

TAX AUDIT EFFECTIVENESS AND REVENUE COLLECTION OUTCOMES IN INDONESIA

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Abstract

This article considers links between Indonesia's tax collection performance and the design and operation of its tax compliance system through a study of the tax audit practices and procedures of Indonesia's tax authority, the Directorate General of Taxation. The article considers the distortionary effect of some features of Indonesia's tax compliance approach under which audits tend to be focused largely on taxpayers who are already compliant and audit activities are narrowly focused and not risk based. The article also considers ways in which Indonesian tax authorities could expand tax audit coverage and modify audit procedures and thereby increase the effectiveness of their compliance activities in the future leading to improved revenue collection outcomes.

Key Words: Indonesia, Tax Compliance, Tax Audits, Tax to GDP ratio

I INTRODUCTION

The article considers the relationship between Indonesia's generally poor revenue collection outcomes and the effectiveness of its tax compliance approach, by an examination of the way in which Indonesia's main tax authority, the Directorate General of Taxation (DGT), carries out tax audits and other tax compliance activity. The potential importance of further reform to the DGT's tax compliance practices is highlighted by Indonesia's consistently low tax to GDP ratio, which was in the 8% to 10% range over the 5-year period from 2017 to 2021.¹ This is well short of the Indonesian Ministry of Finance's "Tax Policy Objective" to achieve a tax to GDP ratio of 16%.² Recent World Bank data indicates that Indonesia's tax to GDP ratio remained 9.1% in the 2021 year, and that Indonesia's declining tax to GDP ratio reflects

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¹ Directorate General of Taxation, *DGT Annual Report 2021: Collaborative Effort for National Economic Recovery* ('DGT Annual Report, 2021') 192; accessible at [Laporan Tahunan DJP 2021 - English.pdf \(pajak.go.id\)](https://www.pajak.go.id/Laporan_Tahunan_DJP_2021_-_English.pdf)

² Directorate General of Taxation, *DGT Annual Report 2019: Continuous Development of Organizational Capacity through Strengthening the Governance of Taxation Data and Information Technology*, 60.

a long-term trend.³ The Indonesian Government has recently introduced various legislative and regulatory measures to increase tax collections, including an increase in the top marginal tax rate for individuals from 30% to 35%, an increase in the Value Added Tax (VAT) rate to 11% (with a further increase to 12% in 2025), the adoption of broad based anti-avoidance rules, improved DGT access to taxpayers’ financial data, and a new “Electronic Transactions Tax” applying to foreign e-commerce business.⁴ In this context, the focus of this article is on identifying potential inefficiencies in the design and delivery of the tax audit program which might contribute to the DGT’s difficulties in achieving higher levels of taxpayer compliance.

“Tax compliance” generally refers to compliance with a range of tax obligations imposed under a tax system, which extends to taxpayer registration, lodgement of tax returns, and payment of tax liabilities. In an Indonesian tax context, the term “compliance” is sometimes taken to have a narrower meaning and may refer only to the extent to which registered taxpayers have complied with their obligations to lodge tax returns. In this article, “compliance” refers to fulfillment of all tax obligations in the broader sense, rather than the narrower sense sometimes used in Indonesia. Taxpayers who are registered and participants in the system but delinquent in some respects (for example, who may not have disclosed all income in tax returns, or made other errors) could be considered to be “semi-compliant” or “broadly compliant”, whereas those individuals and entities which should be registered as taxpayers but have not done so could be regarded as “non-compliant” (in the sense that they do not comply with any of their tax compliance obligations).

The article deals mainly with the DGT’s compliance enforcement activities with respect to Income Tax and VAT, and associated withholding taxes, and it examines in detail the DGT’s practices when conducting tax audit activity. Any inefficiency in conducting the audit process could reduce the capacity of the DGT to extend tax audit activity to other non-compliant taxpayers. As an OECD working paper has observed: “Tax audits constitute an integral part of any tax system based on self-assessment. Given that the tax administration has limited resources to conduct tax audits, these should be allocated in a way to maximise expected revenue collection”.⁵

By its examination of the tax compliance approach adopted in Indonesia, the article considers whether, through a combination of the human resource constraints within the DGT, the nature of the tax audit methodology that is generally applied in the conduct of tax audits, the legal requirement that all tax refund cases must be audited, and the workload on audit teams resulting from that legal requirement, the practical effect is that only already-compliant taxpayers are likely to be subject to tax audit.⁶ Consequently, there is a very low audit probability for Indonesian entities that should be paying tax but elect to be non-compliant or partially compliant and this, in turn, has a direct and adverse impact on revenue collection outcomes (when measured by the tax to GDP ratio achieved by Indonesia). The magnitude of the tax gap reflected in Indonesia’s low tax to GDP ratio is an indicator that non-compliance

³ Data about Indonesia’s historical tax to GDP ratio outcome, with the most recent data being for the year ended 31 December 2021, can be accessed here: [Tax revenue \(% of GDP\) - Indonesia | Data \(worldbank.org\)](https://data.worldbank.org/SD/SH.UY.CV) (accessed 3 June 2023). Tax to GDP ratio calculations by different economic agencies can vary; here, World Bank data is used to enable a “like for like” comparison.

