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Analysis on Deductibility of Royalty Expenses in the form of Utilization of Intangible Properties and/or Know-How for Corporate Income Tax Purposes in Indonesia

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Abstract

The rapid changes of globalization provide easy access for mobilization of people, goods, and investment across countries creating multinational companies to record royalty expenses in the form of utilization of intangible properties and/or know-how. In nowadays digital era, numbers of cross-border royalty payment transaction by the corporate taxpayers are more intensive in terms of amount and size. In the event of tax audit, this royalty payment usually being adjusted as non-deductible expense by the Indonesia Tax Authorities (ITA) despite technically the prevailing Income Tax Law mentions in explicit that this royalty payment is considered as deductible expense for the purpose of corporate income tax calculation. The objective of this research is to identify the rationale of fiscal adjustment made by the ITA on this royalty expense as well as to analyse this practical challenge from legal certainty aspect and efforts that are carried out by the corporate taxpayers to solve this tax dispute. This research used a qualitative approach with in-depth interview and literature study for its data collection technic. Result of this research identified that royalty expenses in the form of utilization of intangible properties and/or know-how, during the tax audit process conducted by the ITA, usually become a fiscal adjustment due to unfulfillment of 3 (three) cumulative tests, namely existence test, economic/commercial benefits test and arm's length principle test. However, from the verdicts of the Indonesian Tax Court, we found many of disputes were won by the taxpayers making this fiscal adjustment ambigu. As such, it will be critical for the ITA to reformulate the provision of royalty as deductible expense in order to increase legal certainty for corporate taxpayers.

Keywords: Corporate income tax; Deductible expense; Royalty; Intangible properties/assets; Know-how; Fiscal adjustment; Existence test; Economic/commercial benefits test; Arms length principle test; Legal certainty principle

1.0 Introduction

At the recent date globalization has been rapidly developed all over the world and makes easier the spread of products, technology, information and works across national and cultural borders. Many countries have built economic cooperation for facilitating globalization. The term of globalization itself, is being famous after the cold war was over in the early of 1990s. Globalization is believed can increase standard of living of people in developing countries as it created various jobs vacancy, modernization and the ease of taking goods and services. Between 1985 up to 2007, globalization related to the exchange of goods, services and capital was growing faster double compared to the growth of world economics, i.e. reaching out around USD 30 trillion or approximately 53% of World Gross Domestic Product (GDP) in year 2007. However, after 2007, growth of goods, services and capital trade and their contribution to the world GDP has been reduced and slowly increased as shown in the Diagram 1 below.

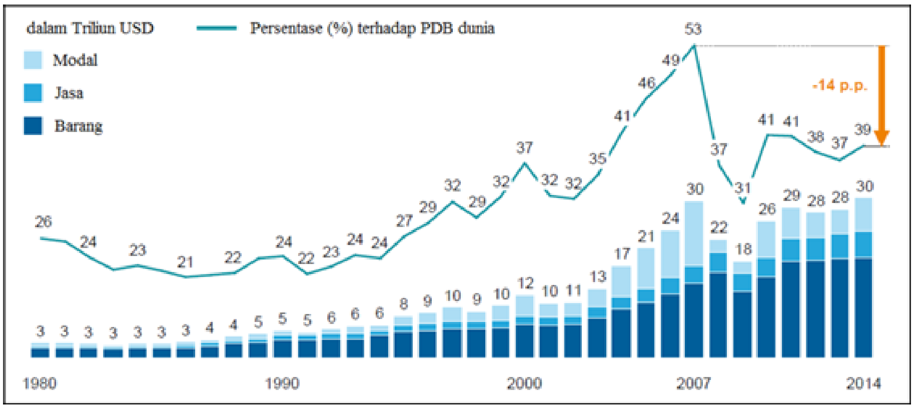
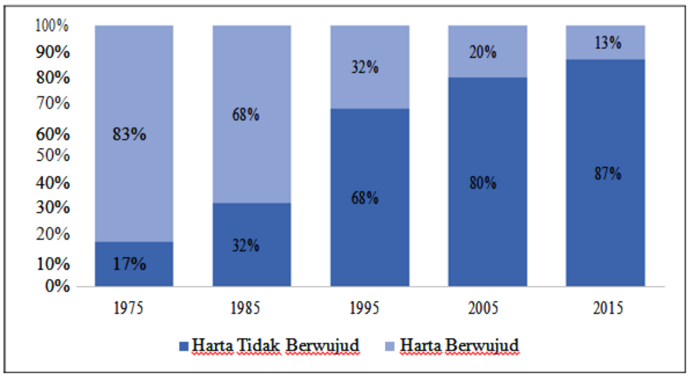


Diagram 1 – Globalization contribution to the World GDP

Source: McKinsey Global Institute. (2016). *Digital Globalization: The New Era of Global Flows*. United States: Mckinsey & Company

From the above diagram, we see there was a drastically reduction in the growth of goods, services and capital trade as well as its contribution to GDP. The reduction reached out at USD 8 trillion and USD 4 trillion for growth of goods, services and capital trade and it represents around 16% and 6% for World GDP contribution. The reduction trend was still continue after those years due to the development of information technology that leads to digitalization process making opportunity for broaden cross-border business transactions. As the new information, technology and communication are rapidly changed, increase of investment income from cross-border transaction are also occurred, particularly for income from intangible assets/properties.

Based on report titled "*Annual Study of Intangible Asset Market Value*" released by Ocean Tomo, starting from 1975 up to 2015, market value of the intangibles properties continually increased compared to tangible assets. Trend of increase of market value of the intangible properties is shown in Diagram 2 as follows.



