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The Tax Landscape of Split Contracts in Engineering, Procurement, and Construction (EPC) Investments: An In-Depth Study

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Abstract

The study examines tax complexities in Engineering, Procurement, and Construction (EPC) contracts, focusing on Indonesia's regulations. It stresses the importance of segregating contracts to simplify taxation, with Final Income Tax applying mainly to construction services. Challenges arise from offshore and onshore components, like equipment supplies and services, leading to disputes over Permanent Establishment (PE) presence and income attribution. Case studies from Indonesia and India demonstrate different tax interpretations. Indonesia typically taxes EPC contracts as unified, while India focuses on profit attribution within its jurisdiction. The paper highlights the role of Tax Treaties, like the Indonesia-Germany protocol, in determining tax treatment based on activities within each country. It underscores the need for consistent tax treatment through contract segregation, considering jurisdictional activities and relevant Tax Treaties.

Keywords: EPC Taxation, Contract Segregation, Jurisdictional Activities

Introduction

Infrastructure development is one of the leading sectors in Indonesia (Marcelo, House, & Raina, 2018);(Huang et al., 2021);(Yu, 2017). In 2023, the Ministry of Public Works and Public Housing received a budget allocation of Rp125.18 trillion. This amount is higher compared to the 2022 budget ceiling of Rp116.37 trillion. The Indonesian construction sector currently contributes 7-9 per cent of the national gross domestic product, thus significantly contributing to economic growth and creating a multiplier effect to facilitate other sectors' roles (Liu, De Angelis, & Torbert, 2017).

Currently, Indonesia has the second-largest construction market after China. There are 4,595 certified consultants and 105,510 contractors in Indonesia's Construction Services Business Entity. More than 90 per cent of these business entities are in the medium and small categories. One way to improve the efficiency and accountability of the transaction process in the construction sector is to implement an output-based procurement system such as Design and Build, Performance Contract, and Engineering Procurement Contract (EPC) (Lubis, Situmorang, & Rosnelly, 2021);(De Angelis, Torbert, & Liu, 2017).

With so many processes that must be carried out in the implementation of an infrastructure project, it is difficult if these activities are carried out by only one business entity, and many parties are trying to overcome these problems through engineering, procurement, and construction contracts (EPC contracts), or often also referred to as turnkey projects (Hussain, Fangwei, Siddiqi, Ali, & Shabbir, 2018);(Filion & Keil, 2017). A turnkey project is a contract in which the Contractor is fully responsible for carrying out activities from start to finish, from designing, constructing, and handing over to the project owner when the project is ready (Pala, Edum-Fotwe, Ruikar, Doughty, & Peters, 2014);(Indrajaya, Suhendar, & Nurhidayat, 2019). One type of turnkey project is an EPC contract.

Based on the Construction Indicators for the Second Quarter of 2022, the contribution level of the Construction sector is in the fourth position in the Indonesian economy or 10.12% of Indonesia's Gross Domestic Product (GDP). However, in the context of its contribution to taxation, the construction sector still provides a minimal contribution. Therefore, reviewing and researching EPC projects in Indonesia is necessary.

There are many construction works, especially design and build (EPC), which foreign companies still dominate (Kusuma Wardhani, 2022). The construction market is estimated to be absorbed by 20% by small/medium-scale national contractors, 15% by large national contractors, and the rest by foreign companies. So, it is necessary to analyze the tax aspects of EPC contracts because there are cross-border transactions in EPC contracts, and EPC investment contracts involve many parties with complex transactions (Nugroho & Handayani, 2020).

EPC stands for "Engineering, Procurement, and Construction." An EPC contract is commonly used in construction investments and significant project developments, particularly in infrastructure projects such as power plants, factories, oil refineries, etc. EPC (Engineering, Procurement, and Construction) contracts have several key differences from general construction contracts. Regarding scope and responsibility, in traditional construction contracts, the project owner is usually responsible for planning, designing, and procuring materials and equipment (Kusuma Wardhani, 2022). The construction contractor is responsible only for the physical execution of the project. In contrast, in EPC contracts, the EPC contractor has full responsibility for the planning, design, procurement, and physical execution of the project. This includes managing the entire project cycle from start to finish.

