



Tax Cases of Transfer Pricing Among Multinational Companies in Indonesia

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ABSTRACT

“The expansion in the global business tend to increase cross-border transaction. MNCs seek to expand their business by increasing production and ultimately economies of scale through improving capital mobility, country specialization and cost reduction. In the meantime, the growth of these companies is also to increase the practice of transfer pricing disputes. Transfer pricing is generally considered to be the major international taxation issue faced by MNE’s today. One of the foundation of the arm’s length principle is examining the pricing of comparable transactions. Proper comparable is often difficult to achieve in practice. This concept of comparability analysis used in the selection of the most appropriate transfer pricing method, as well as in applying the selected method to arrive at an arm’s length price or financial indicator (or range of prices or financial indicators). The study would more emphasis on a benchmarking activity using external comparable based on application on the TNMM model. Comparable search has been fixed on this paper about analyzing years of comparable with resulting on Profit level Indicators (PLIs). However, either multiple years or single year in benchmarking activity need align with arm’s length principle.”

KEYWORDS: *Transfer Pricing, Arm’s Length Principle, Benchmarking Analysis, Multinational Companies*

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I. INTRODUCTION

Indonesia adopt on a self-assessment system whereas the companies setting their own transfer prices. The burden of proof lies with taxpayer not with the tax administration to prove that the original price has been set at arm’s length. For income tax purposes, the legislation dealing with transfer pricing is found in Article 18 of the 1983 Income Tax Law, as revised by the 1991, 1994 and 2000 and further income Tax Law No. 36.2008. Article 18 states that the tax administration may adjust a taxpayer’s taxable income for related party transactions that were not carried out on an arm’s-length basis. In September 2008, Parliament passes Income Tax Law No. 36/2008, which come into effect 1 January 2009. Article 18 (3) of the Income Tax Law provides that the five arm’s-length price methodologies from OECD Guidelines should be used to set or review transfer prices. In the cross border context, dispute avoidance and resolution are particularly important to avoid double taxation of the same income for a tax payer or for associated enterprises. Dispute avoidance and resolution procedures are essential to the effective and efficient functioning of all tax administrations. Such procedure, if properly designed and implemented, can enable fair and expeditious resolution of differences between tax administrations and tax payers regarding to interpretation and application of the relevant tax laws. These procedure can also help to avoid the imposition of tax not in accordance with the provision of the applicable tax treaty.

During the examination process the tax payer’s information need to obtain in order to understand the business. Such information will affect the choice of comparable transactions or companies. Similar efforts will conducted in refining the taxpayer’s industries by reviewing product line financial statements for multiple years to detect unusual fluctuations or deviations from industry norms that may not result from business cycles or product life cycles.

The ALP is the basic international-standard rule for the implementation of transfer pricing to determine the transfer price for tax purposes as stipulated in Article 9 of the Organization for Economic Cooperation and Development Model Convention with Respect to Tax on Income and Capital (hereafter, OECD Model Tax

Convention) and Article 9 of the United Nation Double Taxation Convention for Developed and Developing Countries (hereafter, UN Model Double Taxation Convention). However, those principles are varied in different countries, as it is in Indonesia (OECD, 2018).

The TNMM method is the determination of transfer price which uses an independent comparable rate of profit indicator for transactions to determine the net income for affiliated transactions (PER-22/PI/2013).

In applying TNMM to the test party the resale price and the operating expenses of related party are known, while the arm's length net profit margin is found on the basis of a benchmarking analysis.

In conducting benchmarking activity an analysis should be carried out on the factors that can affect the comparability level. Comparative analysis is an analysis comparing conditions of affiliated transactions of independent transactions. The economic characteristics of both transactions should be sufficiently comparable.

The internal comparisons are relatively difficult to apply because the absence or rarity of comparable conditions. The difficulty of finding reliable internal comparable and the availability of shares price and company financial statements that can be accessed by the public are the main factors in the use of external comparable. The attempt to select reliable comparable from commercial databases is difficult and requires an iterative process. Selection of data comparable often potentially lead to disputes between tax payer and tax administration. Due to the background elucidated above. It is necessary to understand degree of comparability of transactions is not on whether the comparable transaction originates from internal or external sources. For that reasons, this study aims to analyze benchmarking activity on years of comparable and its implementation in Indonesia to get the fair result.

II. LITERATURE REVIEW

Transfer Pricing and Arm's length principle

Organization for Economic Cooperation and Development (EOCD) and United Nations (UN) are two large contributors in establishing the standards that are used as international tax regime (Karyadi and Irawati 2017). Therefore, these institutions have contributed in establishing the guidelines for transfer pricing since decades ago (Darussalam et al., 2013). Eden (1998) proposed that the purpose for establishing these guidelines is to avoid double taxation on MNEs' income and to avoid tax evasion and tax avoidance practices.