Harta Tidak Berwujud = Intangible assets; Harta Berwujud = Tangible assets
Diagram - 2 Growth of Market Value of Intangible Assets

Source: Stathis, K. L. (2015). Ocean Tomo Releases 2015 Annual Study of Intangible Asset Market Value. Chicago: Ocean Tomo (has been reprocessed, 2020)

As you can see on the above diagram, the market value of intangible assets are grown faster compared to tangible properties. In line with the development of information, communication and technology which offers easier process of doing business and access of business information, the key success of business usually determined based on the ownership of the intangible properties. By this, the company may maintain and sustain its competitive advantages and sometimes the ownership of intangible assets used to be foundation for new products category (Parr, 2007). This causes rapid use of intangible properties amongst entities within a group company both under domestic and cross-border transactions.

Pursuant to the Indonesian income tax law and regulation, the company who utilizes intangible assets and/or know how, is liable to pay royalty to the owner of the intangible properties/know-how. Royalties, in general terms are defined as payments of any kind received as consideration for the use other right to use any copyright of literary, artistic or scientific works including cinematograph films, any patent, trademarks, design or model, plan, secret formula or process, or for information concerning to industrial, commercial or scientific experience and know-how (OECD, Model Tax Convention on Income and on Capital, 2010). Based on Law Number 36 Year 2008 regarding the rth Amendment of Law Number 7 Year 1983 regarding Income Tax, further referred as to the prevailing Income Tax Law, royalties is mentioned in Article 4 paragraph (1) leter h, where the definition of royalty is further stipulated in the Elucidation of that article as follows: “royalty is payment of any kind received or earned either regular or irregular as consideration of the following:

1) Right over intangible properties, such as copyright of literacy, art or scientific masterpiece, patent, design or model, plan, formula or secret process, company trade secret, or industrial/intellectual rights or other similar rights.
2) Right over the tangible assets in the form of any industrial, commercial or scientific equipment
3) Provision/transfer of technical, industrial, commercial or scientific information and/or knowledge.
4) Additional aid or complement relating to the use of or the right to use rights referred to as paragraph 1, the use of right to use equipment/tools as referred in paragraph 2, or transfer of knowledge and information referred to in paragraph 3, in the form of:
    a) The acceptance of or the right to receive the recording image and voice media, or both, which is distributed to public via satellite, cable, fibre optics, other similar technology channels;
    b) The use or the right to use of the recording image and voice media, or both, for television or radio broadcast via satellite, cable, fibre optics, other similar technology channels;
    c) The use or the right to use some or all of the radio spectrum communication.
5) The use or the right to use motion picture films, tape or video tape for television and radio broadcast.
6) The release of all or parts of rights associated with the use of or provision of intellectual property/industrial rights or other similar rights”.

Further, according to Article 6 paragraph (1) letter a) point 3) of the prevailing Income Tax Law, it is mentioned that “Resident taxpayers and permanent establishment are entitled to claim the deductions in the form of expenses to earn, obtain and secure income from the gross income, including: a) the expenses that are directly or indirectly related to the business operation of the company, among others:

1. *material purchase costs;*
2. *costs in relation to employement and services, including wages, salaries, honoraria, bonus, gratifikasi, and cash allowances;*
3. *interest, rent and royalty;*
4. *travel expenses;*
5. *waste processing expenses;*
6. *insurance premium;*
7. *promotional and marketing expenses as stipulated and based on the Minister of Finance Regulation;*
8. *administration expenses; and*
9. *tax except income tax”.*

Based on the above provisions, royalty expense related to the utilization of intangible properties and/or know-how is clearly treated as deductible expense for corporate taxpayers in calculating their corporate income tax at the end of fiscal year. However, from our observation in the daily practice, especially during the performance of tax audit, corporate taxpayers usually face the practical challenges from the Indonesian Tax Authorities (ITA) that such royalty payment could not claimed as deductible expenses for corporate income tax calculation. For this purpose, the research will identify the rationale as to why the ITA took this fiscal adjustment on this royalty expense, as well as to analyse efforts from corporate taxpayers to solve this taxation dispute from legal certainty point of view.

2.0 CONCEPTUAL FRAMEWORKS

2.1 Deductible Expense

Expenses or burden is substantially the sacrifice of available resources to achieve a specific goal. From accounting perspective it is known as a resource sacrificed or forgone to achieve a specific objective. Similar definition is also initiated by Lumbantoruan in relation to expenses, that is monetary sacrifice to obtain goods and services (Lumbantoruan, 1993). As in nature expenses are purposely to obtain required goods and services for business operation, expenses become one of important elements to determine the amount of tax liability (Gunadi, 1997). From tax point of view, there are some expenses that can be claimed as deductible expenses than those non-deductible items for corporate income tax calculation purposes. Deductible expenses basically are expenses related to earn, collect and secure taxable income, expenses with useful life not more than 1 (one) year, supported with appropriate documentations, not related to income subject to final tax and/or income exempted from tax and fair (arms length). Otherwise, the expenses are considered as non-deductible expenses for corporate income tax calculation.

Dora Hancock stated that to be tax deductible, expenses should satisfy 3 (three) criterion, namely: “For expenditure to be allowable deduction from income it must satisfy three criteria. It must be a revenue item, it must be incurred wholly and exclusively for the purpose of the trade, profession or vacation, finally it must not be specifically disallowed as a deductible expense by statute (Hancock, 1997).”

In addition to Dora’s criterions, Sommerfield also shared the same view that deductible expenses should have a legal basis specifically stipulated in the tax legislation. “As a general proposition, most of the items that would fall into the account’s classification called “expenses” are also “deductions” for tax purpose; in addition, however, the code provides for many other deductions in the calculation of taxable income. Thus, the term “deduction” is much broader, more generic and legalistic term than the term “expenses”. The difference between the expenses under accounting principle and the deduction pursuant to the prevailing income tax regulation causes the occurrence of fiscal adjustment (or tax correction), as some expenses may deductible from accounting commercial purposes but not for taxation, since the tax law and regulation prohibits those as non-deductible expenses.

