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How is the Transfer Pricing Concept “Arm’s Length Principle” Applied in Indonesia?

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Abstract. The research is aimed at analyzing how the arm’s length principle has been applied to transfer pricing cases in Indonesia. The arm’s length principle has become a global formula used by entities to ascertain that the transaction value has been done in an acceptable manner. The arm’s length principle has also become a fundamental basis in Indonesian tax regulations to assess the fairness of price for transactions undertaken by multinational entities with their affiliation located outside the Indonesia’s jurisdiction. This research used qualitative approach and qualitative research method. The research shows that the manufacturing entities in Indonesia are mostly contract manufacturers which have less risks and non-sophisticated functions. The contribution to global value chain is not substantial. However, the way it has been assessed with regard to its affiliated transaction does not follow its function. The tax authority selected a certain method, transaction net margin method (TNMM) that may be flawed to test the price fairness for such a condition. The test was performed at the level of operating profit of the company without being affected by differences in transactions at the level of operational costs and functions. This behavior could be done differently among individual tax auditors. Therefore, the tax authority may consider institutionalizing a unit to specifically deal with transfer pricing issue.

Keywords: transfer pricing, arm’s length principle, transaction net margin method, international tax

INTRODUCTION

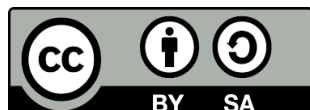
The Base Erosion and Profit Shifting (BEPS) Report released in 2013 has emphasized transfer pricing as an important issue. It explicitly mentions that transfer pricing issues are important concerns as they are related to risk shifting, the use and payment of intangibles, ownership splits in a legal context, and transactions between affiliated parties which are not normally carried out by independent parties. In addition, the BEPS Report also emphasizes that with today’s globalization, multinational companies tend to be more integrated as business strategies are carried out comprehensively for each part of the business unit. Although the geographical location and jurisdiction of each member of a multinational entity is different, they tend to implement a strategy that is regulated centrally by the parent company. With such business operational conditions, the issue of transfer pricing is increasingly important (Brekel, 2013). Issues related to transfer pricing that need attention at least include the following aspects:

a) There is a shift in risk between entities in multinational business groups, thereby increasing the complexity of transfer pricing issues. The basic question is how much risk is distributed/borne by each member of a business entity. b) On the risk distributed in each unit, to what extent each unit has managerial

control over its respective units, including controls related to financial management, should be on counting. c) How much compensation should be obtained by each entity for contributions to other business units in the same group.

Ernst & Young (2019) conducted a survey on transfer pricing and international taxes and discover some important points. First, the global environment is increasingly dynamic and uncertain where the risk of problems related to transfer pricing is getting higher and becomes a top priority. Second, specifically related to transfer pricing issues, transfer pricing documentation has become increasingly important even though in some jurisdictions it still does not meet global standards. Third, efforts to mitigate transfer pricing risk are also increasingly important as an effort to prevent double taxation or double non-taxation.

In the Indonesian context regarding the practice of tax revenues erosion, the Ministry of Finance noted that around 2000 foreign companies did not fulfill their income tax obligations for about 10 years (Sari, 2016). One of the main causes of such behavior is the practice of transfer pricing from companies located in Indonesia to affiliated entities in other jurisdictions. Various previous studies have also stated that this practice is increasingly at risk in Indonesia (Huda, Nugrahaeni & Kamaruddin, 2017). Thus, the government needs to pay more attention to this issue



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(Trisanti, 2016). In this practice, the transfer/reallocation of profits from Indonesia to other jurisdictions has existed so that profits in Indonesia are relatively small (Suroyo and Danubrata, 2016). One of the reasons why the transfer pricing policy has not received widespread attention is the lack of information about transfer pricing practices and profit shifting, and the limited publications related to cases that occurred widely (Purba, 2018). Implementing the so-called "arm's length principle" as the main concept in transfer pricing examination is still a big challenge.

On the other hand, it should be emphasized that basically transfer pricing provisions have been adopted in the Income Tax Law at the beginning of the tax reform in 1983. However, with all the limitations of the Indonesian tax authorities during the early period of tax reform, the technical provisions for transfer pricing were formulated in 2010 with the issuance of PER-43/2010 concerning the Application of the Principles of Fairness and Business Ordinance in Transactions between Taxpayers and Related Parties. The issuance of these provisions is inseparable from the increasingly massive transfer pricing practices that occurred (SGATAR, 2012).

The automotive industry is one of the industries that has a "global footprint" that has occurred for a long time. Globally, the industry has existed for hundreds of years (Gottert & Usaich, 2019). The automotive industry also has the largest global intercompany transaction volume with varied and complex types of transactions (Eigelshoven, 2016). This industry continues to experience rapid changes and is driven by relatively fast technological developments. In general, the automotive industry has a fragmented supply chain in various countries (Deloitte, 2014). Thus, in many countries, the fulfillment of the automotive industry's tax obligations is one of the important concerns of the tax authorities (Eigelshoven, 2016). The complexity of the intercompany transactions, such as transactions for the use of intangibles, non-intangibles, services, finance and various other transactions, remains challenging. This also causes the supervision of transactions to be quite crucial (Slowinski & Bowen, 2010).

In the context of Indonesia, at least four industrial sectors often practice tax avoidance with transfer pricing schemes. The industrial sectors are automotive, electronics, mining, and plantations (Kusumastuti, 2018). The automotive manufacturing industry is an important pillar in the manufacturing sector. The automotive industry is also one of the sectors with a fairly large volume of market transactions with transaction volumes accounting for one-third of the total transactions in Southeast Asia. Companies engaged in automotive manufacturing in Indonesia play an important role in the assembly and sale process on a large scale for the purpose of domestic and export markets (Indonesia Investment, 2017). Such a large volume of transactions should be a concern of the government whether each transaction carried out is in a reasonable price range (Trisanti, 2016).