OECD (2001) defines "transfer price as a price, taken for book- keeping purposes, which is used to value transactions between affiliated enterprises integrated under the same management at artificially high or low levels in order to effect an unspecified income payment or capital transfer between those enterprises. This definition is match with the purpose of transfer pricing scheme to impose arm's length principle ("ALP") in related-party transactions, as if they occur between a company and an unrelated party (Darussalam et al., 2013).

The term of related parties, which is provided in Article 18(4) of Law No.7 (1983), stipulates that related parties takes place if a taxpayer has:

- A direct or indirect ownership of at 25% or more capital of other taxpayer(s);
- A direct or indirect control through management or ownership, where two taxpayers or more are under common control; or
- A family relationship by blood or marriage with other taxpayer(s).

Although there are many transactions that are susceptible to related-party transactions, the most common transactions are categorized into four groups: goods/service sales or purchase, intra-group services, intangible asset and interest on loan (Simamora and Hermawan 2018)

Overview of the 5 Comparability Factors

1. Characteristics goods and services

Is a starting point for identifying comparables that are in the same category of goods and services. Comparability of tangible goods (product) is easier for products that do not have much added value or commodity products.

2. Functional Analysis

Functional analysis is the process of gathering facts about functions, assets, and risks to obtain an accurate identification of the business characteristics of the tax payer and its counterparties so that it can be estimated how much compensation each party deserves. Function analysis is also often referred as FAR analysis (functions, assets and risks). Functional analysis is the foundation in any fairness analysis.

OECD Transfer pricing Guidelines 2017	Per-22/PJ/2013	SE-50/PJ/22-13
"The analysis aimed at identifying the economically significant activities and responsibilities undertaken, assets used or contributed, and risks assumed by parties to transactions."	Functional analysis is carried out to obtain accurate identification of the business characteristics of taxpayer and their counter transactions. By knowing characteristic, it will possible to estimate the level of risk borne and remuneration	Functional analysis is a mapping of economically relevant facts and characteristics of affiliated transactions by taking into account functions, assets and risks, as well as the allocation of functions, assets and risks between parties involved

	(profit) that is commensurate with the risk borne by each party.	in an affiliated transactions so that the characteristics of each party can be identified accurately.
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Things that need to be considered related to functional analysis as a comparability factor:

1. Determine the tested party

Tested party are parties that are tested or reviewed for the reasonableness of their price or profit in the analyzed transactions. In OECD TP guidance 2017 states that the most appropriate parties to be tested are those where the transfer pricing method can be applied more precisely and where reliable comparative data can be found. The parties being tested are generally those that have simpler function (less complex function) SE-50/PJ/2013.

2. Searching comparative data

Used as a filter to eliminate disproportionate independent transactions in transfer pricing analysis. Data comparable tend to be easier to find if the tested party performs only routine functions, has no ownership of intangible assets and carries limited risks.

3. Contract Term

Comparability analysis requires detailed information regarding the term and conditions of the transaction. To see more details of the agreement, generally it is done by obtaining an agreement. Level of responsibility, Risk and profit sharing compared with independent party.

4. Economic Conditions

Analysis economic conditions is needed to obtain a level of comparability in the market in which the parties conducting transaction operate. The economic circumstances that must be identified to determine market comparability include:

- Geographic location
- Market size
- The level competition in the market and the position of competition between buyer and sellers.
- Availability of substitute goods or services
- The level of demand and supply in the market both as a whole and regionally.
- Purchasing powers of consumers
- The nature and scope of government regulation in the market
- Production cost include land cost, labor, capital, transportation cost and market rates.
- Transaction date and time.

5. Business strategy

The assessment and analysis of the business strategy need to carried out among others by identifying:

- Innovation and new product development
- The level of diversification of goods/services
- Market penetration rate
- Others business policy

Comparables Search

Most countries have set out legislation and practical guidance on how comparability analysis should be performed, broadly reflect the guidance given in Chapter III of the OECD Transfer Pricing Guidelines. This chapter has not been revised further to the recent Report on BEPS Action aligning Transfer Pricing Outcome with Value creation and is confirmed as setting out the process of “making comparisons between the controlled transactions and the uncontrolled transactions in order to determine an Arm’s length price for the controlled transaction”. Many sources of information are available within the companies and can be used when setting up a comparable search. A broad range of sources, including external data based. External Comparables is comparables that come from a transaction conducted between independent parties (OECD TPG 2017).

Finding acceptable comparable data is regarded as a challenge in the practical application of transfer pricing. But there are some point to be considered as follows:

1. Both taxpayer and tax administration should apply a principle of transparency when they respectively conduct or control a comparable search. This mean that tax payers should justify and document the steps of the searches of the tax administration and symmetrically, that the tax administration should provide the relevant information for these steps to the taxpayer, when preparing or challenging such searches.

2. The comparable search should be appropriately documented and supported, particularly by mentioning financial the data on the comparable used and the respective source (e.g data base references). This should include sufficient detailed search and rejection matrices and should consider the information relevant to be provide in cases where tax administration may not be able to verify the authenticity of the information and/or have access to the data. While performing the search, screenshot may be useful for documenting information that may not be available in the future.

