



## **The Problem of Transfer Pricing in Indonesia Taxation System**

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### **ABSTRACT**

This paper aims to analyze Indonesia taxation system in term of transfer pricing transaction held by multinational enterprises cooperating with affiliated ones overseas. As the consequence of transfer pricing, the government has a decreasing potential income from tax, since those multinational companies are more likely to shift their tax liabilities into other countries with lower tax rate. The practice of transfer pricing commonly happens as a form of minimizing tax expense by making use of the loopholes of tax provision without disobeying any taxation rules (tax avoidance) and the transaction in order to minimize the payable tax liabilities by disobeying any tax provision (tax evasion). Transfer pricing is held by multinational companies in order to minimize their operating performance and optimize the tax arrangements as either as the main or important priority.

**Keywords:** Transfer Pricing, Multinational Enterprise, Taxation System, Indonesia

**JEL Classifications:** H2, L1

## **1. INTRODUCTION**

Organization for Economic Co-operation and Development (OECD) defines transfer pricing as in a multinational enterprise (MNE), many transactions that normally take place between members of the group. The prices charged for such transfers do not necessarily represent a result of the free play of market forces, but they are probably charged for a number of reasons such as that the MNE is in a position to adopt whatever principles are convenient to it as a group (OECD Committee on Fiscal Affairs, 1979; Rosenberg, 1983, p. 505). On the other hand, Tsurumi thinks that transfer pricing is a counted price for management control of transferring goods and services in a group of companies (Gunadi, 1997).

Transfer pricing is derived from an attempt to control another party through its owner. There are two kinds of transaction in transfer pricing, those are intra-company and inter-company transfer pricing. Intra-company transfer pricing is a transfer pricing among divisions in a company. However, inter-company transfer pricing is gone between two companies with special relation. The transaction can be conducted both in the same country (domestic transfer pricing) and in different country (Setiawan, 2014). Transfer pricing, in the part of Government, has decreased or even lost the potential tax revenue of a country

since the multinationals tended to shift their tax liabilities toward other countries (Biro, 2012).

## **2. LITERATURE REVIEW**

### **2.1. Tax Provision on Transfer Pricing**

Economic globalization aims to integrate the economy of worldwide into a whole unit across countries. World Trade Organization, European Union, General Agreement on Trade and Tariff and ASEAN Economic Community contribute to promote the globalization of economy through some particular jargons such as the borderless world (Bureau of State Budget Analysis, 2012; Huda et al., 2015). Globalization refers to a growing process of economic dependence among countries with: A rapid growth in financial and international trade, primarily among national enterprises; foreign direct investment with broad support from multinational companies; global market; technology; and various ideas as the result of expanding rapid transportation and communication all over the world.

Globalization impacts on the increasing cross-border transactions. The distribution of goods, services, capital, and manpower among countries becomes easier and faster. The developing countries precisely become a potential market for enterprises as their

business base. Thus, subsidiaries or branches of the multinationals are held across the world. A reasonable consequence of those multinationals is transaction among members that includes goods and service sale, license rights and other intangible rights, loan provision; and etc., The pricing of such various transaction among members is known as “transfer pricing”.

Transfer pricing, in general, is a manifestation to conduct tax avoidance and tax evasion. Tax avoidance refers to a transaction scheme aimed to minimize tax expense by making use the loopholes of tax provision in a country without disobeying any taxation rules. Conversely, tax evasion refers to a transaction scheme aimed to minimize the payable tax by disobeying the taxation rules, such as by not reporting a part of sales earned or increasing expense through fictitious accounts (Setiawan, 2016). According to Ernest and Young’s survey in 2003 on a Germany enterprise, it found two intentions of conducting transfer pricing which included: Maximizing operating performance (73%) and optimizing tax arrangements (68%) as either as the main or an important priority (Hiemann and Stefan, 2012).

A big issue that happens in Google, Starbucks, and Amazon, in which all were located in UK, is an attempt to avoid the tax liabilities. Starbucks, in 2011, paid nothing for their company’s tax liability although, in fact, it gained £ 398 million as their business profit. In addition, they admitted that since 2008, they had lost up to £ 112 million or about Rp 117 trillion. However, the report they sent to their investors in USA showed that for 3 years long (2008-2010), Starbuck had earned £ 1,2 billion or about Rp 18 trillion as their profit. Similarly, although Google, in 2011, succeeded gaining profit £ 398 million, they only paid £ 6 million for tax. Amazon also did the similar thing, in which they succeeded gaining profit £ 3.35 billion in 2011 but paying £ 1.5 million for tax (Setiawan, 2014).

