Legislative Reform Proposals to Address Aggressive Transfer Pricing: A Comparative Study of Indonesia and China

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Abstract

The objective of this paper is to examine the legislative reform proposals designed to address aggressive transfer pricing in Indonesia utilising China as a comparative study. Multinational enterprises (MNEs) frequently employ aggressive transfer pricing to shift profit from high to low tax jurisdictions. This tax minimization strategy impacts negatively on the tax revenue of Governments, and it is estimated that the size of the potential tax loss in developing countries is more significant than in developed countries. However, less attention has been paid by researchers to how developing countries respond to aggressive transfer pricing. In determining whether an alternative transfer pricing regime should be adopted in Indonesia, this research considers China's transfer pricing regime as an alternative model. In completing the analysis, this paper utilises a comparative tax law research as the chosen methodology.

This paper considers Zweigert & Kötz's (1992) functional approach to comparative law. The findings of this paper demonstrate that Indonesia and China have adopted transfer pricing regimes to ensure that corporate profit is taxed in the location of economic activity. Indonesia's interpretation of the arm's-length principle is through the reallocation of income and deductions by tax authority as if MNEs transactions would have made between unrelated parties. While China interprets the arm's-length principle by introducing location-specific advantage, i.e., benefit related to geographic location. This paper offers insights from China that could potentially inform Indonesia's policymakers to consider location-specific advantage as a legislative mechanism to address aggressive transfer pricing in Indonesia.

Keywords: comparative tax research, transfer pricing, tax reform, location-specific advantage, law interpretation, developing country

1. INTRODUCTION

Multinational enterprises (MNEs) often employ aggressive transfer pricing to shift profit from high to low tax jurisdictions [see, e.g., Eden (1998), Eden and Smith (2001), Bartelsman and Beetsma (2003), Clausing (2003), and Benshalom (2012, p. 430)]. Transfer pricing refers to the price at which an enterprise transfers its physical goods and intangible property or provides services to associated enterprises (OECD, 2010). The term of 'aggressive transfer pricing' is used to show a legal transfer pricing scheme with the purpose to reduce MNEs' overall global profit. This tax minimization strategy affects Government's tax revenue in which according to the OECD reports, the percentage of tax on corporate profits to gross domestic products (GDP) in the OECD member countries have declined substantially from 3.25 % in 2000 to 2.80% in 2015 (OECD, 2017e). Several researchers explained that the size of potential tax loss in developing countries is bigger than in developed countries [see Fuest, Hebous, and Riedel (2011), and Cobham and Jansky (2017, p. 21)].

There are several reasons why transfer pricing policy in developing countries is to be the focus of this paper. First, in adopting the OECD Transfer Pricing Guidelines, developing countries are facing constraints on the implementation of transfer pricing policy such as unavailability of the comparable data [see Cooper, Fox, Loeprick, and Mohindra (2016, p. 143), and Picciotto (2013, p. 23)], tax administration complexity [see Picciotto (2013, p. 23)], and the challenge in designing and implementing effective transfer pricing [for example (IMF, 2015)]. Second, transfer pricing in developing country becomes a concern of international organisations that transfer pricing regime for developing world should be distinctive considering its unique economic factors [e.g., United Nations (2013), and Cooper et al. (2016)]. Third, the economic size of developing countries including BRICS countries is almost equal to developed countries [see Baistrocchi (2013, p. 734), and Knox and Agnew (2014, p. 69)], and it is predicted that in the future developing countries have a bigger contribution in world's trading. Fourth, currently developing countries are in the stage of searching for a simple transfer pricing system which is easy to administer [for instance see Picciotto (2013, p. 23), and (Durst, 2014, p. 1)].

This paper focuses on the Indonesian context in order to respond what Cobham and Jansky (2017, p. 27) said that the loss of potential tax revenue from tax avoidance in Indonesia had estimated the US $ 6.48 billion annually. In Indonesia, the percentage of corporate income tax has declined from 30.9% in 2005 to below 25% in 2015 [see e.g., OECD (2015, p. 18) and OECD (2017d, p. 29)], and corporate income tax revenue as percentage of GDP has declined from 3.6% in 2002 to 2.7% in 2015 (OECD, 2017d, p. 24). Indonesia is one of the largest developing countries regarding its gross domestic products, and the number of inhabitants [see CIA (2017)]. Indonesia is an example of capital import country in Asia Pacific region (OECD, 2016, pp. 10-11) where many multinational enterprises (MNEs) operating their business in Indonesia leading to increasing cross-border transactions with their foreign related parties.

In addressing aggressive transfer pricing in developing countries especially Indonesia, this paper considers the interpretation of the OECD Transfer Pricing Guidelines in BRICS countries especially China as the baseline of this paper. Developing countries along with the United Nations have attempted to develop their transfer pricing regimes through the UN's Practical Manual on Transfer Pricing for Developing Countries (United Nations, 2017). There are five countries selected as country practices: Brazil, China, India, Mexico, and South Africa. For this paper, China is selected under four categories: the legal system adopts the civil law, considered as developing nations, capital import countries, and China was selected as a country practice in the United Nations Transfer Pricing Manual. A detailed discussion on how to consider China's as a compared country will be discussed further in Section 3.2.

The purpose of this paper is to examine Indonesia's position and explore the compared country of China to ascertain the legislative considerations to deal with aggressive transfer pricing. This paper considers whether China's solution of aggressive transfer pricing could be adopted to Indonesia. Thus, this paper aims to answer the research question: *"To what extent Indonesia could adopt an alternative transfer pricing system, such as the transfer pricing regime that has been adopted by China to minimise aggressive transfer pricing practices by MNEs in Indonesia."*

The rest of this paper is organised into the following sections. After the Introduction, Section 2 discusses the reason why a comparative tax research analysis is suitable for this paper, and how to implement the method. Section 3 is to apply Zweigert and Kötz (1992) five suggested steps of undertaking a comparative law study: identification of the legal problem, selections of comparative jurisdictions, descriptive, identification, and explanatory phase. Section 4 concludes with the provision of recommendations to Indonesia's policymakers related to China's approach to addressing aggressive transfer pricing.