In various media coverages, the automotive industry sector often draws the attention of the tax authority due to the transfer pricing practices (Putri W.A., 2018; Quddus & Wikanto, 2017; investigation tempo, 2013). This is also one of the researchers' findings from a preliminary study on disputes decided in the tax court within the 2015-2019 period. The automotive manufacturing industry has the largest proportion of total disputes according to previous research. The dispute that occurred was mainly caused by transactions related to the fairness of royalty payments to the determination of selling prices to affiliates which were not in accordance with the appropriate price range (Sulistiyawati, Santoso & Rokhmawati, 2019). This study is aimed at analyzing how the arm's length principle has been applied to the transfer pricing cases in Indonesia with automotive manufacturing industry as the background.

RESEARCH METHOD

Research related to taxation in general is either interdisciplinary or multidisciplinary. To conduct research on taxation, researchers can use various methods and approaches adopted from the disciplines that are the basis for conducting research (main discipline) (Lamb, 2004). As McKerchar (2008, 5) asserts.

Taxation is not a discipline in its own right, but a social phenomenon that can be studied through various disciplinary lenses. Commonly, taxation attracts researchers from the disciplinary of law, accounting economics, political science, psychology, and philosophy. These disciplinary backgrounds are each understandably narrow, and in spite of researcher being no doubt expert in their field, it can be challenging to apply their skills and knowledge to the complexities of research problem that emanate from the study of taxation.

This study uses a qualitative method as it is intended to understand social and community problems by forming a comprehensive and complex picture presented in words, reporting in details from sources of information, and interpreting the phenomenon which has occurred (Creswell, 1994). In qualitative research, theory does not serve as a central guide for designing research and interpreting data. Instead, it becomes the final product reconstructed based on solid research findings. In addition, this research is not intended to reduce the phenomena that occur and then reflect into a theory that has been processed into certain variables aimed at testing hypotheses. In this study, the phenomenon of transfer pricing practices carried out by the manufacturing industry is re-constructed to describe a pattern. Further, how current tax policies have been used to overcome problems related to transfer pricing in the manufacturing industry and how the current tax policies must be improved to minimize transfer pricing problems, especially for the manufacturing industry, are examined and interpreted.

Data for this study was collected and abstracted from the tax court decisions on the transfer pricing

cases in the manufacturing sector which were stipulated between 2015 and 2019. The researcher also conducted interviews with an expert and practitioners of transfer pricing issue in Indonesia consisting of six tax auditors (DGT) who engage for MNEs from five foreign tax offices under Jakarta Special Regional Tax Office, MNEs taxpayers, tax consultants, academician, and tax policy makers. Inductive technique was used in data analysis. Technically, the researcher abstracted the tax court decision and found the pattern on how the transfer pricing concept has been applied during the tax audit and how tax policy regarding transfer pricing should be improved.

RESULT AND DISCUSSION

Fundamental Aspect of Arm's Length Concept on Transfer Pricing

In general, the concept of arm's length has been recognized as a tool to measure that price between related parties is in a comparable condition to independent parties. It should be noted that transaction conditions are related to transactions where these conditions play a role in shaping prices. (Bullen, 2011).

"If associate enterprises make or impose special condition in their controlled transactions which differ from those independent enterprise would have made, the arm's length principle may authorize a profit adjustment. Such special condition will not necessarily only be the price condition but may also include any other condition. Hence, associated enterprises may not only value or price their transactions differently from independent enterprises, but may also structure them differently, and even enter into transactions independent enterprise would not contemplate undertaking at all" (Bullen, 2011, 3).

OECD member countries state that price adjustments pay attention not only to how much the transaction price is (price condition), but also other conditions (other valuation elements) that influence it, including how the transaction structure occurs (transaction structured). These conditions and structures may be reflected in a contract. So, the price that differs from that of an independent party may be due not only to conditions, but also to the existence of a transaction structure where independent parties will not consider doing so (Bullen, 2011). Various studies state that transactions carried out by related parties cannot be compared to the terms and conditions in an equal comparison (under the same terms and circumstances) with independent parties (Ioana Neacsu & Feleaga, 2019; Pozzoli & Venuti, 2014).

However, in practice, the use of the arm's length concept becomes very narrow and does not reflect the concept as expected. Tests with arm's length often focus on the existence of price differences on the compared transactions. When the tax authority faces a condition where there is a difference in transaction price between affiliated parties and independent

parties, the price is referred to by the tax authority as an artificial price. The concept of arm's length offered in the OECD Transfer Pricing Guideline Paragraph 1.64 states that the tax authorities conduct transaction "based on the transaction actually undertaken by the associated enterprises as it has been structured by them" (Bullen, 2011). Furthermore, Bullen (2011) also mentions that the allocation of taxation in domestic regulations in practice often does not refer to what has actually happened (actually done), but what is in the perspective of the tax authorities regarding what should have happened (should have done).

Having a different perspective, Navarro, (2018) states that the arm's length principle should be used in a tax justice perspective, that arm's length should be a relevant tool to distribute the tax burden among the taxpayers concerned, not solely determining the amount of tax to be paid. The concept of justice in taxes regarding horizontal and vertical justice should be reflected in the concept of arms' length. Taxpayers with different conditions should be treated differently. In a situation where taxpayers are in different conditions compared to the condition of independent comparators, in the process of making comparisons, it is necessary to carefully consider whether the conditions of comparison have been carried out properly. Navarro (2018, 2) mentions that "the arm's length principle from a tax justice perspective, as a tool relevant to reach an adequate distribution of the tax burden among taxpayers, not only what regards its aim". Further, transfer pricing whose reasonableness is tested using the concept of arm's length is a fictional calculation of transactions controlled by affiliated parties. Navarro (2018, 3) mentions that

"Transfer pricing regulations complying with the arm's length principle standard impose a fiction by which profit derived from controlled transactions are calculated, taking into account the outcome unrelated parties would have agreed on within the same circumstances. Thereby, the arm's length principle set an optimization mandate by which one should try to reach an outcome that must be the closest possible to what independent parties would have achieved under similar circumstances".

