

LITERATURE REVIEW

Income Tax Reconstruction on Construction Services to Support Development in Indonesia

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ABSTRACT

PURPOSE: The rapid development of construction companies is still dominated by various illegal acts including bribery, embezzlement, and fraud, meaning that the proper tax income is not reported to the tax office. It is necessary to produce a reconstruction of the income tax provisions on development-based construction services.

DESIGN/METHODOLOGY/APPROACH: This paper applied a normative juridical method with an evaluative and prescriptive thought.

FINDINGS: The applicable income tax regulations on construction services have not been able to overcome various illegal acts, such as fictitious subcontractors, fictitious work units, replacement or deterioration of material quality, transfer of lump-sum costs to material costs, tender collusion, personal use of project equipment, and money laundering.

RESEARCH LIMITATIONS/IMPLICATIONS: This paper requires in-depth study using a socio-legal approach, but can enrich subsequent empirical research.

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ORIGINALITY/VALUE: It is important and urgent to renew income tax laws to overcome existing fraud in construction services, including the regulation of the Construction Industry Schemes obligations together with sanctions for each violation, revocation of final income tax on construction services, and the obligation to use the percentage-of-completion method in construction services whose project completion exceeds a financial year.

KEYWORDS: *Income; Tax; Construction; Contract; Illegal Act*

INTRODUCTION

The construction industry has become a big business sector in Indonesia in recent years. The Central Bureau of Statistics (2018; 2020a; 2021) reported that the total gross income from construction industries from 2016-2019 has increased year on year, reaching Rp.938.36 trillion (US\$60,841,402), Rp.1,525.16 trillion (US\$9,888,835), Rp.1,745.03 trillion (US\$11,314,428), and Rp.2,048.56 trillion (US\$13,282,457), respectively. Gross income has increased tax revenues in the construction sector in 2016-2019, amounting to Rp.57.08 billion (US\$370,095), Rp.60.83 billion (US\$394,409), Rp.64.49 billion (US\$418,140), and Rp.66.63 billion (US\$432,015) respectively (Directorate General of Taxation, 2019).

However, the increase has brought with it certain challenges, such as bribery, embezzlement, and fraud that can occur at any stages of a construction project. Therefore, a strategy that focuses on raising awareness that every illegal act can hinder the sustainability of development is needed (Sohail and Cavill, 2008). This is because illegal acts are not only limited to the violation of the law but also damage the morals, propriety, care, and prudence of the society (Sinaga *et al.*, 2019). It is clear that illegal acts in the construction sector led to improper income (Sinaga and Hermawan, 2021) as formulated in Article 4 paragraph (1) of Law Number 36 of 2008 concerning Income Tax (*UU PPh*).

The fact that the challenges that occur in the construction sector are directly and indirectly related to taxes can be seen, among others, in the court's verdict on a fictitious project carried out by five defendants in one of the State-Owned Enterprises construction companies, PT. WK, causing state losses of Rp.202.29 billion (US\$131,160). One of the methods used showed several companies affiliated with several suspects as subcontractor companies undertake fictitious subcontractor work, with the appointed fictitious subcontractor companies given a "flag borrowing" fee of 1.5%-2% of the contract's value (Ramadhan, 2020). In addition, various modes of fraud potentially occur in the construction industry, such as bills for fictitious work units, fictitious vendors, replacing or lowering the quality of materials, transferring lump-sum costs to material costs, tender collusion, personal use of project equipment/equipment, and money laundering (Aprilliani, 2021).

The state must emphasise that the growth of tax revenue from the construction sector will have a significant impact on the country's economy and the state's welfare (Setiawan and Erdogan, 2020). This would be in terms of energy absorption work, turning the supplier business wheel related to the construction industry, and the income of construction workers. However, it must

be realised that there are challenges in construction business activities that intersect with many regulations, such as construction service, environmental, land, investment, labour, tax, and many other regulations (Lature, 2018). Therefore, it is important to keep the construction sector running in a healthy, growing, and sustainable manner by minimising every illegal act; this all comes down to income, which is the object of income tax.

