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# Reclassification of Excessive Royalties as Disguised Dividends: A Normative Analysis of Secondary Adjustment in Indonesian Tax Law and OECD Standards

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**Abstract:** Transfer pricing practices in related-party transactions often involve royalty or service payments that deviate from the arm's length principle, leading to tax base erosion. In Indonesia, Article 18(3) of the Income Tax Law authorizes the tax authority to reallocate profits and to treat the excess portion of such transactions as hidden dividends. This paper aims to analyze the concept of reclassification of excessive royalties into disguised dividends through the framework of primary and secondary adjustments. Using a normative juridical approach, the study examines statutory provisions in the Indonesian Income Tax Law, implementing regulations such as PER-22/PJ/2013, and international guidelines including the OECD Transfer Pricing Guidelines (2017) and OECD Model Convention Commentary on Article 10. The results show that primary adjustments on royalties—when deemed excessive—necessitate secondary adjustments in the form of constructive dividends to align profit allocation with the arm's length principle. This constructive dividend concept is consistent with international practice where excess profits are recharacterized as disguised dividends, equity contributions, or loans. The findings further demonstrate that Indonesian law explicitly recognizes disguised dividends under Article 4(1) of the Income Tax Law, thereby reinforcing the legitimacy of secondary adjustments as a safeguard against profit shifting. In conclusion, reclassifying excessive royalty payments as hidden dividends not only ensures fairness in taxation but also harmonizes domestic practice with international standards while preventing tax avoidance.

**Keywords:** Royalty, Transfer Pricing, Secondary Adjustment, Disguised Dividend, Tax Avoidance

## INTRODUCTION

### Background: Transfer Pricing Dynamics, Base Erosion, and the Need for Anti-Tax Avoidance

The dynamics of economic globalization and the increase in cross-border transactions have made transfer pricing (TP) a key focus in international tax administration. Unfair transfer pricing practices are often exploited by multinational enterprises (MNEs) to erode their tax bases and shift profits (Base Erosion and Profit Shifting-BEPS). The scale of global tax revenue losses due to BEPS is estimated at USD 100 billion to USD 240 billion per year, equivalent to 4 to 10% of global corporate income tax revenues. Intergroup payments, such as royalties or management fees, are a highly effective means of eroding the tax base in source countries by artificially shifting profits to jurisdictions with low or zero tax rates.

"Economic globalization dynamics and an increase in cross-border transactions have transformed transfer pricing (TP) into a core challenge of international tax administration. Abnormal transfer pricing is frequently used by multinational companies (MNEs) to prevent tax base degradation and to transfer profits (Base Erosion and Profit Shifting—BEPS). Global tax losses from BEPS are estimated to reach USD 100 billion to USD 240 billion per year, which amounts to 4 to 10% of corporate income tax revenues worldwide. Intrachapter payments such as royalties or administration services fees are the most efficient instruments for tax base degradation in receiving countries through artificial shifting of profits to no-tax or low-tax countries."

In response to this issue, the Organization for Economic Cooperation and Development (OECD) and the G20, through the BEPS Project, have developed rules and instruments, including the OECD Transfer Pricing Guidelines (TPG), which aim to ensure profits are taxed where economic activity and value creation occur. The Arm's Length Principle (ALP) is the international standard foundation for determining legitimate transfer prices. For developing countries like Indonesia, which tend to prioritize source country taxation, strong domestic legal instruments for reallocating transferred profits are vital.

### The Problem of Excessive Royalty Payments in Cross-Border Affiliate Transactions

The core problem arises when royalty payments in related party transactions exceed the threshold set by the ALP. This excess royalty payment is considered profit shifting without reasonable commercial substance. In Indonesia, the correction of this overpayment is made through what is known as a primary adjustment, which is a direct adjustment to the taxable profit of the company paying the royalties.