The second distinguishing component is the price and cost factor. In traditional construction contracts, project costs can be more variable because the project owner is responsible for procurement and materials (Silaen, Sandhyavitri, & Ikhsan, 2020). This can lead to greater cost risk for the project owner. The price is often fixed or at least more structured in EPC contracts. The EPC contractor typically bears greater cost risk and must ensure that the previously agreed-upon budget completes the project.

Furthermore, in traditional construction investment contracts, the project owner has more control over the procurement and design process and must collaborate more actively with the Contractor. In contrast, the EPC contractor has more control over the entire project, allowing the owner to focus more on general oversight rather than technical details (Rusba et al., 2022).

In conventional construction contracts, the risk of additional costs and delays is often higher for the project owner because the owner must face potential problems that arise during procurement and project execution. In contrast, in EPC contracts, the EPC contractor is responsible for managing and mitigating these risks, although the risks still need to be eliminated. If there are delays or additional costs, the EPC contractor will be more active in addressing these issues.

These differences make EPC contracts popular for large projects where the owner wants to reduce risk and complexity and ensure efficient execution. However, the choice between an EPC contract and a construction contract will depend on the project characteristics, the project owner's objectives, and the project owner's risk preferences. The coordination of implementing an EPC (Engineering, Procurement, and Construction) project is the primary responsibility of the EPC contractor. The EPC contractor is responsible for planning, managing, and executing all aspects of the project, from initial planning to completion.

Although the EPC contractor is primarily responsible for coordinating the execution of an EPC project, the project owner also has a vital role in project oversight and control. The project owner usually oversees to ensure that the EPC contractor complies with the contract, executes the work by expectations, and achieves the project objectives. Therefore, close collaboration between the project owner and the EPC contractor is crucial for the success of an EPC project.

Thus, in an EPC contract, the responsibility for project execution lies entirely with the Contractor because the responsibility and control for coordinating project execution shifts from the project owner to the project contractor. The EPC contractor is burdened with fully performing design, procurement, installation, construction, and commissioning activities. In other words, the EPC contractor is responsible for the entire project from the planning stage, execution, and handover in a state ready for operation.

Contract splitting is a practice in which project owners or EPC contractors attempt to circumvent limitations or requirements within a contract or regulation by dividing a large project into several more minor agreements. This is done to avoid specific requirements, such as competitive bidding or equitable risk allocation, that typically apply to large projects.

In addition to this motive, globalization has influenced the transformation of the business world, including EPC contracts. Project owners are beginning to utilize contractor services from overseas, enabling their contracts to span multiple jurisdictions. Consequently, contracts involving parties in various jurisdictions often give rise to issues stemming from differences in the applicable legal regulations of the respective jurisdictions. Another emerging trend is that cross-jurisdictional EPC contracts prompt companies to split the contracts through a split approach.

However, cross-jurisdictional EPC contracts are generally split to avoid taxation on activities conducted outside the jurisdiction where the project is established (offshore activities). By exploiting loopholes in tax legislation in each jurisdiction, splitting such contracts can reduce tax costs and save funds expended by project contractors. A locational splitting project contract is used in projects that involve separating or dividing certain geographical areas into several separate contracts. In this type of contract, a project initially centralized in one geographical location is divided into several parts or contracts, each operating in a different location.

Locational splitting is often used in large projects involving extensive or diverse geographical areas. This type of contract improves project efficiency and management by accommodating differences in geographical conditions, local regulations, or specific needs across various locations. In a locational splitting project contract, each contract typically has the scope of work, schedule, and requirements for a designated location. This allows for more efficient project management at each location and enables better monitoring of each area's challenges and requirements.