Based on this thought, this study seeks to answer two main problems. First, what are the current income tax regulations in the construction industry in Indonesia? Second, what are the ideal provisions for *PPh* on construction services in the future? The existence of these two questions can explain the imposition of income tax (*PPh*) and produce a concept of income tax on construction services based on development in Indonesia. Development growth will significantly increase the rule of law so it can significantly increase the level of prevention and control of illegal income and expenses (Hermawan and Sinaga, 2020).

METHODOLOGY

This study uses a qualitative approach that is expected to produce a reconstruction of income tax provisions on construction services based on future sustainable development. The urgency of the reconstruction is based on the need for a philosophical and juridical study to tackle violations or crimes that are detrimental to state finances; this should be done through actions or processes that rebuild, recreate, or reorganise existing legal constructions, to be used as a solution that prioritises output and outcome (Gardner, 2009; Sinaga and Sinaga, 2018; Sinaga *et al.*, 2020). The reconstruction is in line with the efforts of the juridical study as prescriptive thinking to obtain suggestions to overcome the problems posed in research, and evaluative, namely to assess the programmes being implemented (Soekanto, 2010).

In aligning with the research objectives, this normative juridical method will start from the inventory of statutory regulations, laws *in concreto*, legal principles, and legal comparisons by examining library materials or secondary data in the form of primary, secondary, and tertiary legal materials. Primary legal materials consist of binding legal materials in the form of laws and regulations related to taxation. Secondary legal materials include the use of textbooks, legal expert opinions, articles, seminar results, and research results in the field of law and taxation, while tertiary legal materials are materials that support information on primary and secondary legal materials, including newspapers, dictionaries, and encyclopedia (Soekanto and Mamudji, 2007).

INCOME TAX ON CONSTRUCTION SERVICES

Income related to construction services is an object of income tax, as stated in Article 4 paragraph (1) of the Income Tax Law; this emphasises that the object of income tax is “*any additional economic capability received or obtained by taxpayers, both from Indonesia and from outside Indonesia, which can be used for consumption or to increase the wealth of the Taxpayer concerned,*

in whatever name and form". Then, Article 4 paragraph (2) of the Income Tax Law stipulates that income in the form of a construction service business is an object of final income tax.

Subsequently, Government Regulation (GR) Number 40 of 2009 concerning Amendments to GR Number 51 of 2008 concerning Income Tax on Income from Construction Services Business was issued; this is an explanatory regulation, the implementation of which regulates the payment of income tax on construction services (Tjahjono, 2015). On income received or obtained by domestic taxpayers and permanent establishments (BUT) from businesses in the construction service sector, final income tax will be imposed for taxpayers who meet the qualifications as small businesses and the procurement value is a maximum of Rp.1 billion (US\$6,483,801). Non-final income tax relates to non-small business taxpayers and/or where procurement is greater than Rp.1 billion. The income from construction services business in the form of final income tax will be subject to final withholding tax at the time of payment of advances and terms, or subject to final tax by self-payment of income tax payable at the time of receipt of advance and term payments. The amount of income tax payable must be deducted by the service user or paid by the service provider taxpayer, in accordance with GR Number 40 of 2009, is 4% of the gross amount. This is received by the taxpayer providing construction planning services, 2% of the gross amount, received by the taxpayer of the construction implementation service provider, or 4% of the gross amount received by the taxpayer of the construction supervision service provider.

Article 10 letter (a) number 1 (b) GR Number 40 of 2009 regulates non-final income tax on income from businesses in construction services that are:

- a) income received or earned by domestic taxpayers, and BUT is subject to withholding tax based on the provisions of Article 23 of the Income Tax Law by service users in the event that the service user is a Government entity, domestic Corporate Tax Subject, BUT, or an individual as a resident Taxpayer appointed by the Director-General of Taxes as the withholding of Article 23 income tax at the time of payment of advances and terms;
- b) imposed based on the provisions of Article 25 of the Income Tax Law in the event that the income provider is another service user other than as referred to in (a).