⁴ See generally: PwC, *Indonesian Pocket Tax Book, 2023*

⁵ J Arnold, ‘Improving the Tax System in Indonesia’ (2012), *OECD Economics Department Working Papers*, No. 998, 28

⁶ There is a specific requirement under Indonesian law that an audit must be conducted in all cases where a taxpayer seeks a tax refund: refer to Article 17B(1) of the *General Provisions and Tax Procedures Law*. Arnold (supra, 29) has suggested this requirement should be abolished.

in the sense considered in this article (i.e., disengagement with tax registration and compliance requirements) is a major contributor to the revenue collection challenges Indonesia experiences, and that greater focus on enforcing compliance by the non-compliant should therefore be a greater priority for the DGT.⁷

II RESEARCH METHOD

The research employs a mix of methods, including analysis of primary legal sources (e.g., English-language versions of Indonesian tax legislation and regulations), other official data sources such as the comprehensive annual report published by the DGT (in English), as well as legal textbooks, academic literature, journal articles, newspaper reports, and other publications such as those produced by professional tax consulting firms based in Indonesia. The core research about tax audit practices and procedures is based on face-to-face interviews with active participants in the Indonesian tax audit process, comprising past and present DGT audit officers and professional tax advisors, and with tax academics based at Indonesian tertiary institutions. The research employs a qualitative approach, within an interpretivist research framework, using qualitative research methods, comprising semi-structured interviews in combination with other non-doctrinal legal research methods such as textual analysis.⁸

A *Interview design and approach*

A total of 24 semi-structured interviews were conducted, which allows the research to be informed by a range of views expressed by participants in the Indonesian tax system. The interview data has been anonymized, necessitating a sufficiently large sample of interview subjects to ensure that anonymity is maintained. Interviews were conducted with the following people: 9 experienced tax practitioners (senior partners from 3 of the “Big 4” international accounting firms, 2 partners in a leading local tax consulting firm, and 3 senior staff from smaller local firms); 11 past and present DGT audit officers; and 4 Indonesian tax academics (drawn from 3 different Indonesian tertiary education institutions). Interviews were conducted face-to-face at various locations in Indonesia between September 2019 and February 2020. All interviews were conducted in English, with contemporaneous notes of discussions being taken by the researcher and provided to interviewees for review and correction or clarification (if required) prior to finalisation. The interviews with DGT officials and tax practitioners (20 in total) were structured around 6 main themes, designed to explore how tax audit activity in Indonesia is conducted by the DGT, to help gain an understanding of the DGT’s audit objectives and the effectiveness of tax audit activity. The interviews with tax academics were focused more on understanding the process in Indonesia for developing tax policy and implementing change (these issues were also canvassed to some extent in the interviews with tax practitioners and DGT officials). The use of the interview methodology allowed information to be compiled by drawing on the direct experience and

⁷ A 2013 study by the IMF suggests that Indonesia’s tax system has a theoretical capacity to generate revenue of around 28% of GDP, which by comparison with the actual achievement of a 9.1% tax to GDP ratio in 2021 indicates the extent of the “tax gap”. See: R Fenochietto and C Pessino, ‘*Understanding Countries’ Tax Effort*’, International Monetary Fund, working paper: WP/13/244, 2013, 13. Note that whilst some changes to the Indonesian tax system have been made since 2013, broadly, these further measures have been designed to increase revenue rather than to erode the tax base.

⁸ M McKerchar, M 2010, *Design and Conduct of research in Tax, Law and Accounting*, (Lawbook Co, 2010) 118; T Hutchinson, *Researching and Writing in Law*, (3rd edn, Law Book Co, 2010) 113

knowledge of the interview participants, and the data gained from the interviews with the 24 individuals referred to above is sufficient in the context of this research (consistent with the literature about interview-based research of this nature).⁹ Further, the possibility of conducting further interviews after February 2020 was prevented by travel restrictions introduced by both the Australian and Indonesian governments in response to the COVID-19 pandemic.

Written consent was obtained from all interview subjects, and ethics approval for the research was obtained from both the University of South Australia (where the researcher was based when the interviews took place) and from the Indonesian Ministry of Research, Technology and Higher Education (usually referred to as “RISTEK”), the Indonesian Government agency which (at the time the research was conducted) had regulatory oversight of foreigners conducting research in Indonesia. The interview-based research approach employed is consistent with the approach taken by other tax compliance researchers, notably Braithwaite, but also by numerous other researchers who have used an interview-based approach in studies about Indonesian taxation.¹⁰

B Tax Compliance Theory

Although the present research is about the practical operation of the Indonesian tax compliance system, and the identification of potential inefficiencies in the way in which it operates in practice, it is informed by general scholarly theories of tax compliance. Principles for designing taxation systems can be traced to Adam Smith’s *Wealth of Nations*.¹¹ In a more modern context (comprising a wholesale policy-based review of Australia’s tax and transfer system on behalf of the Australian Government), Henry articulated five key design principles that underpin an effective tax system under the headings of equity, efficiency, simplicity, sustainability and policy consistency.¹² Henry noted that “legal and administrative institutions and frameworks should also be robust to maintain the effectiveness of the system and underpin the legitimacy of the system”, in which it is implicit that a “robust” and “effective” tax compliance system is a necessary and important element of tax system design.