2. METHODOLOGY: EMPLOYING COMPARATIVE TAX RESEARCH

This paper employs comparative tax study as a primary research method because the function of comparative law as an instrument for a law reform is suitable with the purpose of this paper to provide a policy recommendation in addressing aggressive transfer pricing by multinational enterprises in Indonesia [see, e.g., Schmittoff (1941), Chommie (1955), Kamba (1974)]. For instance, Chommie (1955, p. 219) states that comparative legal studies provide a stimulant for reform. Kamba (1974, p. 496) asserts that the main function of comparative law is to facilitate legislation and a practical improvement of the prevailing law. While Zweigert & Kötz (1992) finds that comparative law is the methodology that can be used to find a better solution to preventing and resolving social conflicts. Moreover, the comparative law allows the author to undertake an analysis of legislative differences and similarities between the two compared countries. The analysis will reveal Indonesia's position and China's approach to address aggressive transfer pricing. Thus, this paper will inform Indonesia's policymakers to consider China's legislative approach to deal with MNEs' tax minimisation strategies

In particular, 'comparative tax research' is the application of the comparative law in the field of taxation. A number of tax scholars argue that comparative tax research is the application of the comparative law in the field of taxation [see, e.g., Chommie (1955), Ault and Glendon (1975), Thuronyi (2003), Barker (2004), Garbarino (2009), and Marian (2010)]. For instance, Chommie (1955, p. 607) states that "possible approach comparative

tax problems in the same manner as another field of law." Moreover, Chommie (1955, p. 607) explains that comparative tax analysis can be used in the level of sub-policy and technical rules to reach the desired policy result. In his seminal work, Thuronyi (2003) provides a framework for understanding tax law in other countries. While Garbarino (2009) introduces an evolutionary approach to comparative taxation and identifies several challenges of comparative tax.

There are four different approaches to comparative law: historical, political, descriptive, and functional (Hutchinson, 2010). Historical approach examines the different of legal systems from the perspective of history. For example, the historical approach focuses on the successes and mistakes of tax systems as well as concentrates on how the tax systems evolve. Political approach examines the legal system through a political lens, for instance, how politics affects the domestic legal system. The descriptive approach aims to describe the characteristics and phenomenon being studied. Functional approach examines the function of the law as Zweigert and Kötz (1992, p. 66) argues that "the basic methodological principle of all comparative law is that of functionality." In undertaking comparative tax research, this paper considers the functionalist perspective because the study focuses on the function of transfer pricing as an instrument of allocating profit to tax corporate profit of MNEs operating in many jurisdictions. This paper will apply Zweigert and Kötz's (1992) comparative law to Indonesia.

This paper considers Zweigert and Kötz's (1992) five steps of comparative research because the suggested steps offer a complete phase from identifying the problem until evaluating the result critically. First, Zweigert and Kötz (1992) suggest undertaking an identification of a legal problem in the specific country. In this paper, the legal problem is the aggressive transfer pricing by MNEs operates in Indonesia. The second step is to provide criteria for selecting comparable jurisdictions. Thus, the compared country is then selected. The third step is to describe countries' legal system and social background. Fourth, tax law and policies are compared thematically to identify the similarities and differences, enhancing the functional equivalence. The last step is to undertake critical evaluation and to explain the findings using 'the superiority' to determine which country's approaches are able to address aggressive transfer pricing. A summary of Zweigert and Kötz (1992) five suggested steps are depicted below.

Table 1. Five Steps of Comparative Law using Functional Approach

No.	Comparative Steps	Description
1	Identify the problem	Addressing aggressive transfer pricing
2	Select comparable jurisdictions	Criteria of comparable jurisdictions: - The legal system adopts civil law - Considered as developing nations - Capital import countries - The UN Transfer Pricing Manual's country practice
3	Describe the relevant law of the legal system	To describe Indonesia's and comparable countries' law and policies to address aggressive transfer pricing
4	Compare and contrast to identify similarities & differences	Tax law and policies are compared thematically to identify the similarities and differences, enhancing the functional equivalence
5	Critically evaluating the different solution	To critically evaluate the results and to explain the similarities and differences

Source: Zweigert and Kötz (1992)

3. FIVE STEPS OF COMPARATIVE TAX RESEARCH

3.1. Identifying the Problem: Addressing Aggressive Transfer Pricing

The initial step of comparative tax research is to identify the transfer pricing problem in Indonesia. There is no written Indonesia's legislation to state that Indonesia adopts the OECD Transfer Pricing Guidelines. However, the adoption of the OECD traditional arm's-length transfer pricing regime into Indonesia's legislation could be seen from its characteristics. For instance, a number of publications state that Indonesia's transfer pricing regime refers to the OECD [see, e.g., Feinschreiber and Kent (2012), Lohse, Riedel, and Spengel (2012), OECD (2012), and Ernst & Young (2016)]. Accordingly, this section provides an identification of aggressive transfer pricing in Indonesia under three major themes: (1) the implementation constraints in adopting the arm's-length principle including the unavailability of comparable data, tax administration complexity, and the challenge in designing and implementing effective transfer pricing, (2) the phenomena of loss-making companies, and (3) the decline in corporate tax revenue.