Transfer pricing in Indonesia was done by PT. Asia Agri which was the second biggest holding company of Garuda Mas Group, a company owned by Sukarno Tanoto who was the richest person in 2006 as Vorbes version. The Supreme Court had sentenced 14 companies of Asian Agri Group (AAG). Asia Agri Group’s embezzlement through transfer pricing by selling their crude palm oil to affiliated companies overseas with lower price and then resell it to the real buyers with higher price, so that the domestic tax expense could be minimized. It was assumed that such embezzlement had brought financial loss for the country in about Rp 1.3 trillion (Sugeng, 2014).

In order to alleviate the transfer pricing which made financial loss, the government has managed several regulations as follows.

#### *2.1.1. Enactment No. 7 of 1983 amended with enactment No. 36 of 2008 on income tax*

Based on article 1 act 1 of Enactment No. 6 of 1983 about General Provision of Taxation Procedures which has been revised 2 times with the Enactment No. 16 of 2009 as the last revised one, the term tax is defined as a must-payable contribution of taxpayers, whether personal or corporation, toward their country based on its regulation, by not taking back any direct benefits and is used to

fulfill the country needs for the greatest of its peoples’ prosperity. Article 18 act (4) of the Enactment No. 7 of 1983 on income tax which has been revised two times with the Enactment No. 36 of 2008 states that a particular relationship is justified if: A taxpayer has at least a 25% capital equity, which is either direct or indirect, toward another taxpayer. The relationship is gone between a taxpayer and such 25% capital equity toward two or more taxpayers; or the relationship between two or more taxpayers that are latterly mentioned. A special relationship is justified if a property relationship in the form of a 25% capital equity or more, either directly or indirectly exists; a taxpayer controls another taxpayer or two or more under the same rule, both directly and indirectly. It is due to the control of management or technology usage although the taxpayer does not have any property relation. A special relationship is justified if one or more companies are kept under the same control. So does the relationship among companies which are under the same control; and having a kinship, either incest or in-law within equal direct lineage or lateral. The incest kinship in equal direct lineage is father, mother, and child, whereas, the lateral kinship is relative. Furthermore, the in-law kinship in direct lineage is mother in-law and stepchild, whereas in the lateral ones is relative in-law.

In short, a special relationship among taxpayers may happen due to their dependence or relationship at each other. It is due to property or capital equity; or any control through management or technology usage. Besides, such special relationship among individual taxpayers can happen due to their kinship, either incest or in law.

#### *2.1.2. The enactment No. 8 of 1983 that is revised with the enactment No. 42 of 2009 on value added tax and luxury sales tax*

Article 2 act (1) The enactment No. 8 of 1983 about the value added tax on goods and services, and sales tax on luxury goods, which has been revised 2 times with the enactment No. 42 of 2009 as the last revised one, states that a transaction is classified into a transaction with special relationship if the businessman has a 25% or more capital equity, either direct or indirect, toward another businessman, or the relationship between a businessman and the 25% or more capital equity toward two or more businessmen, so does with the relationship between two or more businessmen that are latterly mentioned or; the businessman controls another or two or more businessmen who are under the same control. It is, either directly or indirectly, under the same control; and having a kinship, either incest or in-law in an equal direct lineage and/or lateral.

#### *2.1.3. Double tax avoidance agreement*

Article 9 at 1<sup>st</sup> paragraph in the provisions of double taxation avoidance states that: (a) An enterprise of a contracting state participates directly or indirectly in the management, control or capital of an enterprise of the other contracting state, or (b) The same persons participate directly or indirectly in the management, control or capital of an enterprise of a contracting state and an enterprise of the other contracting state, and either case conditions are made or imposed between the two enterprise in their commercial or financial relations which differ from those which will be made among independent enterprises, then the profits

which would, but for those conditions, have not so accrued, may be included in the profits of that enterprise and taxed accordingly.

#### *2.1.4. DGT regulation No. per-32/pj/2011 on amendment of DGT regulation No. per.43/pj/2010 on the implementation of the principle of arms length principle in a transaction between taxpayer and party with special relationship*

Article 1 of DGT regulation states that there must be two parties that should obey the regulation. The guidelines of transfer pricing prevails on transfer pricing of a transaction by resident taxpayer or such a permanent company in Indonesia with non-resident taxpayers. The difference of transfer pricing guidelines between PER-43/PJ/2010 and PER-32/PJ/2011 shows that PER-43/PJ/2010 did not differentiate the transaction conducted among parties with special relationship, whether it is cross border transfer pricing or transfer pricing in Indonesia.