Based on Dora Hancock and Somerfield opinion outlined above, it can be concluded that there 3 (three) criterions for the expenses to be claimed as tax deduction for corporate income tax calculation, namely:

1. The expenses in nature are related to earn income of daily business operation of the company (revenue expenditure);
2. The expenses are incurred fully and exclusively for trading business operation: and
3. The expenses as deductible pursuant to the prevailing tax law and regulation.

From the Indonesian income tax provision, the 3 (three) criterions above, obviously have been accommodated under the term expenses incurred to earn, collect, and maintain taxable income which are stipulated as follows (Gunadi, 2009):

1. Expenditures with useful life not more than 1 (one) year are treated as current expenses;
2. Expenditures with more than 1 (one) year useful life are expensed through depreciation, allocation or amortization;
3. Not considered as non-deductible expenses stipulated under the prevailing income tax law and regulation;
4. Not related to expenses incurred to generate income exempted from tax and/or income subject to final tax;
5. Not related to expenses those are not associated with the process for generating taxable income;
6. Not in the form of fringe benefits or enjoyment;
7. Full fill the arm’s *length principle*;
8. Not considered as private (non-business) expenses; and
9. Taxes other than income tax and tax penalty.

In principle, the tax provision does not limit any expenditure incurred by the taxpayers to earn income. So long the taxpayer can convince such expenses are related to earn, collect and secure taxable income, then substantially the expenses are tax deductible. Further, with regard to income tax calculation, it is also know the substance over form principle where in case there is a different in terms used for naming such an expense, it should be no problem from deductibility aspect, provided the expenditure is clearly spent for business purposes (Rosdiana &

Irianto, 2014). For calculating the income tax, expenses that are considered as tax deduction, have to be in line with match and link concept, which mean they are incurred in relation to business activity of the company to earn, collect and secure income (Gunadi, Pajak Internasional, 2007).

Other element to be noted in computing the income tax payable are those under category of non-deductible expenses. On these non-deductible expenses, the company will add back as positive fiscal adjustment when doing year end corporate income tax calculation. The higher non-deductible expenses amount, the bigger the income tax liability of the corporate taxpayers.

2.2 Royalty

In general, royalty are difined as any consideration for the use or the right to use (utilization) of intangible property. Burns & Krever (1998) explained that the terms of royalty for tax purposes are separated into payment on the use of intellectual property, payment on transfer of intellectual assets, and payment on natural resources exploitation. Whilst, Surahmat (2001) foresee that royalty is payment in connection with the provision of right to use intellectual property where the owner of such intellectual property does not participate in carrying out such rights. Further, Rohatgi (2002) defined royalty as the payment received for the utilization of right to use the intangible property or know-how under a license contract.

Rosdiana (2006) explained that royalty is divided into 3 (three) typed, namely any reconsideration with regard to the use of or the right to use:

1) Right over the intangible property such as copy right, patent, trade mark, formula or secret process.
2) Information that have not been publicly exposed, may not patented yet such as experience in industrial field and know-how.
3) Right over the tangible assets concerning to industrial, commercial and scientific equipment.

In many tax jurisdictions, royalty is treated as deductible expenses since it relates to the process for earning, collecting and securing taxable income of the company. Considering that royalty is also subject to withholding income tax, one may correlate the deductibility concept of royalty expenses with the obligation to deduct withholding tax on this tax object, follows the taxability-deductibility principle (the tax object that is liable to tax for the recipient, will be claimed as deductible expense for the paying party).

2.3 Intangible Assets/Properties

According Boos (2003), intangible property is non-physically assets owned by the company i.e. all element of the assets of the company other than tangible and monetary assets. For the owner and the investor point of view, intangible assets represent source of value of non-financial or non-physically property resulted from future benefits. OECD takes the view that the term intangible assets is something that are not assets with physically tangible or financial property owned by the company. Intangible assets can be owned or controlled for commercial activities where the use of or transfer of intangible assets will be compensated if it is occurred between independent party having such comparability. In commercial terms, intellectual property is also inclusive in this definition. OECD TP Guidelines mentions intangible property for tax purposes consist of the following:

1) Patent.
2) Know-how and trade secret.
3) Trade/name mark and brand.
4) Rights under license contract or government agreement, including contractual commitment for manpower supply.
5) Licence and similar limited right over intangible assets, and
6) *Goodwill* and sustained carrying value of the right

Further, Glossary OECD Guidelines separates intangible assets into marketing intangible and trade intangible. Marketing intangible is intangible asset associated with the marketing activities, assistance in commercial explotation of a product or service and/or having important promotional value for the product. Marketing intangible can be in the form of trade/name mark, customers list and relationship, etc. Whilst, trade intangible is intangible assets which are developed through research and development (R&D) activities which may take such longterm period with significant costs incurred. Those considered as trade intangible are patent, know-how, design, model that is used for mass production, etc. Rachmawati & Riandoko (2014) in their research conclude that intangible property has some characteristic, as the following:

1) Having substantial value that will be acquired over the utilization of intangible assets.
2) Potentially generating economic benefits in the future.
3) Does not have physical substance.
4) Having existence and can be identified.
5) Can be owned and controlled by the owner of the intangible property.
6) Transferable to other parties.