In a locational split, an EPC contract is divided into two separate agreements based on geographical location: an onshore contract and an offshore one. This division is based on geographical location, hence the term "locational split." The responsibilities of the offshore Contractor typically include providing design and engineering services delivered outside the host country (offshore services) and supplying plants, equipment, and materials from abroad (offshore supplies). Meanwhile, the obligations of the onshore Contractor generally include providing equipment sourced from the host country, assembling equipment originating from abroad after it arrives in the host country, and construction, testing, commissioning, and other activities, including providing design and engineering services in the host country related to project execution.

The EPC contract is a tool for allocating risk between the project owner and the project contractor. In this case, the project contractor assures the project owner by providing a 'one point of contact' and 'single point of responsibility.' Thus, a split EPC contract structure could reduce the single point of responsibility held by a single EPC contract (Saputra & Fathoni, 2023). This occurs because, with the contract split, responsibility for project execution is also divided among several contractors. This division of responsibility reduces the single point of responsibility in completing the project (Pradani, Maharani, & Ramli, 2021). Contract splitting also creates difficulties in determining the accountability and responsibility of the parties involved, which rests with the project contractor in a single contract (Arkedis et al., 2021).

A split contract has a Coordination Agreement or Wrap Around Guarantee (WAG) to address this accountability and division of responsibility issues. A WAG is an agreement signed by the contractors and the project owner. The WAG contains the contractors' work scope, work coordination, delivery timelines, a guarantee from the project leader or Contractor to the project owner that the project will be successfully executed, and so on. A WAG also includes contractors' obligations, both abroad and in the host country, to coordinate the execution of a project.

If several contractors join a consortium, the consortium leader usually assures the project owner that if combined, the separate scopes of work in the split contract will be equivalent to the overall project scope.

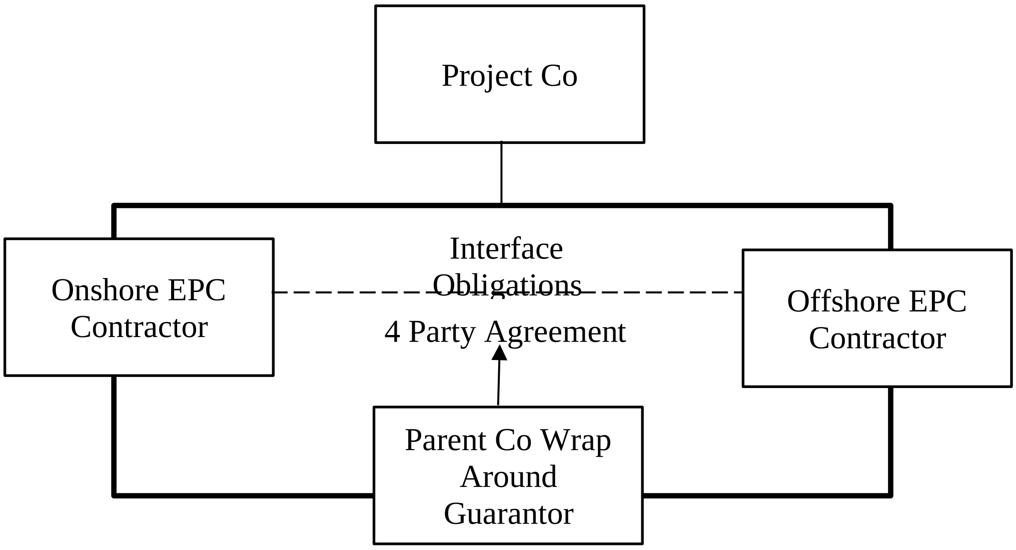

Figure 1. Split EPC Contract

The scope of this research is limited to analyzing the international tax aspects of several cases of EPC contracts abroad and domestically that the author can find the author can find. Therefore, the analysis is only based on the cases in question, not including analysis from the point of view of cases not mentioned in the study.