3.1.1 Administrative Difficulties

First, Indonesia deals with difficulties in applying the traditional transfer pricing regime. In this regard, Indonesia addresses restraints in adopting the arm's-length principle. For instance, Muhammadi, Ahmed, and Habib (2016, p. 330) reveal some problems related to technical aspects of tax audits such as finding reliable comparable data for intangible property transactions and determining their market value, complicated regulatory frameworks, human resource issues, and the levels of knowledge of tax auditors. Mulyani (2010, pp. 239-242) finds some challenges related to unavailability of special organisation structure to deal with transfer pricing, lack of transfer pricing knowledge, and lack of transfer pricing provisions.

The administrative difficulties lead to allow MNEs to legally utilise transfer pricing legislation for their benefit.

3.1.2 The Loss-making Companies

The second problem is the existence of loss-making companies in Indonesia. Many MNEs have reported their continual losses for years, but they still operate normally without signs of bankruptcy [see, e.g., Suroyo and Setiaji (2016)]. Paragraph 1.129 of the OECD Transfer Pricing Guidelines indicate this phenomenon by stating that "when an associated enterprise consistently realizes losses while the MNE group as a whole is profitable, the facts could trigger some special scrutiny of transfer pricing issues" (OECD, 2017c, p. 80). In this regard, the Indonesian Tax Authority has anticipated this issue by deciding that companies' losses for more than two consecutive years are subject to a transfer pricing audit (TPA-Global, 2015, p. 2).

3.1.3 The impact of Declining Corporate Tax Revenues

Third, Indonesia encounters a problem of a declining percentage of corporate income tax revenue compared to total tax revenue. In Indonesia, there has been a significant decline in corporate income tax revenue caused by a number of factors such as macroeconomic downturn, low tax compliance, falling commodity prices, and MNEs

international profit shifting [see e.g., Kristiaji (2015), Chilkoti (2015), Maulia (2016), and Hamilton-Hart and Schulze (2016)]. This paper focuses on the decline of corporate income tax due to aggressive international profit shifting activities. The loss of potential tax revenue as a result of tax avoidance in Indonesia has been estimated around the USD 6.48 billion annually (Cobham & Jansky, 2017). Moreover, in Indonesia, the percentage of corporate income tax was declined from 30.9% in 2005 to below 25% in 2015 (OECD, 2017d). In addition, Oxfam (2016, p. 34) finds that the loss of Indonesia's corporate income tax caused by Australian-based MNEs which shifts profits from Indonesia to tax havens reached USD 344 million in 2016 and this is estimated to reach approximately USD 685 million over the next five years.

There is an impact of declining in tax revenue on domestic resource mobilisation [see, e.g., Oxfam (2016), and OECD (2017a)]. For instance, Oxfam (2016, p. 26) has reported that the potential tax loss could be used for schools, hospitals, roads and other essential services that fight poverty and generate prosperity. Moreover, Oxfam (2016, p. 34) estimates that more than half of the potential tax loss could be used for education that is enough to provide nearly 5,000 classrooms per year, and around $61 million is being torn out of public sanitation that could provide over 40,000 permanent toilets each year. While the OECD (2017a) has reported that falls in tax revenue weaken domestic resource mobilisation in developing Asia including Indonesia.

After identifying the problem in addressing aggressive transfer pricing, the next step is to determine the criteria of why this paper considers Indonesia and China as the compared countries based on their functional equivalent. For this paper, functional equivalent refers to the four criteria in selecting a comparable jurisdiction: tax jurisdiction that has a similar type of legal system, a developing nation, a capital import country, and is selected in the country practice of the United Nations Transfer Pricing Manual for Developing Countries.

3.2.Selecting Comparable Jurisdiction: Indonesia and China

This section provides a justification for the selection of the country which is being evaluated by the author. It is critical to determine the comparable jurisdictions of countries being evaluated. In selecting comparable jurisdiction, this paper considers that the comparable jurisdiction is functionally equivalent. This paper identifies four criteria in selecting comparable jurisdiction: the legal system adopts the civil law, considered as developing nations, capital import countries, and country practice of the UN Transfer Pricing Manual.

3.2.1. Civil Law Jurisdictions

Indonesia has a mixed legal system, i.e., civil law, Muslim, and customary [see, e.g., Burns (2004), and Juriglobe (2017)]. Indonesian legal system is the product of institutional transplantation inherited from the Dutch Colonialisation in 1800s, combined with customary law and Islamic legal influence (Burns, 2004). Similar to other European continent countries, the Dutch legal system refers to civil law. Since the era of reformation in 1998, Indonesia with its culture, political and economic systems is considered as a democratic country [see, e.g., Abdulbaki (2008), Freedman and Tiburzi (2012), and Shidiq and Vermonte (2013)]. Indonesia adheres separation of powers: legislative, executive, and judicial powers [see, e.g., Mahfud (2011), and Butt and Lindsey (2012)]. In Indonesia, the separation of powers could be seen in legislative power that lies in Parliament, executive power lies in the President, and judicial powers lies in Courts. In particular, the Parliament make law, the President implement the law, and the Courts interpret the law and deciding disputes. The President represents the government in general, including ministries, departments, and governments institutions.

While China has a mixed legal system of civil law, and customary law [see, e.g., Potter (2013) and Juriglobe (2017)]. The operation of law in China is affected by the fact that the China’s legal models have been adopted from European and American legal models and suffused with local norms and culture (Potter, 2013, p. 3). Although Indonesia and China have a mixed legal system, the current majority of their legal system is influenced by civil law. The political and economic systems in China developed from an

ideology of collectivism which focuses on group and society [see, e.g., Li (2010), Li (2012) and Pinto (2012)]. China is a socialist country ruled by law, and there is no separation of powers (Li, 2010, p. 671). In China, the State Council and the People Courts are subordinate to the National People Congress. In this regard, the National People Congress is the formal lawmaking body. Li (2010, p. 671) states that although a significant law reform has been conducted in China due to its associate to World Trade Organisation, fundamental system of the legal system remains the same. Chinese entrepreneur considers local values such as maintaining a long-term relationship and pragmatic approach to problem-solving. For instance, Chinese considers a win-win solution to disputes, and its approach to problem-solving is pragmatic as described by Deng-Xiaoping famously saying ‘crossing the river by groping the stone underfoot’ (Li, 2012, p. 661).