Much of the early research on tax compliance focused on economic deterrence and was influenced by the analysis of illegal behaviour using an “economic framework” undertaken by Becker, which sought to “demonstrate that optimal policies to combat illegal behaviour are part of an optimal allocation of resources. Since economics has been developed to handle resource allocation, an ‘economic’ framework becomes applicable to, and helps enrich, the

⁹ As few as 12 interviews may suffice where “the aim is to understand common perceptions and experiences among a group of relatively homogenous individuals”: G Guest, A Bunce, and L Johnson, ‘How Many Interviews are Enough? An Experiment With Data Saturation and Variability’, (*Field Methods*, Vol. 18 No.1, February 2006) 59-82

¹⁰ J Braithwaite, *Markets in Vice, Markets in Virtue*, (Oxford University Press, 2005) 16. See also: J Braithwaite and P Drahos *Global Business Regulation*, (Cambridge University Press, 2005) 12; P Grabosky, P and J Braithwaite, *Of Manners Gentle* (Oxford University Press, 1986); N Korte, N 2013, ‘The Political Economy of Public Administration Reforms in Southeast Asia: A Comparative Analysis of the Tax Administration in Indonesia and the Philippines’, (PhD Thesis, University of Hamburg, 2013); A Rosid, C Evans, and B Tran-Nam, ‘Perceptions of Corruption and Tax Non-compliance Behaviour: Policy Implications for Developing Countries’, *Bulletin of Indonesian Economic Studies*, Vol. 54, No. 1, 2018, 25–60; K Prasetyo, ‘The Role of Effective Tax Administration in Encouraging Greater Compliance with Taxation Laws in Indonesia’ (PhD Thesis, Curtin University, 2018); MH Pratomo, ‘Investigating Tax Compliance Risks of Large Businesses in Indonesia’, (PhD Thesis, RMIT Graduate School of Business and Law, 2018)

¹¹ Adam Smith, *Wealth of Nations* (1776), Chapter V, Book II

¹² K Henry, *Australia’s Future Tax System*, (The Treasury, Canberra, 2009) 17

analysis of illegal behaviour”.¹³ Allingham and Sandmo’s early study on tax evasion employed this economic approach in considering the impact of deterrent factors such as the probability of detection and penalties.¹⁴ Subsequently, a view emerged that a broad range of factors affect levels of tax compliance, highlighting the need for an integrated approach to be taken in efforts to improve levels of tax compliance, with McKerchar observing that “it may be more fruitful (and economical) to abandon the search for the all-encompassing single model of taxpayer compliance and consider the use of different models to explain different types of compliance behaviour”.¹⁵

Within that broader theoretical context, the Indonesian study considered in this article highlights an issue (the effectiveness of tax compliance activity) that is directly relevant to any consideration of whether Indonesia’s current tax administration approaches meets the requirements articulated by Henry. If tax compliance activities are inefficient, poorly targeted, or ineffectual, not only are deterrence objectives compromised through the reduction of an individual taxpayer’s risk of detection of non-compliance, but Indonesian tax morale (the motivation to pay tax) may also be compromised, if taxpayers form a general perception that their peers are unlikely to meet tax compliance obligations.

III LITERATURE ON INDONESIAN TAX AUDIT PRACTICES

Although there is a growing body of literature about Indonesian taxation generally, with numerous journal articles published by both Indonesian-based and foreign researchers in recent years, the literature on Indonesian tax administration and tax compliance approaches is more limited, and many studies approach tax compliance issues mainly from the taxpayer’s perspective, without considering in detail the possible impact of the DGT’s own compliance actions. Whereas some articles refer to Indonesia’s tax compliance challenges and examine a range of factors that potentially affect compliance levels, there appears to be no previous comprehensive analysis about the way in which Indonesian tax audits are conducted (in a practical sense) by the DGT. Nevertheless, over the past decade, there have been some significant studies concerning Indonesia’s general approach to tax administration matters, reflecting the upsurge in academic interest in understanding and addressing Indonesia’s poor tax revenue mobilisation performance. From the literature, various features of Indonesia’s approach to tax administration and tax compliance can be identified, which are relevant to the issues explored in this article, although the research relating to the way in which the DGT conducts tax audit activity is limited.

Several previous studies have considered aspects of deliberate non-compliance in Indonesia. In Widihartanto’s study about Indonesia’s failed efforts to implement a High Wealth Individuals compliance program like that successfully adopted in Australia, various interconnected themes were noted, such as Indonesia’s low levels of tax compliance (reflected in its low tax to GDP ratio), and the twin problems of substantial informality in the Indonesian

¹³ G. Becker (1968), ‘Crime and punishment: an econometric approach’, *Journal of Political Economy*, Vol. 76 No. 1, 169-217, at p.209

¹⁴ M. Allingham and A. Sandmo (1972), ‘Income Tax Evasion: A Theoretical Analysis’, *Journal of Public Economics* 1, 323-338

¹⁵ M. McKerchar (2001) ‘Why Do Taxpayers Comply – Past Lessons and Future Directions in Developing a Model of Compliance Behaviour’, 16 *Australian Tax Forum* 99, at p.127

economy (i.e., the cash economy) as well as outright tax evasion.¹⁶ The extent of deliberate non-compliance in an Indonesian context was also considered in a major study by Rosid et al, who used a mixed methodology of face-to-face interviews and self-completed surveys to gauge the attitudes of a broad-based sample of personal income taxpayers in Indonesia to tax compliance, with an emphasis on perceptions of corruption and the impact of corruption on tax compliance attitudes.¹⁷ Their study also noted issues such as the limited enforcement resources available to the DGT, and the low risk of being subject to audit faced by Indonesian personal income taxpayers, which are relevant to the issues examined in this article.¹⁸ However, it should be noted that this study focused on attitudes of individuals who had already registered as taxpayers and were already “within” the formal taxpaying system, and therefore who could be regarded as being at least semi-compliant.