Research Method

The research method employed is descriptive qualitative, utilizing a literature review approach as the data collection method. A literature review involves scrutinizing books, literature, notes, and various reports relevant to the issue (Cahyono, 2020). This method is utilized to explore theories and secondary data as a foundation to support the conceptual framework in discussing the findings of this research.

Results and Discussion

Taxation Aspects of EPC Contracts

If the components within an EPC contract are viewed as a unified whole or if there is no contract segregation, essentially, there are no issues from the perspective of domestic taxation. Under a domestic EPC contract without contract segregation, Final Income Tax (PPh) will be imposed on construction services. Problems arise if the components within such EPC contracts are divided or if one of the components in an EPC investment contract is separated. The uniqueness of tax treatment for EPC contracts lies in the flexibility each party possesses to design the contract arrangements according to their needs. Therefore, differences in the arrangements within EPC contracts result in differences in the tax treatment of those contracts.

In domestic tax regulations, on February 21, 2022, the Government enacted a tax policy update regarding construction services. This provision is stipulated in Government Regulation 9 of 2022 concerning Amendments to Government Regulation 51 of 2008 concerning Income Tax on Income from Construction Services Businesses. This policy enactment aims to simplify the imposition of Income Tax on income from construction services businesses while maintaining a conducive and equitable business climate in the construction services sector.

These provisions also apply to contracts signed before the enactment of Government Regulation Number 9 of 2022 but with payments made after the implementation of this regulation. When these provisions come into effect, all implementation regulations of Government Regulation Number 51 of 2008, including Government Regulation Number 40 of 2009, are deemed valid as long as they do not conflict with the provisions of Government Regulation Number 9 of 2022. Based on the new regulations in Government Regulation No. 9/2022, construction services businesses are now divided into only three classifications: Construction Consultation, Construction Work, and Integrated Construction Work.

Construction consultation activities include assessment, planning, supervision, and construction management work. Construction work includes construction, operation, maintenance, dismantling, and reconstruction. Meanwhile, integrated construction work consists of a combination of construction work and consultation services, including the integration of service functions in a combined model of planning, procurement, and construction and the integration model of planning and construction.

An EPC contract will encompass engineering, procurement, and construction activities as an inseparable business unit ready for operation upon handover by the EPC contractor. If the Business Entity Certificate/Construction Services Business License (SBU/SIUJK) states that the type of business is integrated construction work by a domestic taxpayer, a Final Income Tax of 2.65 per cent will be deducted if the entity possesses a business entity certificate, and a Final Income Tax Article 4 paragraph (2) of 4 per cent will be deducted if the entity does not possess a business entity certificate.

However, EPC contractors are generally handled by several foreign and domestic taxpayers. For foreign taxpayers, it is conducted through a Permanent Establishment whereby the income of the head office from business or activities, sale of goods, or provision of services in Indonesia is similar to those conducted by a PE in Indonesia. Hence, the taxation aspect of splitting EPC contracts becomes more complex because, in this case, business activities are carried out by domestic taxpayers and are subject to Final Income Tax according to Government Regulation Number 9 of 2022. Therefore, a case analysis is needed to avoid potential tax loss due to untaxed cross-jurisdiction transactions and to ensure consistency in tax treatment regarding the splitting of EPC contracts. An EPC contract essentially entails several income streams for the Contractor, including the following four components:

Offshore supplies of equipment. The tax issue concerning offshore plant and equipment supplies essentially revolves around determining whether the equipment supplier, who is not a Domestic Tax Subject, has a Permanent Establishment (PE) in Indonesia. If the supplier does not have a PE in Indonesia, then Indonesia cannot levy tax on the income the supplier receives. However, suppose the supplier does have a PE in

Indonesia. In that case, the issue lies in determining the income attributable to that PE so that it can be subject to taxation in Indonesia.