In the OECD TP Guidelines, some transactions are considered as special transaction and one of them is transaction in relation to intangible property. The discussion on testing steps on transfer of intangible assets is interesting as intangible assets do not have physical substance like tangible assets, so that in case of any transfer of intangible assets then it needs to be tested to ensure such transfer is truly conducted. The testing steps to determine whether the transfer of intangible assets is occurred is governed under Director General of Taxes Regulation Number PER 22/2013 and the Circular Letter Number SE 50/2013. The following are the testing steps for transfer of intangible assets (Ngantung, 2013):

1) Identifying the existence of transfer of intangible assets, through the following steps:
   a) identifying contract and legal agreement on transfer of intangible assets.
   b) identifying typed of intangible assets being transferred to determine if it is in accordance with the definition and characteristic of the intangible assets.
   c) identifying transfer form of intangible assets to compare the legal contract provisions with the actual transfer.

2) Identifying of the ownership of the intangible property by checking if such royalty is truly paid to party owns the intangible property. The ownership of the intangible property is separated into:
   a) Legal ownership that is associated with the legal title of the intangible property. Normally, legal title is related to legal guarantee provisions under Intellectual Property Law, such as patent, copyright, registered trade mark, etc.
   b) Economics ownership that can be viewed based on which party borne significant parts on costs and risks related to the development and value of the intangible assets.

3) Identifying of the materiality truth of transfer of the intangible property, based on the following indication:
   a) Identifying if royalty payment is appropriate referred to the need of the intangible assets transaction, profit expectation on transfer of intangible property, and if independent company want and insist to pay similar royalty.
   b) Indicating economic benefits on transfer of intangible assets with checking if there has been improvement in terms of production operational and financial performance within specific covered periods.

In international transaction, there are numbers typed of intercompany transactions such as transfer of tangible and intangible property/assets/goods, provision of services, financing, rental and leasing, contract manufacturing/makloon, R&D, maintenance services, marketing services and costs sharing. Transfer pricing issue on transfer of intangible assets is differentiated between manufacturing intangibles (which occurs due to pabrication activities or R&D initiatives by the producer, such as patent and technical know-how), and marketing intangibles, from the marketing activities and after sales services, such as trade/name mark. Kind of transfer of intangible assets maybe in the forms of: (i) selling with one off payment, (ii) releasing without any payment (by grant),
(iii) Licencing with royalty payment (can be one off or based on certain percentage from sales, per unit or other basis, (iv) licencing with royalty free.

At the recent technology and information era, ownership over the intangible assets becomes one of success keys of the company. From the research made by Cordoza, 75% market value of the companies in certain business industry consists of intangible assets (Cardoza, Basara, Cooper, & Conroy, 2006). This influences the company’s strategy for minimalizing tax, particularly on transfer pricing. The transfer pricing issues on intangible property are on the problems of identification, valuation and transfer of the intangible assets (Darussalam, Septriadi, & Kristiaji, 2013). Monica Boos also defines intangible assets are nonphysical assets that allow an enterprise to earn profits above the profits the enterprise would have earned with only its physical assets” (Boos, 2003). According Gu and Lev, intangible properties are influenced by some factors namely innovation, human capital, organization process, and the relationship between customers and suppliers (Basso, Oliveira, Kimura, & Braune, 2015).

Meanwhile Smith & Parr as referred to in Boos, stated that intangible property are categorized into several types, such as: (Boos, 2003): (i) Rights like contracts and franchises; (ii) Customer relationships; (iii) Undefined intangibles like going concern value or goodwill; dan (iv) Intellectual property. Intellectual property is kind of unique intangible properties as it has legal protection because intellectual property is created from intellectual process that can be attributed to the business entity. Intellectual property in general can be separated into 5 (five) sub-category, as follows: (i) Marketing related intangibles, such as logo, trademarks, and service marks, (ii) Technology related intangibles, for instance patent, (iii) Artistic related intangibles, for example literary and music copyright, (iv) Data processing related intangibles, such as computer software and chip masks, and (v) Engineering related intangibles, like industrial design and trade secret.

2.4 Know-how

Know-how is kind of property in the form of information or knowledge that assists to improve commercial activities, but unlike patent or trademark, know-how is not registered (OECD, 2017). Generally, know-how consist of secret information related to an industry, commercial or scientific experience and have been applied within the business activities of the company, such as manufacturing process, marketing, R&D or other commercial activities. In her book titled “International Transfer Pricing: The Valuation of Intangible Assets”, Boos (2003) explained that know-how is not legally protected due to its secrecy and confidentiality, so the registration could trigger public information. Thus, know-how license has broadened scope and longer useful life (Poltorak & Lerner, 2004). Further, Viscoti (2019) explains that the know-how means a wealth of non-patented practical information, resulting from experience and testing by the supplier, which is secret, substantial and identified. Secret, in the sense that know-how is considered as a vault of unknown publicly knowledge, substantial means know-how is important knowledge and information for the usage, trade atau resell over the goods or services contract, while identified is that know-how needs to comprehensively explained to enable it being verified that the knowledge satisfy with the secrecy and substantial criterion.

Rachmawati and Riandoko (2014) also describe 2 (two) characteristics of know-how, which are: (i) know-how is part of the intellectual properties, having substantial value, potentially generating economic benefits in the future time, intangible, can owned and controlled, transferable; and (ii) know-how has its own special characteristic which are secret in nature, its confidentiality is continually protected, and could not publicly applied.

According to Ngantung (2013), know-how in general is defined as any kind of secret information related to scientific, commercial and industrial matter that can be applied for business activities and contribute for economic benefits if it is opened for other parties. From that definition, sometimes know-how is treated similarly with services, especially technical services. But, know-how actually is a bit different with services and the fundamental difference between those two is that the owner of know-how will only provide secret information relating to scientif, commercial and industrial experience without taking any responsibility on the result of the user of know-how. Whilst in the case of services, normally the services provider will involve in rendering of the services and taking responsibility on the outcome of the services. As such, in providing know-how, the presence and involvement of the owner are not necessary while in the other hand, in the services rendering, the presence and involvement of the services provider are significantly required.