3.2.2. Developing Nations

The second is to consider countries’ economic development and gross national income (GNI), both countries represent the form of developing countries [see, e.g., United Nations (2014)]. According to Worldbank (2017c), low-income country constitutes a country with GNI over than the USD 1,005, lower-middle income refers to a country with GNI between the USD 1,006 – 3,955, upper-middle income constitute GNI between the USD 3,956 – 12,235, and high-income country for GNI more than 12,235. In 2017, Indonesia’s Gross National Income is USD 3,400, while China’s Gross National Income in 2017 is USD 8,260 (Worldbank, 2017a). Thus, according to Worldbank (2017c), the position of Indonesia is at a lower-middle income country, and China is an upper– middle-income country.

China and Indonesia are also members of G20 countries (G20, 2017). The Group of Twenty (G20) is the premier forum for its member's international economic cooperation and decision making. The G20 consists of 19 countries (Argentina, Australia, Brazil, Canada, China, France, Germany, India, Indonesia, Italy, Japan, Republic of Korea, Mexico, Russia, Saudi Arabia, South Africa, Turkey, United Kingdom, United States) with the addition of the European Union. The G20 countries account for 85% of global GDP and 79% of world trade, and 65% world population, and 79% world carbon

emissions. BRIC(S) is an acronym of Brazil, Russia, India, China and (South Africa) introduced by the British economist Jim O'Neill in 2001 which are deemed to be at the similar stage of newly advanced economic development [for a complete report see O'Neill (2001)]. According to Worldbank (2017b), Gross Domestic Product in 2016 of Brazil was the USD 1,796 billion; China was the USD 11,199 billion; India was 2,263; Russia was the USD 1,283 billion, and South Africa was the USD 294 billion. Considering the population (the world's fourth-most population with 260 million people) and size of GDP, several researchers and institutions nominate Indonesia as the next advance economic country to incorporate BRIICS [see, e.g., Sally (2008), McCann (2009), Schuman (2010), Prokurat and Fabisiak (2012), and Ketenci (2014)].

3.2.3. Capital Import Countries

Indonesia and China are capital import countries. According to the OECD (2017b), the net inflow foreign direct investment (FDI) in China and Indonesia is USD 170.5 billion and the US $ 3.6 billion in 2016 consecutively. While net outflow foreign direct investment (FDI) in China and in Indonesia is USD 20.5 billion and USD 261 million in 2016 consecutively. The data shows that net inflow FDI is higher than their net outflow FDI in both China and Indonesia.

3.2.4. Country Practices at the UN Transfer Pricing Manual

In selecting compared countries, this paper considers country practices at the UN Transfer Pricing Manual because the UN Transfer Pricing Manual was developed as a solution for developing countries in struggling to adopt the OECD Transfer Pricing Manual. Developing countries including Indonesia encounter implementation constraints in adopting the arm's-length principle such as unavailability of the comparable data, tax administration complexity, and the challenge in designing and implementing effective transfer pricing. Brazil, China, India, Mexico, and South Africa were the five countries selected to allow representatives of individual countries an opportunity to set out their individual country viewpoints and experiences for the information of readers.

Table 2. Criteria in Selecting Comparative Jurisdictions

Criteria	Country	
	Indonesia	China
Legal system adopts the civil law	Y	Y
Developing nations	Y	Y
Capital import countries	Y	Y
UN Manual's Country Practice	-	Y

In summary, Indonesia and China were selected because the two countries are sharing similarities regarding the adoption the civil law, to be considered as developing nations, capital import countries. In addition, this paper considers a unique factor that China's transfer pricing regime is mentioned in the country practice of the United Nations Practical Manual on Transfer Pricing for Developing Countries (United Nations, 2017). Each of the compared countries transfer pricing regime will be discussed further in the descriptive phase.

3.3.Descriptive Phase

This section provides a description of transfer pricing law in Indonesia and China. In describing the compared countries, this paper utilises legal and social background of each jurisdiction [see, e.g., Schmittoff (1941, p. 96) and Kamba's (1974)]. Each jurisdiction will be described under three main themes in order to simplify the analysis, considering the functional equivalence which is depicted as follows:

1) Historical context: the historical development of each country's transfer pricing regime
2) The legal framework for transfer pricing, including:
    - The adoption of the arm's-length principle: Tax law is adopted to regulate cross-border transfer pricing
    - Transfer pricing treatment on taxable income: Tax law adopted to regulate intercompany sales of MNEs and their foreign related parties

- Transfer pricing treatment on deductible expenses particularly royalty payments of intangible property: Tax law adopted to regulate royalty payments and other services of MNEs and their foreign related parties.

3.3.1. Indonesia

3.3.1.1. Historical development of transfer pricing in Indonesia

In Indonesia, transfer pricing regime was enacted through three stages of development: the application of the 'substance over form' principle (from 1983 to 2010), the adoption of the OECD transfer pricing guidelines (since 2010), and the Base Erosion and Profit Shifting Project implementations (since 2015).