Offshore services provision. Tax issues concerning offshore services generally revolve around determining whether the Contractor's services abroad can create a PE in Indonesia. If it is found based on facts that there is no PE in Indonesia, then Indonesia does not have the right to tax the Contractor's income. However, if the Contractor does have a PE in Indonesia, the issue is determining the amount of income attributable to that PE so that it can be taxed in Indonesia.

Onshore supplies of equipment. There are no tax issues concerning the provision of factories and equipment within Indonesia because the tax treatment of such transactions follows Indonesian legislation.

Onshore services provision. Similarly to the provision of factories and equipment in Indonesia, there should ideally be no tax issues concerning the provision of services within Indonesia because the tax treatment of such transactions follows Indonesian legislation.

Taxation on offshore supply transactions in EPC investment contracts has long been contentious. Various parties, including the courts, have rendered different rulings, with some decisions favouring the tax authorities while others favour the Taxpayer. The crux of the dispute in most EPC cases is that equipment delivery mainly occurs outside Indonesia in EPC contracts. Therefore, the income derived from such deliveries is considered to originate from outside Indonesia. Ownership of the equipment transfers outside Indonesia; thus, payments for such deliveries are also considered to originate from outside Indonesia. Therefore, no income or portion thereof arises in Indonesia or is deemed to occur in Indonesia.

Another issue concerns offshore deliveries in an EPC contract, which includes project installation and commissioning conducted in Indonesia. Installation and commissioning services are mainly done in Indonesia through foreign consultants who come directly to Indonesia or through subsidiaries, branches, or project offices owned by the Contractor in Indonesia. This may create a Permanent Establishment (PE) for installation or construction in Indonesia that is subject to tax according to the prevailing Indonesian laws and regulations.

In calculating the amount of tax owed by the Contractor, tax authorities often argue that the EPC contract is considered a single contract and, therefore, cannot be split because the characteristics of the contract constitute a composite contract. Tax authorities argue that there is no specific contract for offshore equipment deliveries, so the entire contract value can be subject to taxation in Indonesia. The opinion of tax authorities often leads to disputes between tax authorities and EPC contractors in court, and there needs to be more consistency in court rulings on these disputes because there are rulings favouring tax authorities and rulings favouring contractors.

An example case based on Tax Court Decision Number PUT-105692.25/2010/PP/M.VIB Year 2018, where in 2007, a consortium was awarded a project by PT PL Persero Indonesia to undertake the Pelabuhan Ratu Power Plant construction project. The Work Contract was signed on July 25, 2007, with a contract value of IDR 7.5 trillion. An advance payment of IDR 525 billion was made on November 2, 2007, and the VAT was collected, remitted, and reported in the VAT Return for November 2007. Based on the signed contract agreement, it was known that the project execution and contract payments were scheduled to be completed by August 7, 2010. Besides being subcontracted and as consortium members, the project execution was also subcontracted to various subcontractors or, in this case, conducted through Locational Splitting Contracts with Insema Sunly Engineering, China Harbour Indonesia, Berdikari Pondasi Perdana, and Manunggal Engineering.

In the tax examination result, according to the Directorate General of Taxes, the procurement object is subject to Article 4 paragraph (2) Income Tax because the contract agreement states that within one contract, it covers EPC (Engineering et al.) work. Thus, according to the DGT, procurement is considered a construction service object because the work contract is not made separately and is still in one contract document. The procurement delivery to Indonesia is materially related to the ongoing project, so it can be asserted that it has an effective relationship with the company's activities in Indonesia.

If reviewed based on Article 5 paragraph (1) of the Indonesia-China Tax Treaty, it is regulated as follows: for this agreement, the term "permanent establishment" means a fixed place of business through which the business of an enterprise is wholly or partly carried on. According to this agreement, the term "permanent establishment" means a fixed place of business where the whole or part of an enterprise's business is carried out. From this provision, a PE will be deemed to exist if it meets the criteria of a fixed place of business and business activity is carried out at that place, whether wholly or partly.