In implementing the arm's length concept, there is a distortion where the conversion between "group monetary units" to "market monetary units" in the comparison must be calculated correctly. Comparison between independent and affiliated transactions by comparing their profitability must be done with a very precise and careful treatment. Under the same conditions, transactions conducted by affiliated parties tend to seek various solutions when facing inefficiencies in the imperfect market, while non-affiliated parties tend to avoid such conditions. On the other hand, the benefits obtained by Multinational Enterprise (MNE) from their transactions will be greater than with independent parties. Therefore, there has been a criticism from academics that arm's length does not reflect

Figure 1. The Illustration of Benefit Derived from the Synergy of the MNE Group



Source: Kane (2014)

the actual economic conditions and rationalization of economic activities by multinational companies (Andresen, 2015).

Basically, one of the advantages of multinational companies compared to independent stand-alone companies is the management of the value chain to overcome various market problems (imperfect market scenarios) as the *raison d'être* for the formation of a multinational company. The application of arm's length in ensuring that the tax burden is allocated between units of the entity is often not applied as it should be. Some aspects that are often missed in the application of the arm's length concept in testing transactions are as follows (Devereux & Keuschningg, 2019):

- 1) Transactions within an MNE group tend to eliminate transactional costs. Transactional costs arise when there is imperfect information in the market. There are bargaining and negotiation costs, various policies that cause costs, as well as other factors that cause inefficiency. Entities in an MNE group will try to eliminate these inefficiencies through synergies.
- 2) The synergy within the MNE group will lead to economies of scale. Economies of scale on a high scale can lead to higher profits than independent companies.
- 3) In certain scenarios, MNE has a strategy to overcome its competitors in a certain jurisdiction so that the price determination may be at marginal cost for an intermediary stage. Under such a condition, the transaction price will clearly not reflect the price that would be reasonable for an independent party.
- 4) When the production takes place, there is a possibility of a coordination process related to products that should be the focus of development, where this decision is part of the business strategy. This focused production process may have an impact on financing policies which provide production components to the number of transactions for payments for intangibles.

By looking at such conditions, in the comparison process, it is necessary to have an understanding that basically each transaction between related and non-related parties is a transaction that does not have to be comparable (Devereux & Keuschningg, 2019). In implementing the concept of arm's length, what can be done is to avoid testing which is called "full ALP fiction" (Kane, 2014). A test is said to be arm's length fiction if there is a standardization in which the profits obtained from transactions between affiliates must be adjusted to match the profits obtained by independent parties whose conditions have been agreed to be in equal conditions. "...full ALP fiction, as it regards the arm's length principle as a standard that requires profit derived by controlled entities to be adjusted to match those independent parties would have agreed on in similar circumstances" (Kane, 2014, 303). Kane (2014) illustrates the benefits from the synergy of the

MNE group of companies.

In sections a-b are the profits obtained by company X if they act as independent entities, and c-d are sections that are obtained by company Y if they act as independent entities. Meanwhile, the b-c segment is a profit that is obtained as a result of synergy due to the affiliation. Sections a-d represent the profits obtained by X and Y due to operational integration. Thus, segments b-c will often become part of the problem if the testing process is not carried out properly. When testing and adjustments are made, adjustments tend to be made only on the part that an independent party is willing to do under a certain agreed condition. Such a condition – referred to as "limited ALP fiction" is a condition adopted in Article 9 of the OECD Model Tax Convention.

The concept of arm's length is built on three pillars, (i) the fictional concept of a separated legal entity, (ii) the existence of a contractual arrangement, and (iii) the existence of a comparison transaction (Petruzzi, 2016). However, Commercial rationality should be more emphasized or contribution analysis should be more dominant than the formal legal conditions. On the one hand, the tax authorities do not merely emphasize and focus on testing by making adjustments and presenting comparative information, although there is a development of testing methods. In other words, the understanding of the contractual arrangement – commercial rationality becomes very important, which is related to why and how a contract is made and implemented (Pankiv, 2017). Also, testing the contribution of each entity is not based on formal legal forms, but based on actual functionalities supported by facts related to the risks borne and assets owned (Pankiv, 2017).

In the BEPS Project, the discussion about arm's length is directed at how to reduce the "fictitious" effect into a concrete indicator. For example, if the result of coordination between groups is to get a discount on the value of purchases/sales, then the benefits can be distributed fairly to each member entity. If the benefits are obtained because of a passive association, such as a credit rating, the parent entity does not have to benefit from a member entity that gets a better credit rating. Furthermore, the emphasis is that if no suitable comparison data is found, it does not mean that the affiliated transaction (controlled transaction) does not meet the arm's length principle (Navarro, 2018). The essence of arm's length is not merely a method of testing and determining values.

Although this concept has been introduced and implemented for more than 90 years by the League of Nations, it is still subject to controversy. The classic controversy regarding the concept of arm's length is whether the concept of arm's length is identical to the fair value of financial statements and is the same

standard for domestic tax provisions in each country. In particular, whether the economic and non-economic benefits obtained by multinational companies should be recognized or ignored (Wittendorff, 2011). Wittendorff (2011, 225) cites the definition of fair value from IASB Exposure, where fair value is defined as “the price that would be received to sell an asset or paid to transfer a liability in an orderly transaction between market participants at the measurement date”. Likewise, there has been a criticism toward comparative information that both comparable companies and comparable transactions can indeed correctly describe the market value represented by an independent entity (Beccera O'Phelan, 2016).