2.5 Transfer Pricing

Transfer pricing is the price of transfer of goods or payment on services rendered that has been agreed upon both parties (seller and buyer) in financial and other business transactions (Gunadi, Pajak Internasional, 2007). Similar with the definition according to Darussalam and Kristiaji, from taxation perspective, transfer pricing is a pricing policy in transaction carried out between related parties (Darussalam, Septriadi, & Kristiaji, 2013).

In addition, Tsurumi (1984) as referred to in Gunadi, defines transfer pricing as price that is taking into account on transfer of goods and services within a group of entities (Gunadi, Pajak Internasional, 2007). In practice, multi-national companies use this transfer pricing in selling and transferring assets and services within their group companies. From taxation point of view, transfer pricing is used for reengineering costs of a transaction between related parties to minimize tax liability globally on the whole profit of the group companies (Rahayu, 2008).

2.6 Related Party

In practice, transfer pricing has been usually conducted in companies having special relationship. According to Wittendorff, there are 3 (three) elements in related party transaction, namely: (a) there is controlled transaction exist, (b) there is reference transaction, and (c) valuation in measuring the special transaction (Wittendorff, 2010). Controlled transaction identifies special relationship, typed of transaction, business substance, motivation, conditions of the affiliated transaction, etc. Reference transaction is the comparison stage and condition analysis on the affiliated transaction. Lastly, valuation in measuring the transaction value with the special related parties. Dwarkasing (2011) also explained that special relationship is condition where a party contributes to management, control, or ownership over the others. Definition or forms of special relationship may vary between the countries depending on their each domestic laws. Outlined below are some special relationship terminology from various countries.

Negara	Definisi
USA	2 (two) or maybe more parties will be deemed to have a special relationship if the company is owned or controlled directly or indirectly by the same person; • Companies which shares owned directly or indirectly by others; • All form of control directly or indirectly whether legally or not, including if 2 (two) taxpayers behave for common objectives.
UK	No provision on ownership percentage; • Control ship over party by other or the same party.
South Korea	Ownership directly or indirectly more than 50%; • Ability to determine business policy.
China	Effective influence, including capital ownership more than 25% directly or indirectly; Fund loan relationship; Control over operational business activity through management participation; • Providing of *know-how*, supply materials or products market.
Indonesia	Dependency between one party by another, due to: • Capital ownership, directly or indirectly for more than 25%; • Control over management and/or technology

Table 1 – Special Relationship Terminology

Source: Ngantung, Y. W., & Darussalam. (2013). Transfer Pricing: *Prinsip Hukum Perpajakan Internasional.* In Darussalam, D. Septriadi, & B. B. Kristiaji, *Transfer Pricing: Ide, Strategi, dan Panduan dalam Perspektif Pajak Internasional* (pp. 61-86). Jakarta: DDTC.

2.7 Legal Certainty

Definition of certainty principle including on legal provisions and tax procedures, is a protection guarantee that a law must be respected and conducted in a good and proper manner. Certainty, in substance is a main goal of the law as the law without legal certainty it basically looses its identity and become meaningless. According to Sudikno Mertukusumo, legal certainty is a protection and a wish that the law must be carried out properly. It needs an effort to regulate the legal provisions under the laws that made by the authorized and legitimate institution so that the legislation having their legal and juridical aspect to be respected and obeyed by the people.

Lon Fuller in his book titling "The Morality of Law" introduced 8 (eight) principles that should be fullfiled by the law otherwise it can't be said there is no certainty, namely:

1. Law system consists of regulations, not based on improper verdicts for specific cases;
2. Such regulation need to be publicly announced;
3. Could nor retroactively applied as it will be crashed the system integrity;
4. Made in the clear legal drafting and commonly understood;
5. Should be in line one another and not controversial;
6. Could not ask for a suit exceeding those can be performed (ultra petita);

7. Consistent and could not rapidly changed;
8. Must be similar between those regulated and the execution in daily life.

Lon Fuller's views as outlined above provides a conclusion that certainty principle must be synchronized between the regulation and the implementation, thus legal certainty not only cover the application, behaviors aspects but also influenced factors as to how the existing laws and regulation are executed.

3.0 METHODOLOGY

In this research, a qualitative approach was used where data are gathered, studied and analysed based on inductive method to be deeply understood and explained. Qualitative approach was used as a proper methodology with the aim of conducting in-depth analysis related to practicall challenges from the Indonesian Tax Authorities (ITA) on the royalty expenses related to the utilization of intangible assets and/or know-how deducted by the corporate taxpayer in their calculation of annual corporate tax returns, despite the royalty expense is technically deductible item. This type of research is a descriptive study, to explain the rationale of ITA's challenge in treating the royalty expenses related to the utilization of intangible assets and/or know-how as non-deductible expenses during the performance of tax audit.

This study is an applied research, where this research arises from the practice that occurred in the taxation field regarding the fiscal adjustment on royalty expenses and efforts of corporate taxpayers in solving the disputes through filing tax objection and appeal which were carried out during the period of February - October 2020.

In this study, researcher used qualitative data collection techniques, through literature studies and field observation. This study also uses taxation regulations that apply in Indonesia, books, journals, and corresponding articles related to research topics, so that they can be linked to cases that occur. Field studies used for data collection in this research were collected by conducting interviews with parties who understood well the problem in the study, namely the Directorate General of Taxation, representative of the corporate taxpayers that has been subject to tax audit and the royalty expeses were fiscally adjusted by the ITA, tax practisioners, and fiscal scholars (Indonesian tax expert academician). All data and information obtained from sources and literature studies were analyzed qualitatively by triangulating with relevant theories, regulation, and opinions from tax practisioners and fiscal scholar/expert academician.