However, this primary adjustment, while resolving the problem at the corporate income tax level, fails to address the distortion of actual cash flows that have occurred on the company's balance sheet. The excess cash that has flowed to the affiliated company receiving the royalties remains recorded in the books as an expense, when in fact it is profit.

Therefore, a secondary adjustment is required to recharacterize the excess payment as a constructive transaction. This approach, which can take the form of dividends, loans, or equity contributions, aims to align profit allocation with the PKKU comprehensively and prevent tax avoidance on profit distributions.

### Research Objective: To Analyze the Consistency of Reclassifying Excess Royalties as Disguised Dividends between Indonesian Tax Law and International Standards

The primary objective of this research is to conduct a normative analysis of the legal legitimacy of imposing a constructive dividend on excess royalties corrected through a secondary adjustment. Specifically, this research examines the consistency between the DGT's authority stipulated in Article 18 paragraph (3) of the Income Tax Law (PPh Law), and the concept of disguised dividends in Article 4 paragraph (1) of the PPh Law, with

international standards outlined in the OECD Transfer Pricing Guidelines (TPG) (2017/2022) and Commentaries on the OECD Model Tax Convention (MTC). This analysis is highly relevant given recent regulatory developments in Indonesia, particularly Minister of Finance Regulation (PMK) Number 172 of 2023, which provides a more explicit technical basis for secondary adjustments.

**Scientific Contribution and Article Structure**

This research makes a significant contribution by filling the literature gap created by the rapid evolution of domestic TP regulations. This analysis not only reviews the consistency of norms but also explores the practical and controversial implications of Indonesia's choice to use the dividend construction, particularly the potential conflict with the domestic dividend definition and the risk of international double taxation. Recent regulatory developments, previously a source of dispute, are reviewed to provide legal certainty. The structure of this article includes an Introduction, Research Methodology, Results and Discussion, Conclusions, and a Bibliography.

## METHOD

**Research Type and Approach**

This research uses a normative-juridical approach. This approach focuses on the study of statutory law and the analysis of legal concepts. Specifically, this research is prescriptive, providing an assessment of how the law should be applied based on a comparison between domestic norms and international standards. A comparative approach is used to compare Indonesia's secondary adjustment approach with the practices of OECD member countries.

**Data Sources and Legal Materials**

The data used in this study are legal materials categorized as follows:

**1. Domestic Primary Legal Materials:**

Includes Law Number 7 of 1983 concerning Income Tax (PPh Law), which has been amended several times, including through Law Number 7 of 2021 concerning the Harmonization of Tax Regulations (HPP Law). It's crucial that derivative regulations are Government Regulation Number 55 of 2022 (PP 55/2022) and Minister of Finance Regulation Number 172 of 2023 (PMK 172/2023), which replaces previous regulations such as PMK 22/PMK.03/2020.

**2. International Secondary Legal Materials:**

Includes authoritative publications from the OECD, including the OECD Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations (2017 and 2022 editions) and the OECD Model Tax Convention on Income and on Capital (MTC) and its Commentaries. Reports from international institutions such as the EU Joint Transfer Pricing Forum (JTPF) were also used as references.

**3. Tertiary Legal Materials:**

Consists of academic journals and scientific articles, particularly those published in the last five years (2020–2025), that discuss transfer pricing, secondary adjustments, and related tax disputes.

**Legal Material Analysis Techniques**

The legal materials were analyzed using interpretation and comparison techniques. Grammatical and systematic interpretations were applied to analyze the explicit meaning of Article 4(1) and Article 18(3) of the Income Tax Law and their relationship to the

implementation mechanism in PMK 172/2023. Comparative analysis was used to assess the compatibility of Indonesia's constructive dividend approach with international practices and its implications for Double Tax Avoidance Agreements (P3B). The assessment was conducted carefully to identify potential legal conflicts and double taxation risks.