The first stage is the application of the 'substance over form' principle (1983-2010). Donor countries influenced Indonesia's tax reform in 1983 that Indonesia adheres western countries' tax system [see, e.g., Heij (2001), and Arnold (2012)]. In this stage, Indonesian Tax Authority introduces transfer pricing provision in order to prevent tax avoidance due to cross-border transactions between related taxpayer. The cross-border transaction between related parties might cause understated or overstated income or expense. In assessing financial transaction between MNEs and their related parties, Indonesia's tax system holds the principle of 'substance over form' [for a detail wording of these rulings in the Indonesian language, see Directorate General of Taxes (1993a), and Directorate General of Taxes (1993b)].

The second stage is the adoption of the OECD Transfer Pricing Guidelines in 2010. There is no written Indonesia's legislation stating that Indonesia adopts the OECD transfer pricing guidelines. However, the adoption of the OECD traditional arm's-length transfer pricing regime into Indonesia's legislation could be seen from its characteristics. Several academic scholars consider that Indonesia's transfer pricing regime refers to the OECD [see, e.g., Feinschreiber and Kent (2012), Lohse et al. (2012), OECD (2012), and Ernst & Young (2016)].

The third stage is the adoption of Base Erosion and Profit Shifting (BEPS) Project implementation since 2015. Ministry of Finance or Republic Indonesia confirms that Indonesia will fully implement the Automatic Exchange of Information (AEOI) and the

BEPS program at the latest in September 2018. Moreover, the Minister of Finance states that Indonesia needs to implement the BEPS recommendation as an effort to reduce tax avoidance, and to overcome the loopholes in the tax system to avoid tax evasion [see Ministry of Finance (2017b) and (2017a)]. Following the above commitment, Indonesia has adopted the BEPS recommendations into tax legislation: automatic exchange of information [see Ministry of Finance (2016) and PWC (2017)], mutual agreement procedure [see KPMG (2015b)], advance price agreement [see KPMG (2015a)], debt to equity ratio [see Ministry of Finance (2015)], and country by country reporting [see Ernst & Young (2017)].

3.3.1.2. Legal framework of Indonesia's transfer pricing regime

(1) The adoption of the arm's-length principle

In Indonesia, transfer pricing rules are found in for sources: Indonesia's Income Tax Law of 1983 as amended in 2008, Ministry of Finance Decree, Director of General of Taxation Decree, and Tax Treaties between Indonesia and other countries. The authoritative statement of transfer pricing can be found in Article 18 (3) Indonesia's Income Tax Law of 1983 as amended in 2008:

> "Director General of Taxes is authorized to reallocate income and deductions between related parties and to characterize debt as equity for the purposes of the computation of taxable income to assure that the transaction are those which would have been made between independent parties using price comparison method between independent parties, resale price method, cost-plus method, or other methods."
>
> Moreover, Article 18 (4) Indonesia's Income Tax Law of 1983 defines 'related taxpayer': "A taxpayer who controls another taxpayer; or two or more taxpayers are directly or indirectly under the same control; or taxpayer who owns directly or indirectly at least 25% of the equity of other taxpayers; a relationship between taxpayers through ownership of at least 25% of the equity of two or more taxpayers, as well as the relationship between two or more taxpayers concerned."

It can be seen in Article 18 (3) Indonesia's Income Tax Law of 1983 as amended in 2008 states that the arm's-length principle is adopted in Indonesia, as well as the suggested transfer pricing methods. In Indonesia, the interpretation of the arm's-length principle by tax authority is described as:

1) Reasonable taxable income

2) Reasonable expenses especially on intangible property

3) Determination of debt as equity

This paper focuses on the interpretation of the arm's-length principle for a determination of reasonable taxable income and expenses on the intangible property because these two interpretations are the most common disputes between tax authority and taxpayers. In particular, reasonable taxable income includes transfer pricing treatment on business profits, while reasonable expense includes royalty payments of MNEs to their foreign related parties.

(2) Transfer Pricing Treatment on Taxable Income

Interpretation of arm's-length principle of reasonable taxable income can be MNEs' profit or loss from undertaking transactions with their related parties, and reasonable price of selling goods and services. In applying the arm's-length principle, Article 18 (3) Indonesia's Income Tax Law of 1983 as amended in 2008 requires taxpayers to perform comparability analysis, functional analysis, as well as to determine transfer pricing methods in order to achieve a fair market value. In Indonesia, taxable income is reasonable when the price billed to foreign related parties as though the transactions are undertaken with another unrelated foreign entity.

(3) Transfer Pricing Treatment of Deductible Expenses: Intercompany Royalty Payments

Royalty payments for the use of intangible property and tangible property by MNEs to their related parties are deductible expenses. Article 6 (1) (a) Income Tax Law states that in determining the taxable income of a resident taxpayer, that royalty payments (including to related parties) are deductible expenses as follow: "Resident Taxpayers and permanent establishments are entitled to claim the deductions in the form of expenses to earn, to collect and secure income from their gross income, including costs which are

directly or indirectly related to business: costs of materials; costs in relation with employment or services including wages, salaries, honorarium, bonuses, gratuities and remuneration in the form of money; interest, rents and royalties … "

The royalty payment is deductible expenses on condition that the payments to related parties are rational. For instance, Article 9 (1) (f) Income Tax Law states that excessive compensation paid to shareholders and related parties as consideration for work performed is not deductible for tax purposes. Although royalty payments are deductible expenses, Article 18 (3) Indonesia's Income Tax Law of 1983 as amended in 2008 authorised DGT to assess the royalty payments are arm's-length.

Following the current development of the OECD Transfer Pricing Guidelines, Indonesia has enacted implementing regulations related to the intangible property. In particular, Article 17 DGT Ruling PER-32/2011 provides the scope, criteria, and types of intangible property. For instance, the intangible property includes trade intangibles and marketing intangibles. The three criteria to determine royalty payments for the use of intangible property are: the transaction is actually in place, there is economic benefit, and meets the arm's-length principle.