Testing with arm's length requires comparability based on independent transaction conditions. It should consider economic integration, synergy resources, trade relations that have been running for a period of time, and experience in running a business. In other words, there are various subjective factors that should be attached to a transaction in which the arm's length condition uses assumptions based on profit maximization but recognizes that the possibility of information asymmetry is quite large. Meanwhile, the concept of fair value contains the principle that prices are based on a hypothetical market (the most favorable market conditions), hypothetical transactions (conditioned transactions), and hypothetical market participants (knowing the conditions and having the desire to transact). Wittendorff (2011) compares arm's length with fair value with the following conclusions in table 1.

Thus, it can be said that the concept of arm's length and fair value are not the same concept. However, the arm's length character should be placed in the following framework (Pankiv, 2017, 2009):

1)The contribution of each entity in a multinational group in a global value creation and its contribution to the total profit earned; 2)An assessment of the value chain is carried out to help determine the allocation

of profits for each member entity of a multinational company; although the concept of a separate entity approach is still maintained, the analysis of the single entity calculation due to the existence of a separate entity concept should consider the fact that the single entity company is part of a multinational corporate group.

At a practical level, to eliminate the fictitious effect of arm's length, a study conducted by Navarro (2018) suggests that attention should be given to the following aspects:

1)The advantages from active and passive associations must be considered in accordance with the conditions. Tests on arm's length should be carried out if there is an active effort from one entity (e.g. parent) against another entity (e.g. subsidiary) to obtain a benefit. 2)The distribution or allocation of profits/benefits due to synergies can be done as if each entity was optimizing the benefits that should have been obtained. The calculation mechanism is to find the equilibrium point where each entity will receive and conduct transactions by considering the economic conditions of each entity and its commercial interests. However, it should be emphasized that even though the calculations are carried out, there are structured transactions by affiliated parties. Remuneration is allocated based on the principle of best alternative to a negotiated agreement (BATNA) or based on the bargaining power of each entity. 3)The scope of transaction adjustments should be limited. Any adjustments when testing is carried out should take into account that there is no adequate comparison of information found. Adjustments are made not on controlled transactions, but on comparables so that they are closer to the conditions of the transactions to be tested. 4)The absence of conflict due to inadequate information will affect the analysis. Asymmetric information that may occur in independent party transactions may have different consequences with transactions between affiliates.

Table 1. The Comparison between Arm's Length Principle and Fair Value

Aspect	Arm's Length Principle	Fair Value
Controlled transaction	As being structured	Recognized as actually structured
Reference transaction	Independence requirement	Independence requirement
	Comparability requirement	Comparability requirement
	Actual object	Actual object
	Actual transaction	Hypothetical transaction
	Actual participants	Hypothetical participants
	Actual market	Hypothetical market
	Valuation	Dual perspective
	Aggregation of multiple transactions, broad commercial criterion	Aggregation of multiple transactions, narrow technical criterion
	Arm's length range	Highest and best-use principle
	Best method rule	Best method rule
	Profit maximization	Profit maximization
	Motive immaterial	Motive immaterial
End Result	Subjective, entity-specific value	Objective, market-based value

Source: Wittendorff (2011)

When the calculation of profit allocation carried out by the tax authorities has reached the process of selecting comparative data, apart from the concept of arm's length which is not yet fully capable of describing the transaction structure, the conditions generally faced by developing countries should also be understood by taxpayers and tax authorities such as (Beccera O'Phelan, 2016):

1) Information which is comparative data is only "potential" to describe the conditions being tested. This is based on the condition that basically the transaction being tested is something special, namely a fragmentation of a transaction from a complex transaction. In fact, if the comparison data used is not a direct competitor of the transaction to be tested, then the testing process requires more caution. 2) Twin limitations, in emerging markets there is a possibility that there are not too many business actors with similar types of business (even oligopolies tend to occur) and the information they have is very limited for the public to know.

The OECD also recognizes that arm's length can be applied properly if there are transactions that are truly comparable to the transaction being tested (Lester, 1995). In fact, the availability of comparable comparative data is not an easy matter (Lester, 1995, 302). Thus, there is a possibility that the test results with arm's length are not sensible enough (Avi-Yonah, 2010). However, in the end, in a discussion about the most appropriate method, the members of the League of Nations agreed that basically the taxation ecosystem between the parent company and its affiliates standing in different jurisdictions should be treated as separate entities. However, for accounting purposes, the calculation and treatment can be adjusted according to the accounting provisions as appropriate. Even in accounting records, it is necessary to remember that there is a generally accepted arm's length principle. Thus, the arm's length principle has then been adopted as a basis in the Model Tax Convention which then becomes a reference when negotiating double taxation avoidance agreements that are mutually agreed upon by the members of the League of Nations. To optimize the comparison process, the comparability "standard" becomes very crucial. The OECD TP Guidelines 2010 paragraph 1.33 states that,

"To be comparable means that none of the differences (if any) between the transaction being compared could materially affect the condition being examined in the methodology (e.g. price or margin), or that reasonable accurate adjustment can be made to eliminate the effect of any such difference"

The Implementation of Arm's Length Concept on Transfer Pricing Cases Settlement in Tax Court (Study on Tax Court Decision 2014-2019)

Multinational manufacturing companies located in Indonesia generally function as contract manufacturers. In carrying out their business activities, they have general characteristics such as (i) carrying out limited

functions that an Indonesian resident entity will not sell, export or conduct business in other forms within or outside the jurisdiction of Indonesia if it does not get approval from the parent entity; (ii) production activities of business entities located in Indonesia including technical assistance contracts determined by affiliated entities; (iii) a small part of innovations made by contract manufacturers to meet domestic market demand; this can be carried out by a contract manufacturer company but the company must obtain approval from the principal.

Information collected by the researcher from several multinational companies with industrial activities in the manufacturing business sector compiled from several transfer pricing disputes that have been resolved in the tax court in the 2015-2019 period reveals the following characteristics. Multinational manufacturing companies are part of foreign investment whose up to 90% of the shares are owned by foreign shareholders. In general, the share ownership structure is 90% foreign ownership and the minority is owned by individuals or other business entities which are national private sector businesses.