4.0 DISCUSSION AND RESULT OF ANALYSIS

4.1 Identification of fiscal adjustment on royalty expenses related to the utilization of intangible assets and/or know-how and its rationale from Indonesian Tax Authorities (ITA)

Despite technically the provision of Article 6 paragraph (1) leter a) point 3) of the prevailing Income Tax Law clearly states that royalty expense is deductible expense for the purpose of calculating corporate income tax, however in daily practice of tax audit, there is always practical challenges from the ITA on deductibility of this expense. Some rationales and reason as to why the ITA conducted such fiscal adjustment on this royalty expense, can be categorized as the following:

a) The corporate taxpayers who claimed royalty expenses related to the utilization of intangible assets and/or know-how are deemed failed in providing evidences and explanation for existence test of the utilization on intangible assets and/or know-how. This existence test on royalty normally carried out by the ITA requires the corporate taxpayer to provide: (i) legal existence, in the form of tangible royalty contract/agreement, correlation between the scope of activities mentioned in the contract with the transfer of intangible property that were rendered,
corresponding royalty calculation according to the contract with the actual payment/transfer, evidences of ownership tittle/registration of the intangible property within the Authority from the country where the owner is resident, amount of research & development (R&D) costs to be the basis for royalty charges to entity in Indonesia.
Existence test is the first layer of testing to determine if royalty expense, especially those paid to the related parties, is deductible or not for corporate income tax calculation purposes. If the corporate taxpayers could not show supporting documents on this royalty expense, in tax audit practice, the tendency is high for ITA to make a fiscal correction on the whole amount of the royalty expense so that the exposure for the corporate taxpayers auditee will

be the existing corporate tax rate multiplied by the whole amount of royalty expense that was treated as non-deductible expense.

b) Fiscal correction on royalty expense are sometimes happened due to the corporate taxpayers failed to satisfy the second test, whether such royalty payment were providing economic/commercial benefits to the company. In practice, the ITA will ask the corporate taxpayers to provide tangible evidence on the utilization of the intangible properties and/or know-how that giving commercial benefits to the company. Proofing if the intangible royalty that was paid contributes some tangible benefits is something that is quite struggling for corporate taxpayers to show, because the royalty is intangible and the information supplied is know-how in nature. However, in many tax audit practices, supporting documents as the following are necessary to be provided during the tax audit to encounter this findings: (i) information related to the increase of the company's profit margin caused from the utilization of intangibles assets and know-how can be shown in the form of costs efficiency in the company's costs of good sold; (ii) increment of the company's top line revenue due to the use of new technology, intangible properties and/or know-how that can drive the company's sales; (iii) decrease of statistic on operational damage rate, effectivity of production costs, improvement of system and working process of the company with the evidence of the reviewed Standard Operational Procedures (SOP) done by the royalty provider; or other similar documents that supports the company is in fact receiving economic/commercial benefits from such royalty payment. The ITA proposed to request such evidence, mainly to test if the royalty expense is truly contribute to the company's economic/commercial benefits and related to the business expenses of the company, the amount is not excessive particularly if such royalty are paid to the related parties that potentially done to shift the profit to the party with lowest tax rate. From our field observation, in some cases the fiscal correction are proposed by the ITA through characterization of royalty payment into disguise dividend, most notably if the royalty was paid to shareholders. As it is commonly known, dividend is non-deductible expense pursuant to Article 9 paragraph (1) letter a) point 1) of the prevailing Income Tax Law.

c) The corporate taxpayers paying royalty related to the utilization of intangible assets and/or know-how, most notably to the related parties, need to pass and satisfy the arm's length principle test. Failure to provide tangible evidence that the royalty payment made to the related parties is fair and in line with common business practices may lead the ITA to adjust the royalty expense to be non-tax deductible. In practice, the fiscal correction on this royalty expense under this category are due to the following facts: (i) can't provide if they had prepared Transfer Pricing Documentation (TPD) on royalty payment to the related parties having special relationship; (ii) can show the TPD, but based on review from the tax auditor, such TPD is prepared without following the proper stages as stipulated by the regulation and/or OECD TP guidelines, so that the arm's length principle being not reliable and doubtful. The cause factors are vary, such as TPD does not accurately explain the Functional, Assets and Risk (FAR) analysis, any error in determining the tested-party to test the fairness of the price, any mistake in deciding transfer pricing methodology that fits with the categorization of the company, or any fault in selecting comparison companies and/or source benchmarking. Other technical root causes can be happened in the selection profit level indicator that may not parallel with the business operation or determination of irrelevant statistic tool. Unlike the other two tests having explained above, that normally come up with the full fiscal correction, this 3rd test on arm's length principle may resulted in partly fiscal adjustment, i.e. on the amount that is considered exceeds the fair value.

It can be explained, where for instance a corporate taxpayer having recorded a royalty expense related to the utilization of intangible assets and/or know-how of IDR 20 billion a year with the applicable royalty rate of 3% from net sales. Such royalty paid to the related party has been supported by a TPD report prepared by the individual consultant where such royalty rate is considered arms length since the TPD mentioned that the fair royalty rate is in the range between 2,5% - 4% of the net sales of the company. During the tax audit, the ITA discovered that the company has passed the existence test and the economic/commercial benefits have been satisfactory shown by the audited. However, when the tax auditor reviewed the TPD report, they found that some comparable entities are not in line with the company's business sector thus rejected. As a result, the arms length range is shifted to the lower percentage and ITA decides that the acceptable fair royalty rate should be at 2%, causing fiscal correction on the royalty expense as non-deductible item in the amount of IDR 6,67 billion [= (3% - 2%) X IDR 20 billion/3%]. Tax effect of this correction, on the assumption that the corporate income tax rate is flat at 25%, come out with the total tax liability of IDR 1,67 billion (=25% X IDR 6,67 billion), not including tax penalty in the form of interest charged at 2% per month for a maximum 24 months of late payment.