3.3.2. China

3.3.2.1. Historical development of transfer pricing in China

Transfer pricing regime in China was enacted through three stages of development: a local pilot programme in the 1980s, a national wide transfer pricing legislation in 1990s, and a strict transfer pricing regime in 2007 (Markham & Liao, 2014).

The first stage is local pilot programs introduced by the People's Government of Shenzhen City in 1988 in respond to foreign-invested enterprises (FIEs) avoiding taxes by employing aggressive transfer pricing [see, e.g., Li (2012, p. 637)]. The local pilot program was intended to tackle FIEs activities to shift profits gathered in China to abroad. Between the 1980s and early 1990, approximately three-quarters of FIEs were reported to tax losses. Subsequently, China State Administration of Taxation (SAT) was enacted into Circular No. 376 to the various levels of local tax authorities to implement the transfer pricing provision nationwide.

The second stage is the introduction of transfer pricing legislation that was enacted in Income Tax Law of the People's Republic of China for Enterprises with Foreign Investment and Foreign Enterprises; and its implementing rule in 1991. In particular, Article 13 deals with the arm's-length principle for FIEs undertake financial transactions with their foreign related parties. Article 13 also gives SAT to make reasonable adjustments if FIEs do not comply with the arm's-length principle. Subsequently, Chinese Government enacted domestic transfer pricing legislation in 1993. Thus, China transfer pricing system includes cross-border transactions and domestic transactions. Following the legislation, a number of detailed notices and operative measures are then released. In this period, China has developed a relatively complete transfer pricing regime which was embodied in tax laws, administrative legislation, and department rules. The arm's-length principle was introduced following China's entry to World Trade Organisation in 2001 [see, e.g., Pinto (2012, p. 40) and Li (2012, p. 636)].

The third stage is the adoption of the Enterprise Income Tax Law of the People's Republic of China (EITL); and the implementation of the law in 2007. Chapter 6 of EITL deals with special tax adjustment including cost-sharing agreements, thin capitalisation, controlled foreign corporation, and general anti-avoidance rule. Subsequently, China began strengthening tax investigations of FIEs transfer pricing transactions and their foreign related parties. For instance, SAT uses the statistical indicator to monitor MNEs profitability by geographic regions and industries; and identifies MNEs that have relatively low profitability in China. In this stage, China is famous for one of strict transfer pricing regime in the world.

3.3.2.2.Legal framework of China's transfer pricing regime

(1) The adoption of the arm's-length principle

China's transfer pricing system adheres the OECD Transfer Pricing Guidelines [see, e.g., Ng (2010, p. 55), Pinto (2012, p. 43) and Feinschreiber and Kent (2013, p. 30)]. China's transfer pricing rules are found in four sources: Article 41-4 of Enterprise Income Tax (EIT) Law and Article 36 of Administration of Tax Collection Law enacted by the National People's Congress, EIT Regulations (Articles 109-15) and Rules for the

Implementation of Administrative Tax Collection Law (Articles 51-6) enacted by State Council, administrative regulations/guidelines issued by SAT, and tax treaties (Li, 2012, pp. 640-641). However, China's tax law does not provide a formal definition of transfer pricing transactions between MNEs and their related parties. Article 13 Income Tax Law of the People's Republic of China for Enterprises with Foreign Investment and Foreign Enterprises (ITLEFIFE) 1991 states that: "In respect of income obtained by enterprises in the form of non-monetary assets or rights and interests, such income shall be computed or appraised with reference to prevailing market prices". Article 13 authorises SAT to perform transfer pricing adjustment for MNEs transactions with their foreign affiliate companies.

(2) Transfer Pricing Treatment on Taxable Income

In applying the traditional arm's-length principle, China encounters practical challenges such as lack of appropriate internal and external comparable, quantification and allocation of location-specific-advantages, and identification and valuation of intangible assets (Feinschreiber & Kent, 2013, p. 31). China offers a solution to its practical problem by providing remuneration to China's unique economic and geographic factors (Bell, 2012, p. 683). Thus, China's solution is to introduce location-specific advantage such as location savings, market premium, and alternative transfer pricing methods. To calculate location-specific advantage, Chinese transfer pricing regime proposes four different steps: first is to identify location-specific advantage. Second is to determine whether location-specific advantage adds to profit. The third is to quantify and measure profits generated from location-specific advantage. Fourth is to determine the method to allocate profit generated from a location-specific advantage (United Nations, 2017, p. 569).

China's location-specific advantage was used as country practice at the United Nations Practical Manual on Transfer Pricing for Developing Countries (United Nations, 2017). However, location-specific advantage cannot be found in China's current transfer pricing legislation (Markham & Liao, 2014, pp. 742-744).

(3) Transfer Pricing Treatment of Deductible Expenses: Intercompany Royalty Payments

In China, the definition of intangible property is limited to legally protected intangible property, SAT is likely to take a narrower view of the value of global trademarks, and tax authority tends to focus on local product enhancement and intangible property (Chandler, Foley, Skarstad, & Tseng, 2006, p. 464). For instance, China has not recognised intangible property for trade names and marketing intangibles (Li, 2012, p. 662). Moreover, Pinto (2012, p. 40) argues that the protections of intangible property have not been a major concern due to China's collectivism and communism. For example, in China, the definition of intangible property is still unclear. Chandler et al. (2006, p. 466) inform that previously China's practical solution to intangible property was to enact rule of thumb that royalty payments should not exceed 5% of the revenue. Today, China's intangible property regime focuses on the profit split method. Profit Split Method is to evaluate the allocation of profits and losses between related parties based on the MNEs' relative contributions to the profit or loss.