Based on the data/documents/evidence obtained, the Appellant conducts business activities in Electrical Building Construction (KLU 42213) in Indonesia and has an office in Indonesia, thus fulfilling the Indonesia-China protocol. Furthermore, from the examination of the contract documents, no substantial evidence or reasons were found to suggest that the procurement sales are activities that the Appellant cannot undertake. Therefore, the Appellant's income should be derived from the entire contract value, a unified entity (contract model: EPC Splitting Contract).

The Contractor's duties and responsibilities in an EPC contract include designing, manufacturing, testing, delivering, installing, constructing, pre-commissioning, commissioning, and conducting performance tests, taking over and guaranteeing certain facilities, or in other words, activities from inception until the project is ready for operation. By signing the contract, the Contractor assumes full responsibility and declares its capability to carry out the activities above. Additionally, the procurement delivery to Indonesia is materially related to the ongoing project. Hence, it can be firmly asserted that procurement delivery has an effective relationship with the company's activities in Indonesia.

Another case example that occurred in India, based on Authority of Advanced Ruling (AAR) ruling No. 958 of 2010, where Alstom Transport SA, along with other companies, Thales Security Solutions & Services, S.A, Portugal, and Sumitomo

Corporation, Japan, entered into a contract with Bangalore Metro Rail Corporation Ltd. (BMRC) to design, manufacture, provide, install, test, and commission the signalling/train control and communication system project. According to the clause in the contract, the four companies forming a consortium are jointly and severally liable to BMRC for fulfilling the obligations stipulated in the contract. However, each company's obligations are separated, and each bears the losses or profits associated with the project.

Based on the facts, AAR opines that the disputed contract is a composite contract. Therefore, the contract for installing and commissioning activities in an EPC project cannot be divided into separate parts. AAR refers to previous cases and argues that an EPC contract must be read as a whole in the context of the objectives intended by the parties involved in making the contract so the contract cannot be divided for tax purposes.

Based on Article 5 paragraph (1) of the Income Tax Law, the taxable objects of a Permanent Establishment are the income derived from the business or activities of the Permanent Establishment and assets owned or controlled, the head office income from the company or activities, sales of goods, or provision of services in Indonesia similar to those carried out by the Permanent Establishment in Indonesia, and income as referred to in Article 26 received or obtained by the head office, as long as there is an effective relationship between the Permanent Establishment and the assets or activities generating the income in question.

Based on these regulations, in its examination, the Directorate General of Taxes corrected the business turnover in the form of income from procurement because the Contractor's duties and responsibilities are to design, manufacture, test, deliver, install, construct, conduct pre-commissioning activities, commissioning, and performance testing, taking over until the project is ready for operation. By signing the EPC contract as a unified whole, the company is fully responsible for carrying out the activities above.

Thus, Final Income Tax is imposed on all business turnovers from the contract as construction services. Another argument is that the procurement delivery to Indonesia is materially related to the project being undertaken by the Taxpayer, so it can be asserted that procurement has an effective relationship with the Taxpayer's activities in Indonesia; therefore, the income that should be reported as income is from the entire contract value, which is a unified contract.

There are differences in considerations when determining the tax treatment of EPC contracts in other countries and Indonesia. In determining the tax treatment of income derived from offshore supplies and offshore services in an EPC contract, India considers the following factors: the profit subject to tax in India is only the profit attributable to business activities carried out in India. Thus, the profit from offshore supplies and services can only be taxed in India as long as the profit can be attributed to a Permanent Establishment in India, or in other words, the Permanent Establishment in India is involved in the offshore supply activities. However, in another EPC contract case ruling, there is a decision stating that the EPC contract is a composite contract and cannot be divided for tax purposes, so the income derived from the offshore supply is considered as income of the Permanent Establishment in India and can be taxed in India even though the Permanent Establishment is not involved in the offshore supply transaction.