3. Evidence gathering should be maintained according to the rules regarding the maintenance of documents.

Indonesia transfer pricing guidelines do not specifically mention that local comparables is preferable, but in practice the local comparable is preferred. In general, information on internal comparables has better reliability than external comparables. The reliability of the internal comparables must necessary refer to the five comparability factors.

As there is no particular method that suitable in every related transaction and best method rule is not cost efficient, under OECD (2010), applications of distinct methods across different transactions are allowed. This proposal is also adopted in Indonesia where the hierarchical criteria, which is required by PER-43 has been abandoned by PER-32. The most appropriate method approach is proposed by PER-32 (2011) for related transactions with the following considerations:

1. Each method's strengths and weaknesses;
2. The degree of the method's appropriateness based on related party transaction, determined by a functional analysis;
3. Valid information's availability to be applied under the selected method;
4. The comparability of transactions between related party and non-related party (includes any adjustments necessary to eliminate materiality differences)

Furthermore, when performing the comparability analysis, the elements including characteristic of property transferred or services provided, functional analysis, contractual terms of the transactions, economic circumstances and business strategies should be taken into consideration based on Article 5 of Law No.43 (2010).Nevertheless, Indonesia's regulations for transfer pricing transaction are not as extensive and detailed as regulated by the OECD or UN (Karyadi and Irawati 2017).

III. METHODOLOGY

This primary objective is to analysis discrepancy in adoption of tested party are tested or reviewed for the reasonableness of their price or profit in the analyzed transactions in dispute cases. Moreover, the research questions intended to examine the legal reasoning between the differences .The qualitative research is chosen with exploratory study as the methodologies of this study. There are two steps involved in this research.

The first step, constitutional research, which is predominant to the based principles that govern the transfer pricing across arm's length transactions in Indonesia. This is carried out by searching of the legal sources, relevant regulations and principles that are related to the issues and are charged by the Indonesian Taxation Law. The last, analytical procedures conducted by describing, interpreting, understanding and explain in depth the transfer pricing in taxation system in Indonesia.

The second step is choosing and getting the cases to be studied. There is one case has been selected for the purpose of this study. The case has taken from the appeal process in the Tax Court in 2016. The nature of disputes was the comparable search. Based upon the selected case, analysis has been conducted to assess basis of tax disputes.

IV. RESEARCH RESULT

Based on tax assessment for the FY 2017 done by tax administration. It was issued tax under payment propose that the company owes an additional IDR 6,6 billion in taxes for the years. Due to adjustment of cost of gold sold. The tax administration assumed that sale transfer price to affiliated companies was not fair based on comparability analysis conducted. During the examination process the period analysis was using single year taking 2017 only with 16th companies as comparable with resulting as the followings:

Quartile 1	= 4.39 %
Quartile 2	= 7.35%
Quartile 3	= 13,81%

From the above result, the tax administration using quartile 2 as comparable toward NCP's tax payer. In the meantime. The Tax payer argue in determining the arm's length principle was using the current fiscal year that was 2017 which was the data at that time not available yet. The tax payer was calculating using multiple years that were 2016, 2015 and 2014 with 16th companies as comparable with resulting as the followings:

Minimum	= 1.69 %
Lower Quartile	= 2.82%

Median	= 5.50%
Upper Quartile	= 10.78%
Maximum	= 18.77%

Based on legal research that was performed. Legislation allow or require the use of an arm's length range and/or statistical measure for determining arm's length range. In Indonesia use interquartile range (Q1-Q3) on applying arm's principle based on Article 13 of Director General Regulation number 43 Of 2010.

As regards practice related to the use of multiple year data.

1. In most cases multiple year data may be used to better understand the control transaction and provide useful information on the comparables. In the respect the effect of business and product/intangible life cycles or anomalies in the third party information would need to be considered to determine the applicable period or even warrant consideration of a multiple year data.
2. The use of average may also improve the reliability of a range.
3. As regards the data considered in a multiple year analysis, comparables should not be excluded for the simple reasons that they report losses in a limited number of years covered by analysis.
4. The time period covered by a multiple year analysis will finally depend on the facts and circumstances of the case and often includes a time period of 3-5 years but it should at a minimum cover 3 years.
5. In a multiple years analysis, information which available at the time of transaction should be used and the principles of transparency, proportionally and consistency respected. As aspect to be considered when setting the price at the time of the transaction is the delay of availability of information on third party transactions.

V. CONCLUSION:

The approach taken for applying multiple year data should be used consistently. A consistent approach taken from applying multiple year data should be used and recognized by both tax payer the tax administration. Change to approach taken and the underlying reasons should be explained. Complete and accurate data should be available for the whole period. However, either multiple years or single year in benchmarking activity need align with arm's length principle. I would be more beneficial the Indonesia Taxation Law is able to prescribe a more detailed transfer pricing regulations and guidelines as those proposed by OECD to create more harmonize transfer pricing regulation and adoptions between local and international affiliates.

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