Table 3. Descriptive Phase

Descriptive	**Country**	
	Indonesia	**China**
1. Historical context	Three stages of development: (1) the application of the 'substance over form' principle (1983 to 2010) (2) the adoption of the OECD transfer pricing guidelines (since 2010) (3) BEPS Project implementations (since 2015)	Three stages: (1) local pilot programme (the 1980s) (2) national wide transfer pricing legislation (the 1990s) (3) strict transfer pricing regime (since 2007)
2. Legal framework:		
a. Adoption arm's-length principle	Refer to the OECD Transfer Pricing Guidelines	Refer to the OECD Transfer Pricing Guidelines
b. Transfer pricing on taxable income	Interpretation is closer to the OECD	Interpretation is to introduce location-specific advantage
c. Transfer pricing on royalty	Interpretation is closer to the OECD	Narrow view of intangible property

3.4. Identification Phase: Similarities and Differences Identified

Similarities: The Adoption of the OECD Transfer Pricing Guidelines

In determining tax treatment for cross-border transfer pricing in Indonesia and China, a similar issue arises in terms of the use of the OECD traditional transfer pricing regime. Indonesia and China adopt the more common international transfer pricing practices. The arm's-length principle is transplanted to their tax law. Many studies state that both countries adhere to the OECD Transfer Pricing regime.

In Indonesia, although the Indonesian Tax Law does not explicitly refer to the OECD Transfer Pricing Guidelines, its adoption to the OECD could be seen from the comparison of Indonesia's transfer pricing regime to the OECD regime. A number of studies show that Indonesia's transfer pricing regime refers to the OECD [see, e.g., Feinschreiber and Kent (2012), Lohse et al. (2012), OECD (2012), and Ernst & Young (2016)]. For instance, Lohse et al. (2012) find that Indonesia's adoption to the OECD Model could be seen from its transfer pricing: existence, applicability, methods, documentation requirements, submission deadlines, penalties, statute of limitations, and advance pricing agreements. Moreover, in Multi-Country Analysis of Existing Transfer Pricing Measures, the OECD's (2012) survey reveals that Indonesia's DGT Decree PER-43/PJ/2010 complies with the arm's-length principle.

In China, current tax studies show that China's transfer pricing system follows the OECD Transfer Pricing Guidelines [see e.g., Chandler et al. (2006, p. 464), Pinto (2012, p. 40), Li (2012, p. 636), and Markham and Liao (2014, p. 728)]. For instance, Chandler et al. (2006, p. 464) argue that China's transfer pricing regime follows the principles of the OECD Transfer Pricing Guidelines. Moreover, Markham and Liao (2014, p. 728) provide an example that Chinese transfer pricing rules have adopted the OECD recommendations such as performing comparability analysis in order to select appropriate transfer pricing methods. In addition, Pinto (2012, p. 40) highlights that China's entry into the World Trade Organisation in 2001 leads the country adopting the OECD Transfer Pricing Guidelines. China has been following the 'international tax norm' with the appreciate modifications to suit local Chinese conditions (Li, 2012, p. 638). China's

interpretation of the arm's-length principle could be found at the UN Transfer Pricing Manual.

Lohse et al. (2012) carry out a study to examine the development of transfer pricing regulations in 44 countries including Indonesia and China from 2001 to 2009. According to Lohse et al. (2012), country's transfer pricing stage of development and the categorisation of transfer pricing regulation can be seen from seven aspects as follow.

Table 4. The Development of Transfer Pricing in Indonesia and China

No.	**Description**	**Country**	
		Indonesia	**China**
1	Existence & applicability	TP regulation since 1984	Introduction of TP regulation in 2008
2	Methods	The most appropriate method	The most appropriate method
3	TP documentation	Disclosure. Statutory requirement in 2008	Disclosure. Statutory requirement in 2008
4	Deadlines of TP documentation	Four months after fiscal year end	Five months after fiscal year end
5	TP Penalties	There is no TP penalty, tax adjustment 2% per month	additional special interest levy: federal interest rate + 5% on tax adjustment; late interest (0.05% per day); up to 500% of unpaid tax in case of fraud
6	Statute of limitations	Five years from end of tax year	Up to 10 years from tax year end
7	Advance Pricing Agreements	unilateral, bilateral	unilateral, bilateral

Source: Lohse et al. (2012)

Table 4 above reveals the adoption of the OECD Transfer Pricing in Indonesia's and China's tax legislation. According to Lohse et al. (2012) country's transfer pricing stage of development and the categorisation of transfer pricing regulation, Indonesia and China generally adopt transfer pricing regimes similar to the OECD Transfer Pricing Guidelines. It is also important to highlight that although Indonesia's and China's transfer pricing refer to the OECD, they do not explicitly mention to refer the OECD Transfer Pricing Guidelines in their tax legislation. However, countries' interpretation of the arm's-length principle is different.

Differences: Country's Interpretation to Address Aggressive Transfer Pricing

The previous section has explained that both Indonesia's and China's transfer pricing regimes adhere to the OECD Transfer Pricing Guidelines. China's transfer pricing regime refers to 'international tax norm,' and Indonesia follows the 'internationally accepted principles' which can be found in the OECD Model Tax Convention and the OECD Transfer Pricing Guidelines. However, the difference between Indonesia and China transfer pricing regimes lies in their interpretation of the arm's-length principle.

Indonesia's interpretation of the OECD Transfer Pricing Guidelines covers two areas: transfer pricing treatment of tax deductions, transfer pricing treatment of MNEs' taxable income, and determination of debt as equity. Tax deductions include payments to overseas related parties, while taxable income includes sales to overseas related parties. The wording of Article 18 (3) Income Tax Law of 2008 states that "DGT is authorised to reallocate income and deductions between related parties to ensure that the transactions which would have been made between independent parties." Moreover, commentary of Article 18 (3) Income Tax Law states that "when there is a relationship between MNEs and their related parties, there is a possibility that income may be understated or expenses may be overstated." Article 18 (3) Income Tax Law of 2008 shows that Indonesia's interpretations limited to the reallocation of taxable income and deductions between MNEs and their foreign related parties.