Part of the global supply chain manufacturing industry in Indonesia has the following characteristics:

a) Procurement of raw materials; business entities in Indonesia are permitted to procure raw materials after consulting with the parent company and obtaining legal approval. Subsidiaries in Indonesia do not have full authority to determine the purchase of goods and determine the purchase price of raw materials. b) Inventory control; subsidiaries in Indonesia formally have the responsibility to control the use of inventory, but the inflow and outflow of inventory must be subject to the approval of the principal. c) Production equipment; In general, production equipment has been supplied by the principal, production equipment such as machinery, spare parts and other components needed to optimize production activities. All the means of production, according to the parent entity, are an integral part of the production process. Thus, it can be said that business activities in Indonesia are largely an extension of the parent company. d) Production control and quality standards; Production processes carried out by entities in Indonesia are generally under the control of the parent company. Among the entities in the group that enter manufacturing contracts, there is often a provision containing a technical assistance agreement. In terms of quality assurance, contract manufacturing companies in Indonesia must carry out production activities in accordance with the production process regulated by the parent company. e) Intellectual property ownership; there are contracts related to intellectual property such as knowledge (including guidelines, specifications, product manufacturing or assembly processes, marketing, product distribution and sales), brand ownership and patents with affiliates because companies in Indonesia generally do not own intangible assets related to manufacturing know-how and production process. Accordingly, in relation to this contract, in

return for the transfer of intellectual property, the entity in Indonesia pays a royalty. However, the extent to which contracts for the use of intellectual property have an impact on production and distribution activities is still an issue between business entities and tax authorities. f) Production risk borne by the principal. The subsidiary is only responsible for the assembly or manufacturing process. g) Marketing risk; the percentage of sales with a larger sales volume is still borne by the principal, a small percentage is the responsibility of the subsidiary. h) Production sales; parent companies generally have a global network and sales experience. Products manufactured in Indonesia are under the supervision and authority of the parent company. Some companies do not even perform sales and marketing functions. They only carry out production activities where the products produced will be exported based on orders received, which generally come from affiliates.

Basically, when referring to the concept of transfer pricing with historical arm's length and referring to the BEPS Project, testing using comparative data is not the ultimate method or the main step to test the fairness of the transaction value. However, the tax authorities need to look at the roles and functions of business entities operating in Indonesia and their contribution to the global entity's overall profits. In other words, the tax authorities need to look at the contractual arrangement of taxpayers residing in Indonesia. Testing and examination is the next step that can be done after the tax auditor has obtained the right fundamental understanding on the characteristics of the transaction being tested. Understanding the characteristics and structure of transactions is fundamental as suggested by the OECD Transfer Pricing Guidelines and BEPS Project.

The most dominant activity of the manufacturing industry is assembling, not value creation that ensures global sustainability. Thus, the profit allocation test is adjusted for its contribution to global profits. Then, if the tax authority is going to perform the test, it should be based on that right understanding of the

transaction characteristic so that the tax authority may determine the most appropriate method of testing should be done. As Pankiv (2017, 210) asserts

“The functional analysis should be performed prior to proceeding with the arm's length test which is the final stage of the transfer pricing analysis”.

In fact, referring to the tax court decision in 2015-2019, the test on the arm's length transaction by the Indonesian tax authorities generally used the transactional net margin method (TNMM). Further, the test of transactions using the TNMM is a test performed at the level of operating profit of the company without being affected by differences in transactions at the level of operational costs and functions. It means this method is relatively flexible and is the easiest to perform. Therefore, practically referring to the case brought to the tax court, the method of testing and the object of tested (that is transaction) have been positioned at a different level. The result of TNMM may have been flawed to determine the transaction tested. The reason for the inadequate comparable data to be used on the most appropriate examination method is often the reason for using the method that is considered the easiest. It means, the fairness itself could not be ascertained by such practices of examination. On the other hand, to have a database of comparative information that is always updated also requires considerable financial resources. This is a problem that must be faced by various parties, including taxpayers, tax authorities and the Tax Court.

Thus, the selection of the most appropriate, solid and reliable comparison data when tested under conditions that are not fully adequate is a crucial aspect and requires "wisdom" in conducting fairness testing, especially with the TNMM method. Even so, the most logic basis and steps for making comparisons with the chosen method are also very important. Lack of justifiable circumstances on the selection of comparable data or cherry-picking selection of comparable data will certainly affect the test results, especially

Figure 2. The Level of Comparability in Applying the Examination Method

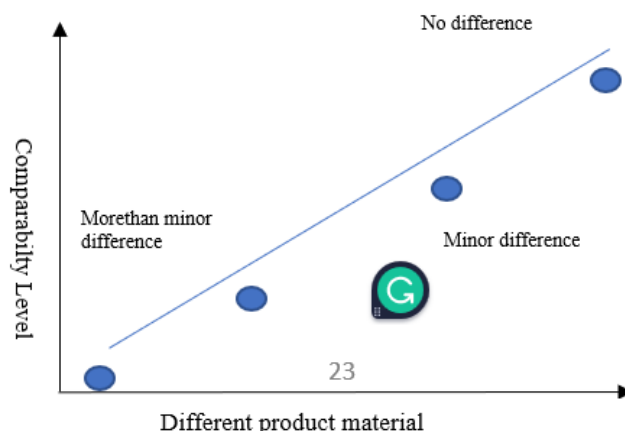


Table 2. Comparability Factors in Determining Transfer Pricing Assessment Method

Transfer Pricing Method	Prioritized Comparability Factors	Note
Comparable Uncontrolled Price	Product and services	Product comparable
Resale Price Margin	Function	Functional comparable
Cost Plus	Function	Functional comparable
Transactional Net Margin	Products or services are considered in a very flexible way	Market-factor comparable

Source: Danny and Darussalam (2017)

considering that finding suitable comparable data is a complicated task but it is very essential to go through the right steps. The inconsistency of the inspection process is shown in the appendix table.