Indonesia adopts self-assessment system in its taxation collection where the taxpayers are obliged to take their own responsibility to compute, calculate, pay, and report their taxation duties. But, the ITA then is authorized to test the compliances of the taxpayers through its right to conduct tax audit and redetermine the amount of income and expenses as well as to redetermine debt to equity ratio to calculate taxable income for taxpayers having special relationship transaction by using transfer pricing methods that has been stipulated in the tax legislation. It is stipulated in the Article 18 paragraph (3) of the prevailing Income Tax Law and the type of special relationship is explicitly mentioned in Article 18 paragraph (4) where the requirements are as follows:

a. The taxpayer is having capital participation directly or indirectly at minimum 25% to other taxpayers; or
b. The taxpayer controls other taxpayers or 2 (two) or maybe more taxpayers are in the same control directly or indirectly; or
c. There is family relationship either through blood or marriage within one degree of direct or indirect lineage.

The above provision reflects that Indonesia transfer pricing rules follow arms length principle to be in line with the OECD TP Guidelines. For the technical implementing regulation, the ITA has released Director General of Taxes (DGT) Regulation Number PER-32/PJ/2011 regarding changes on DGT Regulation Number PER-43/PJ/2010 on the implementation of arms length principles for transactions between related parties (hereinafter referred to as PER 32/2011), DGT Regulation Number PER-22/PJ/2013 regarding Guidelines on tax audit for taxpayers having special relationship, hereinafter referred to as PER 22/2013, DGT Circular Letter Number SE-50/PJ/2013 on Technical guidance on taxpayer having transactions with special relationship parties, hereinafter referred to as SE 50/2013, and Minister of Finance Regulation Number PMK-213/PMK.03/2016 regarding typed of documents and/or additional information that need to be kept by the taxpayers having transactions with related parties and its managing procedures, here in after referred to as PMK 213/2016.

Article 14 of PER 32/2011 specifically explained that a transaction of utilization of intangible assets will be satisfying arm's length principles if the transactions are truly rendered and the occurrence of such transaction contributes sort of economic/commercial benefits to the buyer and if it is conducted between the related parties, such transactions are fairly valued in comparison to similar transaction with the independent party (comparable conditions). Further, in Chapter IV of the Attachment of PER 22/2013, it is mentioned that the implementation of arms length principle on intangible assets transactions to be done with the following steps:

a) Identifying the existence of each intangible assets/properties that can contribute for market success of the product.
b) Identifying the value of intangible assets/properties and determining the contributing parties on the establishment of such intangible assets/properties.
c) Studying whether the transfer of intangible assets/properties are truly delivered in such transaction.
d) Determining the fairly compensation for each intangible assets/properties that are transferred

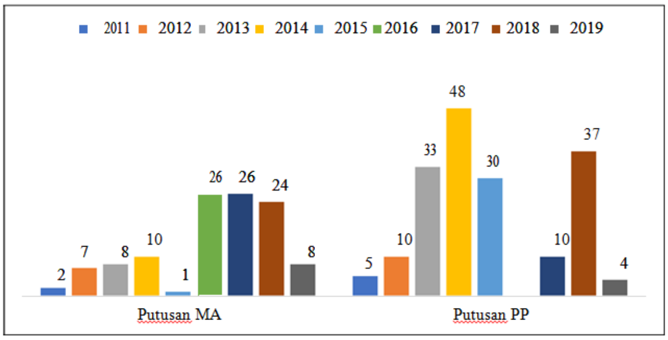
The steps outlined above is basically asked to the corporate taxpayers to prove convincingly that the company has passed the 3 (three) tests for deducting the royalty expenses related to the utilization of intangible assets and/or know-how, namely: existence test, economic/commercial benefits test, and lastly arms length principle test if the transaction is made between the related parties.

4.2 Practical Challenges Analysis on the Royalty Expenses Deduction and Its Dispute Resolution from Legal Certainty Aspect

Facing the practical challenges on deductibility of the royalty expenses related to the utilization of intangible assets and/or know-how, many corporate taxpayers brought the case law into further tax controversy in the form of filing the tax objection to the Regional or Central Tax Office, applying for tax appeal to the Indonesian Tax Court if the tax objection still rejected, and finally submitting the judicial reconsideration memorial (so called "peninjauan kembali") to the Supreme Court. The tax objection is filed on the tax assessment issued by the ITA as a result of tax audit, while the tax appeal application is lodged if the tax objection is rejected either wholly or partly by the Regional or Central Tax Office. In the event of the tax appeal is refused by the Tax Court, the corporate taxpayers can continue an extraordinary legal effort through filing the judicial reconsideration memorial to the Supreme Court, which will be the final and binding in nature, to both ITA and taxpayers.