Insights into the source of Indonesia’s tax compliance problems were provided by Hamilton-Hart and Schulze who noted that whilst the Indonesian tax system is “well-designed in principle”, its problems “lie in tax policy and in tax administration” and they concluded by stating: “[t]here are too few taxpayers, compliance levels are much too low, and auditing is not risk-based”.¹⁹

Another study which considered the extent of non-compliance amongst a segment of Indonesian taxpayers was that undertaken by Mukhlis looking at levels of tax compliance in the SME business sector in East Java.²⁰ This study was based on a survey of 283 individuals engaged in small business activity. Although mainly focussed on compliance cost issues, another study by Susila examined the attitudes of large corporate taxpayers to the DGT’s audit processes and, amongst other things, the study found that large corporate taxpayers have a relatively low (less than 50%) level of satisfaction with the DGT’s tax audit processes, compared with the generally more favourable impressions of other interactions with the DGT.²¹ The study also included some relevant background analysis of the structure and operations of the DGT, including its approach to conducting tax audits.

The tax compliance literature in Indonesia generally does not consider the specific details of how tax audit activity is undertaken by the DGT. Whilst there is some focus in Korte’s research on the DGT’s administrative practices, including compliance activities, her principal focus was on the circumstances in which Indonesia implemented its tax reform program in the period up to 2008. Nevertheless, Korte noted various potentially significant matters affecting the effectiveness of the DGT’s compliance activities, such as misalignment of audit resources, whilst also noting the lack of focus on risk-based auditing, and the low risk of audit faced by most Indonesian taxpayers.²² In this respect, Korte’s study was consistent with the later study of Rosid et al.²³ Sari examined the impact on levels of tax compliance from the adoption of risk management strategies by the DGT, particularly the adoption of the

¹⁶ S. Widihartanto, ‘Regulating Indonesia’s High Wealth Individual Taxpayers: Ideas for Policy Transfer’ (PhD thesis, Australian National University, 2014)

¹⁷ Rosid et al (n 11)

¹⁸ Rosid et al (n 11) 46

¹⁹ N Hamilton-Hart and G Schulze, ‘Taxing Times in Indonesia: The Challenge of Restoring Competitiveness and the Search for Fiscal Space’ (2017) 52.3 *Bulletin of Indonesian Economic Studies* 265, 291.

²⁰ I Mukhlis, ‘Tax Compliance for Businessmen of Micro, Small and Medium Enterprises Sector in the Regional Economy’ (*International Journal of Economics, Commerce and Management*, IV, Issue 9, 2016)

²¹ B Susila, ‘The Compliance Costs of Large Corporate Taxpayers in Indonesia’ (PhD Thesis, Curtin University, 2014) 198

²² Korte (n 11) 69

²³ Rosid et al (n 11)

“Account Representative” strategy, whereby DGT officers are allocated to monitor compliance with tax obligations of taxpayers, using risk management strategies, to ensure higher overall levels of compliance.²⁴

Pratomo also examined the DGT’s compliance approach and identified shortcomings in the way tax audit activities are conducted, suggesting that there should be greater risk-based focus in assessing compliance risks presented by large corporate taxpayers, with a particular focus on “undisclosed high-risk transactions or arrangements or abnormally low tax payments in a specific situation”.²⁵ Pratomo also identified the importance of the DGT adopting a flexible approach in encouraging greater levels of voluntary compliance. The focus of Pratomo’s study was on factors which might affect the way in which large corporate taxpayers approach their tax compliance obligations, which may have either a positive or negative effect on overall tax compliance levels but did not examine the DGT’s own compliance approach. Pratomo noted that the probability of detection and penalties are factors which may motivate large business taxpayers to be more compliant.

As with Pratomo’s research, Prasteyo also considered some aspects of the DGT’s compliance approach, and his research was based on capturing the views of interview participants on how best to improve the DGT’s internal management to improve overall taxpayer compliance levels.²⁶ Most of the factors described by Prasteyo relate to the DGT’s internal working environment, including relationships between staff and supervisors and creating more “positivity” within that environment. Given that the focus of this research was on the need for behavioural changes within the DGT that can assist in implementing tax administration reform measures, it did not examine how tax compliance activities are conducted in practice.

The examination of the DGT’s approach to tax audit activities described in this article therefore builds on the existing literature, particularly with its focus on the issue identified by Hamilton-Hart and Schulze, that Indonesia’s revenue collection problems are not so much because of the design of the tax system, but rather through problems in tax policy and administration. However, unlike other studies, its focus is on the way that audit activities are undertaken by the DGT.