Therefore, the provision of PER-32/PJ/2011 limits the scope of condition for transfer pricing base, however, Article 2 act (2) states that the base of transfer pricing can be applied for transactions among taxpayers with special relationship in Indonesia. Thus, they can take benefit from its different rates due to the management of either final or non-final income taxes of certain sectors of business, the management of sales taxes of luxury goods and transactions conducted by taxpayers as contractors that deal with oil and natural gas (Septarini, 2012).

## **2.2. Special Relationship and the Fairness of Price in Transfer Pricing**

In regard to transfer pricing, DGT generally concerns on two fundamental aspects, so that the tax correction of transfer pricing can be strongly justified. Those two aspects are.

### *2.2.1 Special relationship*

The category of special relationship has been set under article 18 of the enactment No. 36 of 2008 on income taxes that regulates 25% capital equity as minimum rate, the correlation on management organizing, and the kinship both incest and in-law. Whenever the taxpayer could not present the equity of transaction price, Directorate General of Taxation would determine the fair transaction price among affiliated parties.

However, the special relationship based on the Statement of Financial Accounting Standards No. 7 is as follows: Company with one or more intermediaries that controls or is controlled, or under the same control with the rapporteur (including holding companies, subsidiaries, and fellow subsidiaries); associated company; individual with interest of voting, either directly or indirectly, in rapporteur's company that brings significant effect, and that individual's relatives (those who are expected to influence or be influenced by that individual in his transaction with rapporteur's company); key staff, someone with authority and responsibility to plan, lead, and control the activities of rapporteur's company which includes the members of company's commissioner board, directors, managers, and relatives; company with either directly or indirectly substantial interest of voting from each party explained in (c) and (d), or such parties that play significant role on that company. It involves companies belonging to commissioners,

directors, or the key stockholders of rapporteur's company and companies with key management that is similar to the rapporteur's company.

### *2.2.2. Arms length principle*

The equity of price is provided for parties with no special relationship (non-related party transaction). Based on arms length principle, transfer pricing should be established in order to be able to reflect on agreed prices as transactions by non-related parties that act independently. It can be stated that whenever transactions among companies with special relationship happen, the condition of such transactions must be the same with transactions among independent parties. Hence, any discrepancy gets the fiscal authorities to make correction; OECD recommends countries to adopt transfer rules: By giving authority toward countries to distribute, allot, or allocate gross income, income subtraction, credit or allowances or any other items which effect on taxable income among taxpayers with special relationship in order to establish the real taxable income of each tax; equity problem that fairs accounting admission of transferring a source is based on an agreed price by related parties. The price prevailed on parties with no special relationship is exchanging price among independent parties (arms length price. Parties with special relationship may be flexible on the pricing process, which will not happen on the transactions among parties with no special relationship; Indonesia under the enactment of income tax acknowledges the fair pricing methods based on OECD.

Three methods applied to calculate the fair market price are: First, traditional methods which include comparable uncontrolled price, cost plus, release price; second, non-traditional methods which include profit split and transactional net margin method; and third, other methods which include Global Split Method and Formulary Appointment. OECD Guidelines do not allow any other methods in pricing since it may not reflect the real fair market price (Biro, 2012).

## **3. METHODOLOGY**

The research constitutes legal research which Black's Law Dictionary defines it as: The finding and assembling of arthritic's that bear on a question of law; and the field of study concerned with the effective marshaling of authorities that bear on the question of law (Bryan, 1999). Jurisprudence has a normative nature. The research method includes the approach, the determination of legal sources and critical analysis on the sources through exploration, inquiry and interpretation. The research is a normative research which refers to the legal norms contained in statutes and judicial decisions relating to the issues. Steps of collecting sources of law include reading, learning, quoting, comparing and connecting the sources of law and literatures, so that they become a unity to make easy in processing. The collected legal sources are managed by first, editing, namely checking sources of law carefully to avoid errors of sources of law; second, classifying the collected legal sources according to subject; and third, organizing them according to the groups to avoid mistakes and to be as the systematization of sources. The sources of law are then analyzed in accordance with the classification of problems. The analysis is conducted

and written in the form of describing, analyzing, systemizing, interpreting and evaluating them. The next step is that they are theoretically analyzed to find, understand and explain in depth transfer pricing in taxation system of Indonesia.