The non-final income tax rates for construction service businesses in accordance with Article 3 of GR Number 51 of 2008 are:

- 4% for construction implementation carried out by service providers who do not have business qualifications;
- 3% for construction implementation carried out by service providers other than that carried out by service providers who have small business qualifications and service providers who do not have business qualifications;

- 4% for construction planning or construction supervision carried out by service providers who have business qualifications; and
- 6% for construction planning or construction supervision carried out by service providers who do not have business qualifications.

In the event that the service provider is a permanent establishment, the income tax rate referred to above does not include income tax on the remaining profits of the permanent establishment after the final income tax.

AGENCY RELATIONSHIPS OF THE CONSTRUCTION WORK CONTRACTS IN THE INCOME TAX FRAMEWORK

As the entire contract document that regulates minimising the occurrence of tax avoidance and tax evasion in the construction industry, the Construction Work Contract is important in understanding the contractual relationship between the parties involved in the contract considering Article 46 and Article 49 of Law Number 2 of 2017 concerning services. Construction (Construction Services Law) stipulates that the working relationship between Service Users and Service Providers, as well as between Service Providers and Service Sub-Providers, must be stated in the Construction Work Contract. Furthermore, Article 1 point 8 of the Construction Services Law confirmed the legal relationship between Service Users and Service Providers in the implementation of Construction Services. The Construction Work Contract must at least include, clear identities of the parties, the job formulation, the implementation, and maintenance period (which is the responsibility of the Service Provider), equality of rights and obligations between the Service User and the Service Provider, the obligation to employ certified construction workers, payment methods, default, dispute resolution, contract termination, *force majeure*, building failure, worker protection, protection of third parties (other than the parties and workers), environmental aspects, guarantees for risks that arise, and legal responsibility to other parties in the implementation of Construction Works or as a result of Building Failure, and construction dispute resolution options (Emirzon and Sinaga, 2021).

The arrangement of the Construction Work Contract implies that the scope of construction is legally very broad; it contains the totality of legal problems that may arise from certain business fields (Bailey, 2011), including engineering, economics, and taxation. This can be seen from construction products that do not only produce building and infrastructure products, which are public goods (such as roads, bridges, airports, ports, dams, and dams) as well as private goods (such as residential houses, hotels, offices, condominiums, shopping malls, and factories), but also construction sector products that become inputs for other sectors (Central Bureau of Statistics, 2020b), such as the industrial sector (cement, roofing, aluminum, wood, and ceramics), the equipment sector -heavy equipment, fuel oil sector, and technology sector. In addition to referring to the Construction Services Law, contractual relationships in the construction industry must refer to tax provisions in terms of

carrying out their tax rights and obligations. Article 4 of Law Number 16 of 2009 concerning General Provisions and Tax Procedures to Become Law (*UU KUP*) states that taxpayers who have fulfilled subjective requirements must fill out and submit the Tax Return correctly, completely, clearly, and signed by the taxpayer or an attorney with a special power of attorney.

The existence of the obligation to make contracts in the construction industry shows that a good contractual relationship cannot be separated from the implementation of agency theory. Agency relationship problems often arise when the principal, who is the party that mandates the agent to carry out all activities on behalf of the principal (Gardner, 2009), is unable to check whether the agent has behaved appropriately or not. The existence of potential fraud in a construction company shows that agency theory is appropriate to solve the problem of tax avoidance and tax evasion as the Construction Work Contract will be evidence for each party. This is in line with Eisenhardt (1989) and Adams (1994), who show that agency theory is very useful in knowing:

- a. the wishes or goals of the conflicting principal and agent;
- b. the occurrence of information asymmetry between principals and agents; and
- c. how to examine external or internal factors of a particular community (business) that are indeed very complex and generally hidden.

These contractual relationships and agency theory will be the main concerns to minimise tax avoidance and tax evasion in the construction industry. They refer to certain things, such as construction service revenues that do not exceed costs, fulfillment of the demand for construction services, the fulfillment of financial resources in financing the project until the payment terms are received from the customer, the fulfillment of a skilled workforce, and overhead costs that meet the projected workload (Schaufelberger, 2009).