IV LAWS AND REGULATIONS RELATING TO TAX AUDITS IN INDONESIA

Consistent with the civil law tradition that applies in Indonesia, Butt and Lindsey observed that “most Indonesian statutes aim to provide a general legal framework for their subject matter, leaving the regulatory detail to lower-level laws, such as government regulations (*peraturan pemerintah*), presidential regulations (*peraturan presiden*), and ministerial regulations (*peraturan menteri*)” and they comment that statutes might be regarded as a “statement of national intention”, with implementation depending on the promulgation of separate implementation rules.²⁷ In the field of Indonesian tax law, this approach is reflected

²⁴ D Sari, ‘Risk Management and Taxpayer Compliance’, (*Proceedings of the International Conference on Education For Economics, Business, and Finance*, Universitas Negeri Malang, 2016)

²⁵ Pratomo (n 11) 210

²⁶ Prasteyo (n 11) 228

²⁷ S Butt and T Lindsey *Indonesian Law*, (Oxford University Press, 2018) 49.

in the *Law on Income Tax* which comprises fewer than 30 pages, with detailed rules dealing with implementation and application of the law to be found in other regulations.²⁸

The DGT is generally authorised to perform tax audits by Article 29 of the *General Provisions and Tax Procedures Law*. The two main purposes of tax audits are stated as being to test taxpayer compliance and “other purposes in the context of implementing the provisions of taxation legislation” (Article 29.1). Tax audits must be performed within 5 years after the end of a tax period (Article 13). However, in the case of a tax over-payment where a taxpayer requests a refund as permitted by Article 11, Article 17B(1) of the *General Provisions and Tax Procedures Law* requires that the DGT complete its tax audit and issue any tax assessment letter within 12 months of the tax refund request being made. A significant proportion of tax audits are the result of tax refund requests and the time pressures imposed by the 12-month deadline for completing the audit have a significant bearing on the way in which tax audit activities are conducted in practice. Also, given that this requirement is set by legislation enacted by the Indonesian Parliament, which is the highest level of law within the Indonesian hierarchy of laws under the Constitution, it is a requirement which must be strictly adhered to and cannot be modified by Regulations.²⁹ However, it should be noted that in some circumstances a taxpayer with a good tax record (known as a “golden taxpayer”) may seek an early tax refund without an audit being conducted, although in such cases the DGT is still entitled to conduct a tax audit later.³⁰ This potentially reduces the DGT’s burden to conduct tax audits in all tax refund cases.

Article 31 of the *General Provisions and Tax Procedures Law* allows tax audit procedures to be determined by Regulations made by the Minister of Finance and under this specific authority the Ministerial Regulation governing the conduct of tax audits (PMK-17) was made.³¹ This Regulation states that tax audits “must be carried out” where taxpayers seek refunds (Article 4(1)) and “can be carried out” in a number of other circumstances, including where tax overpayments are made (but a refund is not sought), a tax loss is reported, asset revaluations take place, taxpayers have failed to lodge a tax return (or lodged late), and other cases where taxpayers “have been selected for a tax audit based on a risk analysis” (Article 4(2)). The regulation also sets out various procedural obligations relating to the conduct of tax audits e.g., the need for periodic meetings with taxpayers, and the time frames for completing audit activity (4 to 6 months for examination, and a further 2 months for discussion). Note that the DGT has also issued a separate regulation outlining procedures for conducting a group tax audit “of two or more taxpayers within a business group”.³² The need for extensive regulations governing tax audit procedures appears to be a product of the strict timelines set by law for completing audit activities (in particular, the 12-month time limit in tax refund cases) balanced against the need to provide procedural fairness to taxpayers.

PMK-17 does not specify in detail the audit procedures that must be followed by an audit team in its analysis of whether a taxpayer has complied properly with its tax obligations. Rather, the focus of PMK-17 is on various other formalities that must be complied with by the DGT in conducting a tax audit e.g., formal notification of the audit to the taxpayer, then

²⁸ Law Number 7 of 1983, last amended by Law Number 36 of 2008

²⁹ Butt and Lindsey (n 28) 37

³⁰ PwC Indonesia (2023), *Indonesian Pocket Tax Book – 2023*, 99

³¹ Regulation of the Minister of Finance of the Republic of Indonesia Number 17/PMK 03/ 2013 Concerning Procedures for Examination – generally referred to as “PMK-17”.

³² PwC Indonesia , ‘Tax Flash No. 12 – Group tax audit procedure’ (2013) 2; DGT Circular Letter No. SE-26/PJ/2013, dated 30 May 2013

issue of audit findings letters, and setting meeting schedules and timetables for the audit activity to take place. These formal matters are dealt with in exhaustive detail by PMK-17.

Consistent with Article 29 of the *General Provisions and Tax Procedures Law*, PMK-17 confers a broad power on the DGT “to carry out an Audit with the purpose of testing compliance with taxation obligations and/or for other purposes in implementing the provisions of taxation laws and regulations” (Article 2). For these purposes, “compliance” is not defined and “taxation obligations” presumably extends beyond the mere lodgement of a tax return. In PMK-17, “verification” is defined as the fulfillment of obligations to calculate and pay tax, based on data and information obtained or held by the DGT.³³

From this analysis of the *General Provisions and Taxation Procedure Law* and the terms of Regulation PMK-17, various observations about the regulatory framework governing tax audits can be made. First, it is clearly a legal requirement under the *General Provisions and Taxation Procedure Law* that tax audits must be conducted by the DGT in tax refund cases. Also, it is evident that DGT officers are subject to strict timelines within which audit activities must be completed. It is notable that PMK-17 contemplates that group audits can be undertaken. It is also relevant that the regulations provide the DGT with broad powers to request information and documents and impose corresponding obligations on taxpayers to comply with such requests. Perhaps surprisingly, PMK-17 does not impose any requirements relating to the actual verification and checking procedures that must be undertaken during an audit, notwithstanding that it spells out in considerable detail requirements around timelines and formalities associated with communications to taxpayers. Rather, it appears that the way audit activities are conducted is determined by the DGT itself, based on past practice and experience, rather than being governed by the regulation. PMK-17 can be changed by an amending regulation, although (as noted) the mandatory requirement to conduct tax audits in refund cases is set by law and therefore can only be changed by a legislative amendment. Also, there is scope for changes to be made to internal DGT procedures, to permit different approaches to the conduct of tax audit activity.