## RESULTS AND DISCUSSION

### Normative Basis for Primary Adjustment and Re-classification Authority in Indonesia

#### 1. Legal Analysis of Article 18(3) of the Income Tax Law (PPh Law)

Article 18, paragraph (3) of the Income Tax Law is the fundamental legal basis that grants the Indonesian tax authority (Directorate General of Taxes/DGT) the authority to redetermine the amount of taxable income for taxpayers with special relationships, if they are proven not to have applied the PKKU. This authority is realized through a primary adjustment, which is a direct correction to the profit/loss of domestic taxpayers to bring their transaction prices in line with the ALP.

#### 2. The Role of Recent Regulations in Strengthening Primary Adjustment Authority

Historically, the DGT's authority to reclassify and correct transfer prices, although already present in earlier regulations (such as PER-22/PJ/2013 and PMK 22/PMK.03/2020), was often deemed legally inadequate. A notable case demonstrates that the DGT frequently lost in the Tax Court when attempting to recharacterize royalties or interest as dividends, especially before the regulatory strengthening.

The high level of disputes and the need for a stronger legal basis prompted the government to issue the Tax Regulation Harmonization Law (UU HPP) in 2021, followed by Government Regulation 55/2022 and, culminating in Minister of Finance Regulation 172/2023 (effective at the end of 2023). These regulations explicitly strengthen the legal basis for secondary adjustments. Article 36 paragraph (6) of Government Regulation 55/2022 and Article 37 paragraph (1) of PMK 172/2023 confirm that the difference between the affiliated transaction price and the ALP will be considered a dividend. This regulatory development is a direct response to the lack of clear legality that fueled the high number of disputes previously.

#### 3. Recharacterizing Excess Royalty Payments: A Gateway to Secondary Adjustments

Royalties are broadly defined in Indonesian tax law as payments for the use of intellectual property rights (IPR) or other similar rights. If royalty payments from a domestic entity to a foreign affiliate are found to exceed the ALP after a primary adjustment, the excess cash, which should not have been paid as an expense, is deemed to have been distributed unfairly. This excess represents profit disguised as an expense. This recharacterization then triggers a secondary adjustment by treating the excess cash as a constructive dividend.

### Consistency of the Concept of Disguised Dividends as a Secondary Adjustment Instrument

#### 1. Legal Definition of Disguised Dividends in Article 4(1) of the Income Tax Law

Indonesia expressly recognizes the concept of disguised dividends as an object of income tax. The elucidation of Article 4 paragraph (1) letter g of the Income Tax Law provides a specific example where loan interest paid to shareholders exceeding the fair market interest rate must be treated as dividends. It demonstrates a fundamental principle in Indonesian tax law: non-arm's length transactions that result in the transfer of assets from a company to related parties (particularly shareholders) can be reclassified as profit distributions.

In the context of secondary adjustments, the DGT extends this principle to excess royalty payments. The difference in royalty payments is considered a form of profit sharing or indirect dividends. The tax consequences of this reclassification are that the excess royalties: (a) cannot be deducted as expenses by the paying company in Indonesia, and (b) are subject to Income Tax Article 26 (Withholding Tax) as dividends to foreign recipients. If the royalty recipient is a taxable person in a P3B partner country, the applicable Article 26 Income Tax rate is the dividend rate under the P3B, provided there is no abuse of the P3B.

**2. Controversy Over the Application of Constructive Dividends to Non-Shareholder Affiliate Transactions**

While the application of constructive dividends has a strong legal basis in the context of parent-subsidiary relationships, significant controversy arises when secondary adjustments are applied to transactions between non-shareholder affiliates, such as sister companies.

The formal definition of dividends in the Explanation of Article 4 paragraph (1) letter g of the Income Tax Law states that dividends, whether real or disguised, are the portion attributable only to shareholders. If the DGT considers excess royalties between sister companies to be dividends, this could potentially exceed the definition of domestic dividends, as there is no direct shareholder relationship. In such cases, the application of constructive dividends could be interpreted as assuming a layered constructive transaction (for example, a capital contribution from a subsidiary to a parent, followed by a dividend from the parent to a sister company) or as a form of broadening the interpretation by the tax authorities. The lack of clear and explicit guidance on how to handle sister company disputes under PMK 172/2023, as well as the unclear definition of disguised dividends in the context of secondary adjustments, are the main driving factors for the increase in tax disputes in the Indonesian Tax Court.