LITERATURE REVIEW OF INCOME TAX ON CONSTRUCTION SERVICES IN INDONESIA

The total value of the global construction market, which is estimated to have reached a value of US\$3,200 billion per year (Rp.45,920), cannot be separated from fraud in several forms, such as corruption, misappropriation of assets, tax irregularities, and bribery. The American Society of Civil Engineers stated the amount of corruption in the construction industry in the world has reached the range of US\$340 billion per year (Rp.4,879 trillion).

The challenges of economic crime in the construction sector are quite significant and can occur at any stage of a construction project (Sohail and Cavill, 2008). This is also true in the Indonesian construction and real estate sectors; these sectors have a low tax ratio that was only 6.72% of Gross Domestic Product (GDP) in 2019. Therefore, appropriate policy changes are needed, namely through changing the applicable tax rates in the final *PPh* regime or implementing a general scheme in imposing *PPh* on income received by the construction sector (Wildan, 2020).

The occurrence of tax fraud in the industrial sector must be of special concern to the government in Indonesia considering the complexity has been very worrying; the fraudsters disguise income with the intention of deceiving the state (Martin, 2011, Skalak *et al.*, 2011), or carry out hidden activities.

In the case of fraudulent invoices for fictitious work units, fictitious subcontractors, material quality degradation, transfer of lump-sum costs to material costs, personal use of project equipment/equipment, tender collusion, and money laundering, the Tax Authority must be able to implement agency relationships on obligations in the construction contract; this should be done by requiring all contractors to report and register their Construction Industry Scheme (CIS), including certain financial databases, recordings, and bookkeeping, who must report tax returns (Sinaga, 2021). The tax office must have a database of construction companies that have truly verified data, reports, and information, such as companies, management, board of commissioners, shareholders, company qualifications, and a list of certified labour workers (HM Revenue & Customs, 2014). It is necessary to study the rules for withholding income tax on multi-storey construction services carried out by the main contractor to subcontractors, namely the main contractor deducting income tax on their payments at a higher rate to contractors/sub-contractors who are not registered with the Tax Office (HM Revenue & Customs, 2014). The obligation to report this CIS can prevent fictitious transactions, borrowing flags, fictitious vendors, and misuse of fees into personal interests, because before a contractor can make payments to subcontractors for construction work, the contracting company must verify with the tax office that the subcontractor is registered. Each month, the contractor must send a complete list of all payments that the contractor has made under the scheme to the tax office. The reporting or return of the list to the tax office includes details of subcontractors, details of payments and any withholdings that have been made, statements on the status/progress of work of all subcontractors, statements that all subcontractors have been verified (HM Revenue & Customs, 2014). The tax office will then check whether the subcontractor is registered and notify the contractor which tax withholding rate should be applied when the contractor makes payments to the subcontractor (HM Revenue & Customs, 2014).

The existence of the rules of the CIS shows that there is a shared responsibility between the people and the state so that taxes are fair; this can restore the functioning of the market and produce a healthier construction industry (Doree, 2004). The CIS regulations are expected to be one of the solutions in bridging the interests of state revenues in minimising economic crime in the construction sector through increasing the role of taxes; this is because taxes (which are basically non-discriminatory (Soemitro and Sugiharti, 2004)) must be able to realise voluntary compliance to all taxpayers. The imposition of taxes on construction services meets the principles of equity, certainty, convenience, and efficiency, with reference to a good taxation system that must be fair, and collected according to the ability of the taxpayer to pay (Matarirano *et al.*, 2019). Taxpayers know about their tax compliance obligations, and the time and method of tax payment must be the most conducive and not excessive. The principles of certainty and convenience are then fully

related to compliance costs, while equity and efficiency require that compliance costs be ignored so as not to violate the principles of a good tax system (Matarirano *et al.*, 2019).