V HOW TAX AUDITS ARE CONDUCTED IN INDONESIA

This analysis is based on 20 interviews conducted with tax consultants and DGT auditors and is built around 6 main themes covered in the interviews, as follows:

1. DGT’s objectives in undertaking audit activities.
2. Common triggers for a tax audit.
3. DGT’s tax audit practices and procedures.
4. Type of adjustments generally made during a tax audit.
5. Reasons for the DGT’s low success rate in Tax Court appeals.
6. DGT’s efforts to target intentional non-compliance.

As described earlier, detailed contemporaneous records of the interviews were compiled by the author. In preparing the analysis below, the author carefully reviewed the interview data to identify common themes which form the basis for the author’s conclusions.

³³ PMK-17 - Article 1.5

A *Interview Approach*

Tax auditors and tax consultants were asked questions that were broadly similar but given the nature of the different roles that each group of interview subjects play in the Indonesian tax system there were some differences between the questions put to each group. Although standard questions were pre-prepared, not all interview subjects expressed views in respect of all the questions, either because an individual interview subject was unable or unwilling to express a view on a particular matter or insufficient time was available to canvass all issues fully. Therefore, in respect of some of the topics considered here, the analysis may reflect comments from some, but not all, of the interview subjects.

Generally speaking, the level of experience with tax audit work (in terms of the actual number of audit cases worked on) of the tax consultants who were interviewed was less than that of the DGT auditors who were interviewed, although a significant proportion of the professional services provided by tax consultants involves assisting clients during a tax audit, including managing information requests and discussions with tax auditors and associated appeals to the Tax Court against audit based assessments. Foreign tax consultants (who typically work for “Big 4” accounting firms) do not generally have direct contact with DGT audit teams, and when their clients are subject to audit, other Indonesian-qualified tax consultants working for their firm will manage the direct dealings with the DGT auditors. The range of direct tax audit experience amongst the tax consultants interviewed therefore varied widely, from working on as few as 100 or so audits to upwards of 300 audits, over the course of their careers. It should be noted that many tax consultants also work on non-audit related tax matters, especially Mergers and Acquisitions transactions (including tax due diligence checks for potential undisclosed tax liabilities of target companies in an acquisition) as well as tax compliance services (preparation and checking of income tax returns) and general tax consulting and inbound investment advice work.

The DGT audit staff who were interviewed generally have worked on many more audits than the tax consultants who were interviewed. Head Office auditors, and those working in the Large and Specialist tax offices, are usually engaged on fewer audits than those working in a local tax office. Most auditors who were interviewed reported working on 20 to 25 audits a year, but the range varied from 10 to 15 per annum in a large tax office, to as many as 40 to 50 per annum in a local tax office. Accordingly, at any given time, most auditors work concurrently on numerous audits, and it became evident through the interviews that DGT auditors generally have a heavy case load. This high workload highlights the importance of efficient allocation of audit resources and of itself is therefore relevant in assessing whether the DGT’s audit activities are inefficient or poorly focussed.

B *Key Interview Findings*

The first of the interview themes concerns the differing perceptions of auditors and tax consultants about the DGT’s objectives in undertaking audit activities. Tax consultants generally expressed a view that audits were undertaken by the DGT for the direct purpose of extracting more tax from the taxpayer under audit. However, tax auditors were inclined to a view that the DGT’s objectives when conducting audit are broader, and that whilst revenue collection is important, audits also play a significant role in promoting “better compliance” by taxpayers, so that audits also perform an educative function. By educating taxpayers about

their compliance obligations, one auditor explained that this helps ensure that taxpayers “will not make the same mistakes in future”.

In respect of the second theme, the interviews confirmed that the mandatory requirement for a tax audit in tax refund cases remains the most common reason why the DGT will conduct an audit of a taxpayer, with the tax consultants generally have a much stronger perception that this is the case compared to the view of the DGT auditors. Although the interviews with DGT officers revealed that some audits are initiated for other reasons, the interviews also revealed that there is no significant focus on conducting audits of non-compliant taxpayers and that (in effect) there is no real risk that an individual or entity that has not registered as a taxpayer (and therefore chooses to be non-compliant) will be subject to an audit, which is also consistent with the views of tax consultants. As an example of a non-refund case audit, one auditor discussed the case of a company which gets audited every year, because of its past track record, as a result of which the auditors came to the belief that it had a “high potential” to pay extra tax, meaning that it had demonstrated a willingness in the past to pay extra tax and therefore would do so again in other years. This indicated that the DGT does not use “proper criteria” to select audit targets because auditors have a preference to conduct repeat audits of companies they have audited before. The auditor also mentioned that this practice is referred to by DGT auditors as “hunting in the zoo”, meaning that auditors prefer auditing companies that have proved their “potential to pay”.