Meanwhile, in Indonesia, income received by Taxpayers from construction service activities is generally subject to final Income Tax as stipulated in Article 4 paragraph (2) letter d of the Income Tax Law. Suppose residents of other countries receive income from construction services in Indonesia. In that case, such income falls under the category of business profits, which, according to the provisions of Tax Treaties, can only be taxed in Indonesia if the other country's residents conduct their business through a Permanent Establishment (PE) in Indonesia. If the construction service activities undertaken by residents of other countries constitute an EPC contract, then referring to court rulings such as the SEG case, Income Tax is imposed on the value of the entire EPC contract because transactions within the EPC contract, such as offshore supply, are considered a unified and inseparable part as agreed upon in the contract.

However, in determining the tax treatment for EPC contracts, it is necessary to consider the provisions of each country's Tax Treaties. Suppose there are separate provisions regarding EPC contracts, such as the Indonesia - Germany Tax Treaty Protocol, which states that the profit of an EPC contract attributable to a PE in a Contracting State in the Tax Treaty is only the profit derived from the activities of that PE. Thus, if there are activities related to the implementation of the EPC contract that are not carried out by the PE, such as supply activities conducted by the head office, then the profit derived from such offshore supply activities cannot be attributed to the said PE, as long as the contract specifies the separation between activities conducted outside Indonesia (offshore supplies or offshore services) and activities undertaken in Indonesia (onshore supplies or onshore services).

Conclusion

The EPC contractor is fully responsible for planning, managing, and executing all aspects of the EPC project from inception to completion. This encompasses project planning, technical management, procurement, construction management, financial management, quality and testing, scheduling, and subcontracting coordination. With this complete responsibility structure, the risk of EPC project execution significantly shifts from the project owner to the EPC contractor. However, the project owner still maintains a supervisory and control role to ensure compliance with the contract and achievement of project objectives. Close cooperation between both parties is crucial for the success of an EPC project.

The objectives of contract splitting include avoiding specific requirements such as healthy competition and fair risk allocation on large projects and engaging in tax avoidance for offshore activities. However, contract splitting can lead to reduced transparency, unhealthy competition, unfair risk distribution, and potential losses due to exploiting tax loopholes. Coordination Agreements or Around Guarantees (WAG) are typically used in split EPC contracts to mitigate these issues.

EPC contractors involving foreign taxpayers require case-by-case analysis to avoid potential tax losses due to cross-jurisdictional transactions—taxation aspects on EPC Contract Components. Challenges related to separating offshore supplies and services often lead to disputes, especially in offshore deliveries involving installation and commissioning in Indonesia. There are tax disputes related to offshore supplies in EPC contracts, where ownership and payments are considered to originate from outside Indonesia.

The main taxation issue on offshore supplies and services in EPC contracts is determining whether these activities can create a Permanent Establishment (PE) in Indonesia, thus subjecting their profits to taxation in Indonesia. Tax court rulings need more consistency in determining whether an EPC contract constitutes a composite contract, thus subjecting its entire value to taxation, or if it can be separated based on offshore and onshore locations. Case-by-case analysis and consideration of tax provisions in each applicable Double Taxation Avoidance Agreement (DTAA) are necessary to determine the tax treatment of international EPC contracts. There are differing views on the taxation treatment of EPC contracts, such as courts having different opinions.

The Tax Treatment Approach in India and Indonesia emphasizes that India focuses on taxing profits only related to business activities conducted in India. Indonesia, in principle, imposes Final Income Tax on the entire value of the EPC contract as a unit. The taxation treatment of EPC contracts is complex and contentious, especially regarding the separation of contract components. It is essential to consider the provisions of each country's DTAA in determining the tax treatment for EPC contracts involving cross-jurisdictional transactions.

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