Referring to the disputes that occurred in the 2015-2019 period, specifically regarding the selection of the most reliable comparable data, the OECD Transfer Pricing Guidelines 2010 with the latest update in 2017 states that in determining comparability, there are 3 important aspects that must be considered by both taxpayers and tax authorities. i.e. (i) not all conditions accompanying analytical transactions are relevant in the analysis (ii) focusing on comparability factors that materially affect conditions, and (iii) differences can be eliminated by making adjustments. Furthermore, regarding the transfer pricing method, it should be emphasized that basically all comparability factors must be considered in the application of the transfer pricing method. Nevertheless, there is a close relationship between the degree of comparability factor and the transfer pricing method used (Danny & Darussalam, 2017). The degree of comparability can be seen in the figure 2.

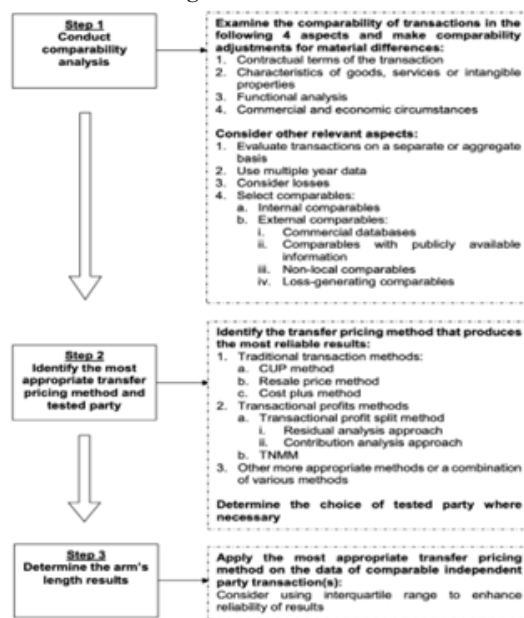
Figure 2 can be described as follows: 1)The Comparable Uncontrolled Price (CUP) method as a method that is considered the most reliable and detailed focuses on the problem of product comparability, but slightly ignores the problem of the function being carried out. For testing transactions related to products that have high sensitivity related to differences, the CUP method can be omitted in testing these transactions. The weaker the degree of comparability, the less appropriate the application of the CUP method to use. 2)The Resale Price (RPM) method is closely related to the functions carried out by the comparison company in the transaction. In this method, the physical comparability of the product and the economic situation becomes less important. The more important factors to consider are the contracts, risks, and functions of the transactions being compared. Generally, there are five types of RPM adjustments, i.e. Inventory, contract terms and conditions, sales and marketing programs, distribution channels and exchange rate risk. Another factor to be considered is the consistency of accounting records in the comparison data. 3)The Cost Plus (C+) method is similar to the RPM method, which prioritizes the comparability

of functions. Product differences in this method are permitted subject to a limitation. In addition, it should be noted that the more comparable the products, the more reliable the analysis results are. However, the mark-up that is used as the basis for comparison is an indicator that is relatively less related to the selling price or the nature of the product. Under this method, adjustments are often made to the cost structure, business cycle, management efficiency, or other factors that substantially and materially affect the gross profit mark-up. 4)The transactional method is the method that is considered the most flexible in terms of comparability. This method requires the existence of a market comparable factor by looking at market similarities that are generally comparable, both in terms of functions and products. The function similarity is less considered when compared to the cost plus or RPM methods. In addition, the similarity of product details is also less considered when compared to CUP.

Thus, the comparability factors described which are the priority in choosing the transfer pricing method can be summarized in the table 2.

Basically, comparability analysis aims to find the right comparable transaction, especially if the transactions made with affiliates are very unique and different from similar transactions. Comparability analysis for certain cases is easy to do, especially if it is associated with comparability factors, such as transactions, economic situation, and business strategy. However, it should be emphasized that the absence of a comparable also does not mean that the transaction is unreasonable or has no business substance reason (or is motivated by tax avoidance efforts) (Danny & Darussalam, 2017, 147). The OECD TP Guidelines 2010 states "A practical difficulty in applying the arm's length principle is that associated enterprises may engage in transactions that independent enterprise would not undertake. Such transactions may not necessarily be motivated by tax avoidance but may occur because in transacting business with each other, members of an MNE group face different commercial circumstances than would independent enterprises. Where independent enterprise seldom undertakes transactions of the type entered into by associated enterprises, the arm's length principle is difficult to apply because there is little or no direct evidence of what conditions would have been established by

Figure 3. The Assessment Process on the Arm's Length Price



Source: IRAS (2018)

independent enterprises. The mere fact that a transaction may not be found between independent parties does not of itself mean that it is not arm's length.

At a practical level, if it is difficult to find comparative data, then efforts can be made to expand the search criteria. However, the search must consider aspects of the selection of transfer pricing methods. Extending the criteria may provide taxpayers and tax authorities with a set of comparative data, but of course with the implication of increasing the need for adjustments to minimize substantial differentiating factors. The substantial differentiator is the distinguishing factor that significantly affects the measurement of the fairness of a method used, both at the price level (CUP method), on profit level indicators (for methods other than CUP).