A key exception to the general proposition that most tax audits are refund related has emerged more recently and relates to transfer pricing compliance. Most of the tax consultants who were interviewed mentioned that transfer pricing audits are sometimes conducted even where taxpayers do not seek a tax refund. This reflects the DGT’s commitment to tackling perceived tax avoidance by multi-national company groups carrying on business in Indonesia. Nevertheless, the interview findings support a conclusion that there is a heavy focus of tax audit activity on tax refund cases rather than on risk-based auditing, and this bias could compromise the effectiveness of Indonesia’s tax compliance program.

In respect of the third theme, the interviews with both tax consultants and tax auditors revealed that the DGT’s audit approach is heavily reliant on a reconciliation methodology (known as “tax equalisation”) which involves a comparison between the tax return information disclosed by the taxpayer and other data provided by the taxpayer, such as its audited financial accounts. Consistently, auditors referred to the reconciliation approach as the “standard” approach, with audit adjustments being made based on items that did not properly reconcile. Tax auditors also expressed frustration about the difficulties they experience in gaining access to data held by third parties about taxpayers. Tax consultants generally viewed the DGT’s audit approaches as simplistic and unsophisticated, with one foreign tax consultant describing the DGT’s audit conduct as “robotic” and another describing audits as “paper warfare”.

Both interview groups indicated they understood there were deficiencies in the DGT’s audit methodologies, and that there is little real focus on employing risk-based audit techniques. Audits tend to follow a “one size fits all” approach. It also became apparent that there is little tax audit focus on detecting non-compliance by entities that should be registered to pay tax but have failed to do so, and even registered taxpayers can avoid audit scrutiny by the simple device of managing their affairs in a way that avoids seeking a refund of tax overpayments. The interviews also revealed that there is no real focus on conducting audits on a company group basis, notwithstanding that (as previously noted) there is specific regulatory guidance

about the conduct of group audits. Rather, the audit focus is generally confined to the individual taxpayer that made the tax refund request, even where the taxpayer is part of a wider company group or is a member of a group of inter-connected family businesses. As a result, these findings support a view that the scope and extent of audit activities conducted by the DGT is limited and provide support for a view that audit activities are poorly focused.

The fourth interview theme relates to the type of adjustments which are generally made during a tax audit in Indonesia, and the information captured through the interviews revealed that the completion of audits is often rushed, with adjustments being made by audit teams based mainly on the data reconciliation process (tax equalisation) described above. Other key findings from the interviews are that audit teams often experienced difficulties in obtaining data and that few adjustments are based on differences of opinion with taxpayers about the technical application of the law.

The fifth theme covered in the interviews relates to an issue identified in the OECD's 2012 report concerning the high proportion of tax appeal cases in which taxpayers successfully challenge DGT assessments before the Indonesian Tax Court.³⁴ The DGT itself has reported that in 2019, its success rate in tax appeal cases was only 40.54%.³⁵ The OECD report attributed this outcome to the availability of better legal resources to taxpayers, and the DGT's own lack of resources, resulting in an uneven playing field. However, based on the interviews, a lack of DGT resources for conducting appeals work does not seem to be the real cause of the DGT's poor record in winning Tax Court appeals. Rather, it was generally acknowledged by both groups of interviewees (i.e., tax consultants and DGT auditors) that the completion of audits is often rushed due to time pressures, with the result that assessments are made without a proper basis, and that taxpayers must rely on appeals to the Tax Court to have a proper consideration of their evidence and explanations. In many cases, this leads to a favourable outcome for the taxpayers. Interviews with the tax consultants revealed a perception that the tax objection process does not involve an independent evaluation of the DGT's assessments and that a taxpayer's objection is rarely upheld. In combination, it is these factors which seem to be the main reason for the high rate of successful appeals to the Tax Court by taxpayers. In turn this is a further indication of inefficiency in the DGT's tax audit process and resource allocation.

The sixth theme covered by the interviews concerns the extent of the DGT's efforts to focus on intentional non-compliance by individuals and businesses which should be registered to pay tax but have not done so. This issue lies at the core of the hypothesis that the DGT's audit activity is excessively focused on compliant taxpayers rather than those who are non-compliant. Based on the interviews with tax auditors and tax consultants, it appears the DGT conducts little compliance activity focused on identifying and conducting audits in cases of intentional non-compliance by individuals and businesses that should have registered to pay tax but have failed to do so. There appears to be limited co-ordination between audit teams and other sections of the DGT that are responsible for "tax extensification" measures (i.e., new taxpayer registrations) and even where unregistered taxpayers are identified, there appears to be no focus on conducting audits in respect of the years prior to the taxpayer's registration. There are some indications that this lack of focus is for procedural reasons, with auditors only being responsible for the audit tasks that are allocated to them and that someone who has not registered to pay tax is therefore very unlikely to be selected for an audit.

³⁴ Arnold (n 6) 28

³⁵ DGT 2019 (n 3) 63

C *Attitudes to changing the DGT's tax compliance approach.*

The interviews with all three groups of interview subjects also canvassed a broad range of other issues, about the way in which the DGT sets audit targets and monitors the effectiveness of its audit program, the extent to which the DGT may be open to changing its current tax compliance approach, and the processes by which tax policy can be developed and implemented in Indonesia. Discussions with tax academics also included a consideration of the extent of academic research about taxation in Indonesia and opportunities for public discussion and consultation about taxation policy.