## 4. ANALYSIS AND FINDING

Term of taxation has comprehensively regulated the practice of transfer pricing and its implementation. In fact, however, there are still lots of abusing practices dealing with transfer pricing which inflicted national financial loss. This is due to the lack of human resources in directorate general of taxation in understanding the transfer pricing, and the increasing number of multinationals by every year as government program in attracting foreign capital investors to put their investments in Indonesia. Thus, the government needs to determine what they are supposed to do to minimize the risk of national income loss due to any transfer pricing. Some actions the government can do to eliminate the transfer pricing are as follows.

### 4.1. International Taxation Agreement (Tax Treaty)

Double tax avoidance agreement is an agreement between two or more countries by splitting the rights in imposing tax of income which derives from a country which residents are from another country. This double tax has existed since both countries got tax of the same income. The provision of double tax avoidance agreement aims to avoid any double taxation. It is a provision to overcome any dual case of residence in which an individual or a corporation becomes dual resident taxpayer of two parties or corporation in two different countries. It is known as tie breaker rule mentioned in article 4 act (2) of double tax avoidance agreement. The provision of splitting rights on tax reporting is in article 6 up to article 21 of double tax avoidance agreement for particular income. Some provisions of implementing that double tax avoidance agreement dealing with its application procedure is under DGT regulation No PER-61/PJ/2009; the provisions of preventing any double tax avoidance lapse is under DGT regulation No. PER-62/PJ/2009; and the provision of information exchange is under DGT Circular Letter No. SE-51/PJ/2009 on the split of taxation rights, the prevention of double tax and double non-tax, and it is now 62 effective double tax avoidance agreement; tax information exchanges agreement. An agreement of exchanging information with partner countries especially in law tax jurisdiction, and for now, there are 4 such exchange agreements signed; Convention on co-administrative assistance in taxation. It has been signed on November 3<sup>rd</sup>, 2011, related to the procedures of information exchange, and tax collection assistance and clauses of taxation, the agreement of promotion and investment protection and bilateral trade agreement.

### 4.2. Mutual Agreement Procedure (MAP)

It provides a legal assurance and guidelines in applying MAP administrative procedures in double tax avoidance agreement, with basic provision: Article 32 A UU PPh, PP 74, 2011 and DGT regulation No. Per-48/PJ/2010. For now, neither taxpayers nor other countries who agree to apply MAP in Indonesia are expected to bring benefit for tax revenue between both countries by applying MAP.

### 4.3. Advance Pricing Agreement (APA)

APA is an agreement between taxpayer and Director General of Tax dealing with the fair product sales price they establish toward any related parties with special relationship. APA aims to reduce any malpractice of transfer pricing by multinationals. Providing equal settlement is not only between the resident taxpayer and the tax administration party in a country the taxpayer live, but also between other related countries. It is under the enactment of article 32 A PPh, article 18 act 3a, UU PPh, PP 74, 2011 and DGT regulation No. PER-69/PJ/2010. Thus, it is expected that Directorate General of Tax socializes and encourages more for taxpayers to implement APA, due to its benefits for both parties.

### 4.4. Tax Revenue on International Taxation Lawsuit

India has had Tax Appellate Tribunal with committee primarily settling any transfer pricing lawsuits. Likely, Indonesia has revised its regulation No. 14, 2012 on Tax Jurisdiction by providing additional authority to settle international taxation issues since transfer pricing had a significant increase in international taxation (Septiadi, 2014).

## 5. SUMMARY AND CONCLUSION

The government minimizes the risk of national income loss from tax sector by imposing the provision of regulation of Income Tax, Value Added Tax, and Luxury Sales Tax, Double Tax Agreement and DGT regulation No. 32, 2011 on the implementation of arms length principle between taxpayers and parties with special relationship. Those provisions are related to the transfer pricing done by the multinationals cooperating with affiliated companies overseas. Transfer pricing is done in the form of minimizing the tax expense without disobeying the regulation (tax avoidance) and conducting transactions to minimize the tax liabilities by disobeying the regulation (tax evasion). In order to justify the assumption of transfer pricing, the government determines two approaches which included special relationship based on financial accounting standard and arms length principle.

As the consequence of transfer pricing, the government needs to make several strategic actions by: Implementing tax avoidance agreement, providing APA, and organizing tax court which primarily concerned on international taxation dispute. Those policies should be supported by establishing single document window (SWD) among countries that has already implemented tax treaty and broadening the criteria of transfer pricing which is not merely related to parties, but also to transactions indicated lower than the reasonable price, including non-affiliated companies.

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