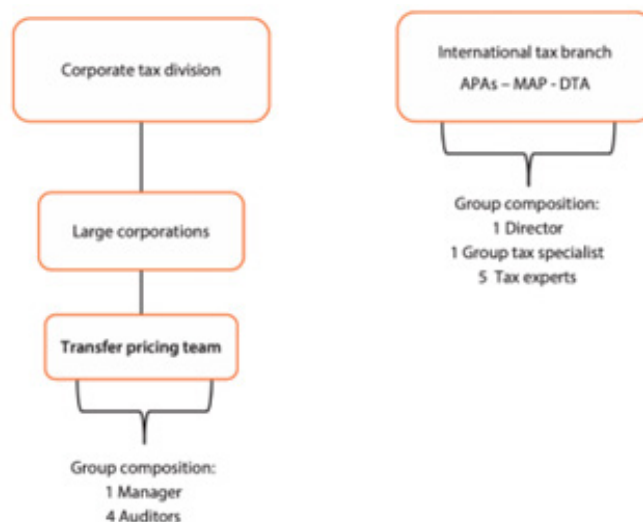
In the transfer pricing dispute, which is the topics of this research, it has become a "custom" that there are two phenomena in the development of analytical practice on affiliated transactions that can affect efforts to find comparability. First, the use of transactional methods, especially the transactional net margin method (TNMM), is increasingly being applied compared to the other three traditional methods, namely CUP, RPM and cost plus. TNMM is a comparison method at the level of net operating profit that less prioritizes the degree of comparability or is more flexible over differences. This clearly creates a change in the perspective of comparability analysis, namely the less prioritized comparability factors. In addition, the adjustments that will be made are relatively not too complicated to perform and are limited to financial indicators only. Second, external databases for comparison searches will be used more often. In the future, the dependence on the availability of an existing and comprehensive database will be even higher. There will be many debates and discussions regarding comparative analysis. So, it is necessary

to return to the principle of choosing comparability (Danny & Darussalam, 2017).

Thus, following the common use of the TNMM method in transfer pricing testing, it is necessary to look more deeply whether the selection of the method is the most appropriate or merely to facilitate the testing process. In the assessment of disputes in the tax court, this matter also needs to be considered by the judge. The judge must be able to assess whether the selection of the testing method is the right choice in accordance with the conditions and facts of the transaction or simply to facilitate the parties in compiling the documentation by the taxpayer or in making a correction or audit finding by the tax authority.

From the the list of disputes stated in the table attached, it can be seen that in many cases, both from the taxpayer's point of view and the Indonesian tax authorities, most disputes are caused by non-compliance with the provisions regarding commensurate testing and the principle of comparability testing, the selection of transfer pricing testing methods, and the use of comparable data to testing whether it is better to use single-year or multiple-year. In terms of comparability testing, basically functional analysis is the basis for conducting price fairness analysis (Presscott-Haar, 2008). Thus, the application of the principle of fairness to affiliated transactions is a necessity and requires an analysis of the functions performed and the risks borne by each party. Citing the Transfer Pricing Guidelines issued by IRAS (2018), as a practical step, the process of applying the arm's length concept in a transaction goes through at least 3 important steps, namely (1) conducting a comparability analysis, (2) determining the most appropriate transfer pricing testing method, and (3) determining the amount of fairness value. Each stage is divided into several rigid and thorough sub-stages so that information is obtained regarding the most

Figure 4. Centralized Approach on Transfer Pricing Administration in Singapore



Source: Cooper, Fox, Loeprick & Mohindra, (2016)

appropriate comparability analysis, the appropriate transfer pricing test method and, the fairness value in accordance with the facts and applicable regulations. The application of these practical steps can be briefly explained in the figure 3.

The problem of transfer pricing is inseparable from the complexity of its implementation. Under various conditions, the analysis is carried out on a case-by-case basis due to the uniqueness of a transaction. Asymmetric information also occurs between taxpayers and tax administrations which ultimately creates distrust in each party (OECD, 2015). In Indonesia, following the cases brought to the tax court, how to actually perform the transfer pricing audit was tightly related to the level of expertise of the tax auditor as an individual person. Even though the Indonesia government has released the guideline for transfer pricing audit, it could not be considered as an adequate tool to perform the transfer pricing audit. In fact, the examination made by tax auditors is inconsistent from one case to another case as shown by the table attached.

The design of the transfer pricing audit process is multifaceted based on the risks faced by a country, for example the level of exposure of a country to transfer pricing issues, the level of experience of the tax authorities in dealing with taxpayers with transfer pricing cases, available resources (HR, technology, finance), expertise in the private sector with expertise in transfer pricing, the ongoing tax system, the organizational structure of the tax authority, and the organizational culture adopted by the tax authority (Cooper, Fox, Loeprick & Mohindra, 2016).

In the tax reform context, the tax authorities should have an institutional set-up in implementing and supervising the implementation of transfer pricing policies. Thus, the existence of a structure responsible for these problems is needed so that the solution of a problem is coordinated. Based on a study by The World Bank (2017), basically the institutional form in relation to the implementation of transfer pricing consists of 2 parts, centralization and decentralization.

The form of centralization and decentralization is the decision of the tax authority leadership, which form is most in accordance with the existing system.