With respect to the DGT's audit objectives, it emerged from the interviews that tax auditors are more likely to see the DGT's audit focus as being to ensure taxpayer compliance, whereas tax consultants believe the DGT is very focused on achieving revenue targets. Amongst the tax auditors who were interviewed, perhaps surprisingly, revenue targets do not seem to have a major influence on their approach to audit work. It should be noted that the auditors who were interviewed were all engaged directly in conducting audits as audit team members and none held a senior management position with the DGT. Therefore, it is possible that for more senior DGT staff, a failure to meet revenue targets may carry sanctions. Nevertheless, it also emerged that the DGT appears to have little interest in improving its audit coverage or effectiveness, and the measures it uses to monitor audit effectiveness are built around maintaining the *status quo*, with a primary focus on audit completion rates and the rate of objections against audit-based assessments. This tends to reinforce a key proposition of this article, which is that the DGT's audit approach is poorly focused.

There was a broad consensus between all interviewee groups that there is some willingness to change within the DGT, and that change has been successfully implemented in the past. However, it also appeared that there is little current appetite within the DGT for changing the way in which audit activity is carried out. In considering whether audit effectiveness can be improved through change, some views were expressed by the DGT interviewees which indicate that such change would be possible if the right impetus can be generated, especially if a proposed change is backed with support "from the top" (meaning from the DGT senior leadership team and the Ministry of Finance).

Also, from the interviews with tax academics, it emerged that there has been a relatively limited focus on academic tax research in Indonesia in the past, but that this has grown significantly in recent years, and the DGT plays an active role in setting the tax academic research agenda, including sponsorship of tax academic research conferences. On the other hand, apart from the DGT sponsored conferences, there are few forums available for public debate and for discussion of tax policy and tax reform in Indonesia, and whilst the Ministry of Finance does seek input to policy development from tax academics and business and professional bodies from time to time, it does so selectively and on an *ad hoc* basis. Based on previous experience, it is also apparent that external agencies (including the major international economic agencies such as the OECD, IMF and World Bank) can influence the tax policy making and reform processes.

VI PRIORITY ISSUES

A key priority for Indonesian tax policy makers should be to analyse who currently pays tax in Indonesia and who does not, which would assist the DGT in better understanding where future compliance activity should be directed. There needs to be a robust policy discussion about the design of the current tax compliance system and to identify ways in which its effectiveness can be improved. These efforts would be enhanced if there is a better understanding of where current tax compliance levels are lowest, and by extension how future tax compliance effort could be more efficiently focused to maximise revenue collection.

The DGT should move away from its current data reconciliation focus and instead adopt more effective data matching methods using third party data, and by using other information available from public sources. Avenues for obtaining data relating to the financial and business affairs of taxpayers under audit, as well as methodologies for identifying risk, and the audit practices and procedures successfully employed elsewhere, all need to be examined. Other key priorities for change should include increased focus on group audit activity and better co-ordination of compliance activities by different DGT offices. It would be more efficient if all companies sharing a significant percentage of common ownership could be consolidated under the responsibility of a single tax office, with a greater focus on group-wide audit activity rather than audits of individual entities (as is the case at present). There should also be greater effort in identifying high-risk businesses, including those which have not registered to pay tax.

Part of a comprehensive review of DGT audit practices should be to examine how other countries conduct tax audits, especially in the field of cross-border transactions, to assist the DGT in identifying the type of information it needs and the methodologies it can use to identify secret asset holdings and income sources outside Indonesia, especially with high wealth individuals (this might have a similar focus to the ATO's Project Wickenby, which commenced in 2006, and targeted tax avoidance practices of the wealthy in Australia). This would require a comprehensive examination of how the wealthy in Indonesia manage their tax affairs and extend to considering the extent to which wealth is held overseas, and it would also require a focus on the tax practices of inter-connected family companies and associated individuals.

VII CONCLUSION

This research has confirmed that the DGT's major tax compliance focus is on audits in tax refund cases and that there is little focus on enforcing compliance by individuals and entities which have not registered as taxpayers. It follows that the DGT's audit activities are almost entirely focused on registered taxpayers who are already compliant or broadly compliant rather than non-compliant entities (i.e., which should be registered as taxpayers but have not done so). The absence of any real risk of detection or adverse consequences for the non-compliant needs to be addressed if greater levels of voluntary compliance are to be achieved.

Other factors that compromise the effectiveness of the DGT's compliance approach and thereby contribute to Indonesia's poor revenue outcomes, principally relate to the narrow scope of audit activities, a lack of focus on auditing groups of related companies, and the heavy reliance on a "data reconciliation" methodology as a basis for identifying audit adjustments. Other significant issues relate to the difficulties DGT auditors experienced in

accessing third party data and the very tight deadlines for audit completion set under the tax audit regulations, which means that the completion of many audits is rushed.

Although the Indonesian Ministry of Finance has set an ambitious long-term review target (a tax to GDP ratio of 16%), it remains well short of meeting this target. This failure should be the catalyst for a comprehensive review of the effectiveness of Indonesia's current tax collection strategies. Efforts to generate more tax by increasing tax rates, and introducing new taxes, do not address the much broader problem of non-compliance, whilst increasing the tax burden on those taxpayers who are compliant. It should be obvious that greater effort by Indonesian tax policy makers and administrators in tackling the core challenges of extensive non-compliance will lead to better overall revenue collection outcomes and achieve progress in meeting the 16% Tax to GDP ratio target.