**Comparative Review of Secondary Adjustment Based on OECD Standards**

**1. Global Context and Recommendations of the OECD Transfer Pricing Guidelines (TPG)**

The OECD standards recognize that primary adjustments alone are insufficient to achieve full ALP consistency. Therefore, the OECD TPG (Paragraphs 4.67–4.77) supports the implementation of secondary adjustments as a follow-up step to address cash balance misalignments caused by primary adjustments. Secondary adjustments aim to explain why an amount of cash is outside the entity that would have owned the funds if the transaction had been conducted in accordance with the ALP from the outset.

**2. Secondary Construction Options: Comparison of Dividends, Loans, and Equity Contributions**

The OECD TPG presents the three forms of constructive transactions most commonly applied by tax authorities: constructive dividends, constructive loans, and constructive equity contributions.

Indonesia consistently chooses and emphasizes the constructive dividend approach. This option is similar to that used by a large number of European Union member countries that apply secondary adjustments, which often treat these adjustments as hidden distributions of profits/dividends.

While other options are available, the OECD notes that constructive loans can create new administrative and tax complications, particularly related to the imputation of interest on the constructive loan. Indonesia chose the construction that most readily has income tax implications (through the WHT on dividends) and has a long-recognized domestic legal basis (Article 4(1) of the Income Tax Law).

3. **Analysis of the Consistency of Indonesia's Approach with Article 10 of the OECD Model Convention**

Indonesia's approach to recharacterizing excess royalty payments as dividends can be harmonized with international standards through the flexibility of Article 10(3) of the OECD MTC. This article defines dividends as including, in addition to income from shares, "income from other corporate rights which are subject to the same tax treatment as income from shares by the laws of the State of which the distributing company is domiciled".

Given that Indonesian domestic law (the Income Tax Law) explicitly treats excess royalties (through a secondary adjustment) as disguised dividends, Indonesia's imposition of Article 26 Income Tax on constructive dividends is consistent with Article 10 of the MTC and its Commentary. This flexibility allows Indonesia, as the source country, to retain its taxation rights on profits that would otherwise be distributed as dividends, thereby strengthening the legitimacy of secondary adjustments in the context of P3B.

**Mitigating Double Taxation Risk: Implications of PMK 172/2023**

1. **Potential and Realization of Judicial Double Taxation Due to Secondary Adjustments**

While secondary adjustments are important for maintaining the integrity of the tax base, they carry a high risk of double taxation. This risk arises because the OECD MTC (Article 9 paragraph (2)) explicitly only regulates corresponding adjustments (CA) as a mechanism to prevent double taxation arising from primary adjustments.

When Indonesia imposes Article 26 Income Tax as WHT on constructive dividends, partner countries may not recognize these amounts as creditable dividends in their jurisdictions (for example, if they do not apply the constructive dividend approach or if the transaction involves a sister company). If tax credits are not available in the recipient country, double taxation occurs that cannot be eliminated through conventional tax treaty mechanisms.

2. **Secondary Adjustment Cancellation Mechanism through Fund Repatriation (Article 37 of PMK 172/2023)**

PMK 172/2023, which came into effect at the end of 2023, introduced significant regulatory developments by providing a "way out" for taxpayers to cancel the imposition of secondary adjustments. Article 37 of PMK 172/2023 stipulates that secondary adjustments do not apply if the taxpayer adds and/or returns cash or cash equivalents equal to the value of the primary adjustment (fund repatriation).

This repatriation process must be carried out before the Tax Assessment Letter (SKP) is issued by the DGT. This physical repatriation of funds eliminates the distortion in the cash balance that forms the basis for the imposition of secondary adjustments, eliminating the need for constructive recharacterization of the funds. This provision represents a progressive step that adopts international double taxation risk mitigation practices and increases legal certainty for taxpayers.