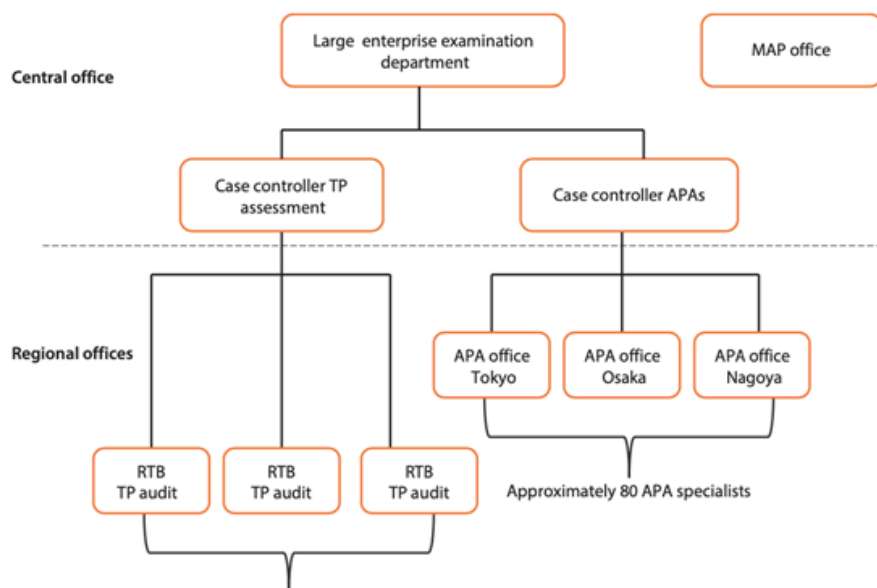
The institutional form most often found by the World Bank is centralized form, where there is a unit consisting of several teams dedicated to improving compliance with transfer pricing using various methods. Usually, such tax administrations have segmentation of tax service offices, for example large taxpayer officers (LTO) and/or large business & international (LBI) where the transfer pricing unit formed is in the LTO or LBI organizational line. So, supervision over transfer pricing compliance is clearly segmented for taxpayers registered with LTO/LBI. Centralized structures are generally implemented by countries with the following conditions:

a)The country is still in the early phase of implementing a transfer pricing policy. b)Transfer pricing cases handled are still limited. c)There is a possibility to focus on audit priorities and targets concentrated on transfer pricing issues. d)The number of human resources with transfer pricing expertise is still relatively small

The institutional form of Singapore's tax authority as cited by the World Bank where Singapore uses a centralized approach related to the implementation of transfer pricing is as in figure 4.

The centralized form can speed up the process of skill formation through the provision of specialist training and creating an "economy of scale" due to training in the form of a centralized group. Likewise, in carrying out their duties, the team will be faster in improving their technical skills due to the knowledge exchange between individuals in the team. In addition, for taxpayers, the existence of a centralized unit will make it easier for taxpayers to know which part of the tax authority will be their partners and able to conduct consultations and discussions if problems or potential problems arise. In implementing the transfer pricing policy, IRAS issued a Tax Guideline – Transfer Pricing which is updated periodically. The

Figure 5. Centralized Approach on Transfer Pricing Administration in Singapore



Source: Cooper, Fox, Loepnick & Mohindra, (2016)

Guideline is a guide for taxpayers and tax authorities so that both parties have at least the same basic understanding and knowledge regarding transfer pricing obligations (IRAS, 2018).

For countries with fairly large international economic activities, the decentralization pattern can be an option because of the size and number of transfer pricing cases that must be faced. Individual tax administrations can no longer fully rely on a centralized institutional unit specifically set up to deal with transfer pricing issues. However, the decentralization pattern will work if the individual tax authority has a similar level of expertise in the transfer pricing field. The coordination is carried out by regionalization or specialization on certain transfer pricing issues. The World Bank uses the example of how Japan redesigned a tax administration institution that specifically deals with transfer pricing issues into a decentralized form.

Suggested Way forward to the Tax Administration

Based on information compiled by the World Bank, in 2011, there were around 160 transfer pricing expert auditors spread across 12 Regional Tax Bureaus (RTB). If there are complicated problems, the expert auditor can ask for assistance from the TP Assessment Case Controller at the Head Office. The choice of institutional model depends on the state's environmental conditions and the organization of a country. However, basically a unit is needed in which there are experts who are responsible for transfer pricing issues. In practice, the spearhead of the process of supervising the fulfilment of transfer pricing obligations lies with the individual tax authorities. Given the complexity of transfer pricing, there will always be a room for discretion and judgment on reviews/audits conducted by individual tax authorities. The tax authority as an institution and organization has a

role to ensure that the audit process runs transparently (European Commission, 2018).

Considering how the institutional pattern of the Indonesian tax authorities regarding transfer pricing audits, based on the information published by the Director General of Taxes (DGT) (2020) to the media, the transfer pricing problems and inspections exist in almost all DGT regional offices, not only in the Special Jakarta DGT Regional Office and the DGT Regional Office for Large Taxpayers (Wildan, 2020). The strategy carried out by the DGT which has been informed to the media is that each work unit can overcome transfer pricing practices with a similar approach (Directorate General of Taxes, 2019). Reflecting on a study conducted by the World Bank, in general a country's tax authorities tend to use a centralized or decentralized pattern. In Indonesia, there is no institutional pattern for resolving transfer pricing issues and currently surveillance and inspection are still scattered. Thus, the Indonesian tax authorities need to rethink and reorganize how the transfer pricing issue management pattern is most appropriate with the objectives to be achieved by considering the current strategic environmental conditions. It would not be appropriate if the judgement on the transfer pricing obligation fulfilment heavily rely on tax auditor as person.

CONCLUSION

In Indonesia, the MNEs' performance and contribution to their global value chain is not substantial. However, the way they have been assessed has not followed their function. The tax authority seem to have a preference to select a certain method, that is the transaction net margin method (TNMM) to test the price fairness. The test is performed at the level of operating profit of the company without being

affected by differences in transactions at the level of operational costs and functions. This selected method would lead to inaccurate assessment results. It might seem reasonable to argue that this happened because of the limited data available to use the most appropriate method. Therefore, this process demands the integrity of tax authority to perform the transfer pricing audit in accordance with the factual condition of assessed taxpayers. Similarly, the taxpayers have to disclose the information based on the actual economic condition. The taxpayer should not manipulate the transfer pricing documentation solely to justify that transaction undertaken has been within the range of the arm's length. This behavior could be done differently among individual tax auditors. Therefore, the tax authority may consider institutionalizing a specialized unit to deal with transfer pricing issue.

The information described by the author regarding the way of tax authority performed the assessment is based on the summary of tax court decision that is widely available in the public. Future research may seek further whether the way the tax authority performs the transfer pricing audit still tends to use the easiest method despite the potential of inaccurate results.

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