CIS obligations will be of key importance in presenting financial reporting consistently from year to year, from project to project, and from month to month in each project. This is based on the consideration that in order to report costs and profit projections consistently, the contractor must at least have a reliable financial management system, especially with regard to cost control. Holm (2019) suggested that construction project teams must follow several basic rules to have an effective cost control system, that is cost reporting data must be timely and accurate. More specifically, in terms of income tax rates on construction services, it is necessary to abolish the imposition of final income tax rates for the entire construction industry in order to minimise efforts to break up subcontractors into small category companies. Contractor's bookkeeping must be kept consistent and accurate during the multi-faceted construction process, relying heavily on audits as an examination of the contractor's financial accuracy. The basis for revenue recognition at the contract stage is recorded by using a certain percentage of completion supported by evidence, such as the results of an internal review related to the achievements of the project progress, or the existence of independent party evidence (such as professional surveyors) about project uncertainty, showing that it is impractical to assess the percentage of completion (Inland Revenue Authority of Singapore, 2021).

The income recognition of contractor companies has been briefly explained in the Elucidation of Article 4 of GR Number 47 of 1994 concerning Calculation of Taxable Income and Payment of Income Tax in the Current Year; this is known as the percentage contract method or the percentage of completion method and completed contract methods. The use of one of the two income recognition methods will result in different amounts of income from year to year, and differences in the calculation of the income tax payable for each tax year. The "percentage of completion method" calculates the income tax payable every year on the basis of the income earned periodically (proportionately) during the completion stage of the work, while the "completed contract method" calculates the income tax payable when the work is completed, because income is only recognised at the end of the year the work is completed. During the completion stage of the work, no income tax is calculated. Furthermore, the Elucidation of Article 4 of GR Number 47 of 1994 confirms that the percentage of completion method is an accrual method commonly found in construction companies or building contractors who work on projects that take several years, with considerations:

- a) equalising the tax burden in every tax year during the period of completion of the work that can ease the burden on the taxpayer, because the tax payment in a tax year is in accordance with the income obtained proportionally during the stage of completion of the work, and the tax burden does not accumulate at the end of the year of completion of the work;

- b) obtain uniformity in income recognition for all taxpayers engaged in construction contractors or building contractors; and
- c) provide equal treatment for taxpayers engaged in the same business.

However, since GR Number 47 of 1994 has been revoked by GR Number 45 of 2019, the obligation to use the percentage of completion method for long-term construction is not explicitly regulated in laws or government regulations. In fact, many developed countries require the implementation of the percentage of completion methods, such as the Inland Revenue Authority of Singapore (2021) and the Internal Revenue Service of the United States (26 U.S. Code § 460 Special rules for long-term contracts). The use of the percentage of completion method for long-term construction contracts will make it easier for the tax office to periodically recognise and monitor revenues and expenses, not when the project is 100% complete.

CONCLUSIONS, IMPLICATIONS, AND LIMITATIONS OF THE RESEARCH

This study produces two conclusions. First, the current income tax regulations in the construction industry in Indonesia, in which the imposition of income tax is final and non-final, could not overcome the fraud that still occurs. The prevailing tax law can justify the financial fraud of certain entities (such as the number of construction companies breaking up the contract value below Rp.1 billion (US\$65,333,834), and the mode of making a “dummy construction company/subcontractor” to legalise fictitious costs) by legalising the payment of income tax at very low rates (only 2% of the contract revenue). These illegal acts will only harm sustainable development given the low quality of buildings and/or mark-up on contract values and/or loss of state’s tax revenue. Second, the ideal provisions for income tax to overcome the fraud on construction services must be done through income tax law reforms. These must include the regulation of CIS obligations (rules that require the reporting and registration of the CIS for all contractors and a database of the construction company that has truly verified data, reports, and information). Also, there must be sanctions for each violation, revocation of final income tax regulations on construction services, the obligation to use the percentage of completion method in construction services whose project completion exceeds a financial year, and the rules that apply the withholding of income tax on multi-level construction services carried out by the main contractor to subcontractors. Hopefully, the implication of the renewal of income tax regulations on construction services will tackle practices that can justify fraud that are detrimental to state finances. This should be through increasing the voluntary compliance of taxpayers, including carrying out tax rights and obligations in a complete, clear and correct manner in the construction service sector.

This research is still limited to a normative juridical study. It is necessary to deepen the research in the form of socio-legal research to find laws that live in the community/society that can improve tax law compliance of construction sector taxpayers.

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