrence of primary adjustment. Primary adjustments definitely are the trigger for secondary adjustments, which

have the potential to increase tax burdens and administrative complexity for taxpayers. By ensuring that affiliated transactions are planned and executed in accordance with the ALP and are carefully documented and compliant with all applicable regulations, companies can reduce the risk of primary adjustments. This will also reduce the likelihood of secondary adjustments that could result in additional tax burdens. Comprehensive Transfer Pricing Documentation that adheres to relevant tax regulations, such as Local Files maintained based on available data and information at the time of affiliate transactions, is crucial in maintaining compliance and preventing secondary adjustments.

Concluding Remarks

The dynamic changes in tax regulations, as outlined in MoFR-172/2023, shows a strong commitment to improving tax governance in Indonesia and preventing tax avoidance practices. Companies are required to continuously adapt, including mitigating the risk of secondary tax adjustments if affiliated transactions are deemed non-compliant with arm's length principles. However, the complexity of domestic and international tax regulations presents challenges for companies. The differences in approaches between various countries and the ongoing evolution of the global business landscape further complicate companies' understanding and effective implementation of secondary adjustment rules.

Considering the complexity and dynamics of current business and taxation, is your company ready to evaluate solutions to facilitate the formulation of optimal tax strategies in facing the challenges of primary and secondary fiscal adjustments?

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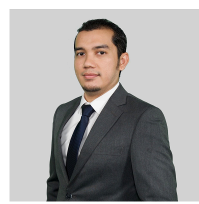
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