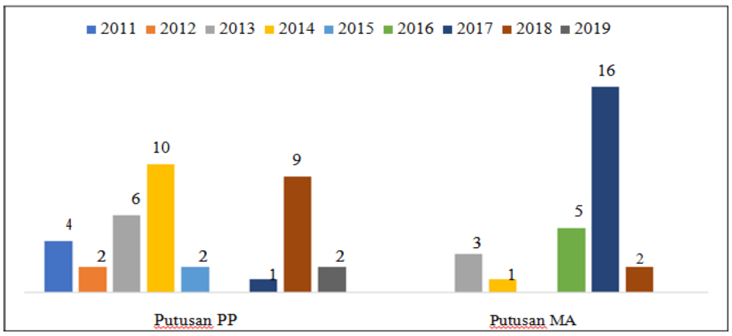
As many disputes on royalty expenses were involving related parties, to anticipate transfer pricing abuse practices, the competent tax authorities of countries around the world always try to continually improve the transfer pricing provisions and to include among others the provisions of the imposition of tax penalty, review procedure on related party transaction, supporting documentation requirement, as well as tax audit protocol that may lead transfer pricing adjustment (Darussalam, Septriadi, & Kristiaji, 2013). In some cases, fiscal correction resulted from a tax audit/investigation will cause the ITA to issue tax assessment letter [that can be in the form of underpayment tax assessment letter (SKPKB), nil tax assessment letter (SKPN) and overpayment tax assessment letter (SKPLB)], the issuance of which may disagreed by the corporate taxpayer and trigger the tax dispute between the ITA and the taxpayer. As previously explained above, in Indonesia, this tax dispute resolution on this transfer pricing transaction in the form of royalty expenses can be performed through the filing of tax objection, tax appeal or judicial reconsideration memorial.

The following are statistic data on the Indonesian Tax Court and Supreme Court verdicts on transfer pricing disputes between ITA and taxpayers during the priods of 2011-2019.



Putusan MA = Verdicts of the Supreme Court; Putusan PP = Verdicts of the Tax Court
Diagram 3 – Tax Disputes on Transfer Pricing Issues
Source: DDTC Engine (has been re-processed, 2020)

The above diagram shows that verdicts from the Tax Court and Supreme Court related to transfer pricing disputes are always incurred every year and the trend is increasing. Even though Indonesia is one of the countries that has been adopting arms length principles and follows the OECD TP Guidelines, however transfer pricing practices are quite many. Based on OECD's assumption, this may happen due to different approach of transfer pricing implemented by each countries so there is no global standard in what should be comprehensively reported by the corporate taxpayer to the tax authorities. The OECD TP Guidelines provides more concern on several related party transactions, so called specific transaction, one of them is transaction on transfer or utilization of intangible assets/property and/or know-how. Along with G20 countries, OECD formulated Base Erosion Profit Shifting Project (BEPS Project), whereby in Action 8 BEPS it contains tax treatment on intangible assets/property. One of the most occurred disputes on this particular issues is tax dispute on the compensation of intangible assets and/or know-how in the form of royalty payment. The following diagram tells the tax disputes related to royalty issue explained above.



Putusan MA = Verdicts of the Supreme Court; Putusan PP = Verdicts of the Tax Court
Diagram 4 – Tax Dispute on Royalty Expenses
Source: DDTC Engine (Has been re-processed, 2020)

From the above diagram, we all know that the tax dispute on disallowance of royalty expenses become tax deduction, continually exist every years. This fiscal correction as have been explained in the previous section, are due to the ITA's view that the existence test is failed on the basis that the corporate taxpayers could not satisfy the ownership/title of right on the intangible assets, more over if it is in the form of know-how which is legally did not registered to the relevant government body, as opposed to trade mark or patent. Other reason is because of there are no real benefits enjoyed by the corporate taxpayers from the payment of royalty on the utilization of intangible properties and/or know-how. Whilst others were adjusted by the ITA due to royalty payment does not constitute fair value and arm's length principle, even in certain cases such royalty payment were characterized as disguised dividend since they were paid to the shareholders.

Our observation and review on several verdicts issue by the Tax Court on this royalty expenses disputes with regard to the utilization of intangible properties and/or know-how from the legal certainty stand point, resulted in the following items:

a) In case the root cause of royalty expenses adjustment made by the ITA is related to existence test that was not passed by the corporate taxpayers, verdicts from the Tax Court were determined after the panel of judges instructed to conduct series of evidence/material test attended by both appellant and appellee. We note some verdicts were won by the taxpayers provided they can convince and show relevant documents on the utilization of intangible assets/properties and/or know-how and able to provide evidence of economic/commercial benefits enjoyed by the company either directly or indirectly, in return to the payment of royalty.

b) For fiscal correction made on transfer pricing reasons, verdicts from the Tax Court were vary taking into consideration of arguments, views and supporting references on the TP adjustments. In case the panel of judges took the view that review of TP Documentation carried out by the ITA is more appropriate with the tax laws and regulation, as well as the theory for TP Documentation preparation, due to no clearly stipulation, then the Tax Court would likely to maintain the fiscal adjustment. On the other hand, if the panel of judges foresee the other way around, the tax appeals filed by the corporate taxpayers are granted. Notwithstanding the above, from our record, only a few verdicts where the panel of judges determined to re-calculate the range of fair value and arm's length principles to be applied, normally in such a point between figures based on ITA and tax payer's fair computation.

5.0 CONCLUSION

1) Corporate taxpayers are always facing practical challenges on deductibility of royalty expenses related to the utilization of intangible properties and/or know-how during the performance of tax audit by the ITA. Even though it is technically clear stated in the prevailing Income Tax Law that the royalty expenses is deductible for corporate income tax calculation, however in practice such royalty payment are non deductible for certain reasons. This research identifies that the royalty expenses are sometimes being corrected by the tax auditor due to failure to pass the existence test, economic/commercial benefit test and/or arms length principles test.

2) From legal certainty aspect, efforts to resolve tax disputes on this royalty expense adjustment are also ambiguous as the verdicts from the Tax Court are vary depending on the cases. Dispute on non-deductibility of royalty expense related to the utilization of intangible properties and/or know-how are casuistic in nature, multi-dimensional and having heavy indication to a transfer pricing element. As such the dispute resolution in the trial procedures at the Tax Court are also vary in terms of approaches and technics carried out by the panel of judges.

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