3. **The Role of the Mutual Agreement Procedure (MAP) and Corresponding Adjustment (CA)**

In addition to the repatriation mechanism, the resolution of double taxation resulting from international secondary adjustments can be pursued through the Mutual Agreement Procedure (MAP) under Article 25 of the OECD MTC [10]. Although the CA explicitly concerns only primary adjustments, countries implementing secondary adjustments are generally willing to address this issue within the MAP procedure. The OECD recommends that taxpayers facing the risk of double taxation due to secondary adjustments submit simultaneous MAP requests for both primary and secondary adjustments.

**Table 1: Evolution of Secondary Adjustment Regulations in Indonesia (2013–2023)**

| Regulation | Year | Legal Foundation | Key Provisions Regarding Secondary Adjustments |
|---|---|---|---|
| PER-22/PJ/2013 | 2013 | DJP Regulation | Establishing DGT authority for primary and secondary corrections [16, 19]. |
| PMK 22/PMK.03/2020 | 2020 | Minister of Finance Regulation | Explicitly defines secondary adjustment as disguised distribution of profits/dividends [19]. |
| PP 55/2022 | 2022 | Government Regulation | Strengthening the legal basis for constructive dividends (Article 36(6)), a derivative of the 2021 HPP Law [4, 14]. |
| PMK 172/2023 | 2023 | Minister of Finance Regulation | Revise and clarify the mechanism; introduce provisions for cancellation of secondary adjustments through repatriation of funds before the SKP is issued [9, 27]. |

## CONCLUSION

### Summary of Normative Analysis Results

This study concludes that the reclassification of excess royalty payments as disguised dividends through secondary adjustments in Indonesia has a solid normative basis. This authority stems from Article 18 paragraph (3) of the Income Tax Law, which is explicitly strengthened through Government Regulation 55/2022 and Minister of Finance Regulation 172/2023, which considers transfer pricing differences as dividends. The constructive dividend approach chosen by Indonesia is consistent with one of the main options recognized by the OECD TPG (Paragraphs 4.67–4.77) and utilizes the flexibility of the dividend definition in Article 10 paragraph (3) of the OECD MTC to ensure taxation rights in the source country are maintained.

However, legal conflicts arise when constructive dividends are applied to transactions between non-shareholder affiliates (sister companies), as this potentially goes beyond the definition of dividends in Article 4 paragraph (1) of the Income Tax Law, which literally relates them only to shareholders. This ambiguity is a major trigger for tax disputes in Indonesia.

### Tax Policy Implications and Recommendations

PMK 172/2023 represents a step forward in international harmonization by introducing a mechanism for canceling secondary adjustments through fund repatriation. This policy effectively mitigates the risk of judicial double taxation arising from WHT on constructive dividends that may not be creditable in partner countries.

To increase legal certainty and reduce disputes, the following are recommended:

**1. Strengthening Technical Guidance:**

The Directorate General of Taxes (DGT) needs to immediately issue detailed technical implementation guidance on the implementation mechanism of Article 37 of PMK 172/2023, including clear accounting procedures and repatriation deadlines, to minimize ambiguity.

**2. Clarification of Non-Shareholder Transactions:**

The government should explicitly clarify the legal construction used when secondary adjustments are applied to sister company transactions. Consideration can be given to adopting the constructive loan option for certain types of non-equity transactions to improve compliance with domestic and international legal principles.

**3. Optimizing the Role of Taxpayers in Mitigating Double Taxation:**

Taxpayers should utilize the repatriation provisions offered by PMK 172/2023 as a first option to avoid secondary adjustments. If repatriation is not possible, taxpayers should proactively submit a Mutual Agreement Procedure (MAP) request simultaneously for both primary and secondary adjustments to ensure that WHT on constructive dividends can be credited in the tax treaty partner jurisdiction.

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