China's transfer pricing interpretation to the OECD Transfer Pricing Guidelines lies in the location-specific advantage [see, e.g., Guo, Tseng, Wei, and Xu (2013, p. 36), and United Nations (2017)]. Section D2 of the United Nations Practical Manual on Transfer Pricing shows China experiences in implementing transfer pricing in detail (United Nations, 2017, pp. 547-580). According to the UN Manual, location-specific advantage refers to a type of benefit related to geographic location such as highly specialized skilled manpower and knowledge, proximity to growing local/regional market, large customer base with increased spending capacity, advanced infrastructure (e.g. information/ communication networks, distribution system), or market premium (United Nations, 2017, pp. 103-104). The implementation of location-specific advantage in China was motivated to the fact that China deals with practical challenges in applying the traditional arm's-length principle such as lack of appropriate internal and external comparable,

quantification and allocation of location-specific-advantages, and identification and valuation of intangible assets [see, e.g., Bell (2012, p. 683) and Feinschreiber and Kent (2013, p. 31)].

China's interpretation to the OECD Transfer Pricing Guidelines shows that in implementing the arm's-length principle, China's approach on profit allocation of MNEs operating in China tends to slightly deviate to the OECD Transfer Pricing Guidelines [see, e.g., Ng (2010, p. 55), Pinto (2012, p. 43) and Feinschreiber and Kent (2013, p. 30)]. For instance, Ng (2010, p. 55) states that the China's transfer pricing rules and measures are close to the OECD Guidelines and the international transfer pricing principles as adopted in most developed countries, with deviations in some areas. Chandler et al. (2006, p. 464) argue that it is common where a country has different ways in implementing the OECD Guidelines so that China's current interpretation differs from most other countries. While (Markham & Liao, 2014) states that the Chinese Tax Authority, the State Administration of Taxation (SAT) establishes its unique transfer pricing system since 1980's.

From this summary, it is evident that Indonesia and China have developed unique approaches to address aggressing transfer pricing, considering the historical and cultural contexts of each country. To show how Indonesia's and China's transfer pricing differs, a hypothetical illustration of transfer pricing in both countries is provided in Table 5.

Table 5. A Hypothetical Illustration of Indonesia's and China's Transfer Pricing Regimes

Description	**Indonesia**	**China**	**Notes**
Sales	2,000	2,100	Location-specific advantage
COGS	1,800	1,800	
Operating Income	200	300	
Operating Expenses	-100	-100	
Net Income (Loss)	100	200	
Tax rate 25%	-25	-50	
Profit After Tax	75	150	

Source: the author (2018)

Table 5 shows identical firms operate in Indonesia and China. The two MNEs have the same expenses and a tax rate of 25%. The difference is only in sales. While MNE in Indonesia reported USD 2,000 sales, China's Tax Authority asks an additional revenue USD 100 due to the location-specific advantage that is received by MNE in China. MNE in Indonesia is subjected to corporate income tax of $ 25 tax. China, by asking an additional $100 for location-specific advantage, collects more taxes from $ 25 to $ 50.

3.5. Explanatory Phase: Similarities and Differences Explained

The explanatory phase explains the similarities and differences that have emerged from descriptive countries' comparison. This phase is to critically evaluate the different solutions adopted in Indonesia and China to determine which solutions superiority to others, or whether there is a new solution to aggressive transfer pricing. Evaluating Indonesia's and China's approaches against the superiority criteria will show both strengths and weaknesses of Indonesia's approach to addressing aggressive transfer pricing against China's approach.

Indonesia's transfer pricing regime is closer to the OECD Transfer Pricing Guidelines. However, China's interpretation of the OECD Transfer Pricing Guidelines diverges from the OECD. China's arguments are twofold: First, China deals with implementation challenges in adopting the OECD Transfer Pricing Guidelines, i.e., unavailability of comparable data and administrative challenges. Second, China considers its geographically unique, economical circumstances, infrastructure, and large domestic market. Thus, China asks additional remuneration for MNEs operate in China. Indonesia and China position to the OECD Transfer Pricing Guidelines is described in Figure 1 below.

Figure 1. Countries' Interpretation of the OECD Transfer Pricing Guidelines

Figure 1 shows that although Indonesia and China have adopted arm's-length principle based on the OECD Transfer Pricing Guidelines, Indonesia's transfer pricing regime mostly convergence to the OECD Model, while China's transfer pricing system is divergence to the OECD Model. The difference lies in their interpretation where China considers its local norms, culture, and economic circumstance; whereas Indonesia less considers local context.

In Indonesia, tax treatment for MNEs' profit does not consider additional remuneration of benefit related to geographic location. In Indonesia, MNEs' profits are determined by adding profit and subtracting expenses. In this regard, the Indonesian Directorate General of Tax as a tax authority is entitled to reallocate income and deductions between related parties for the purposes of the computation of taxable income. In particular, the tax treatment income and deductions are considered the arm's-length principle.

In contrast, in China tax treatment for MNEs' profit considers remuneration of location-specific advantage. China's State Administration of Taxation (SAT) ask for additional profit allocation because MNEs in China receive benefit related to a geographic location by operating in China. In particular, SAT adjusts MNEs income considering its benefit by establishing MNEs in China.

In performing the critical evaluation, this paper considers a new solution that superior to others [see, e.g., Zweigert and Kötz (1992, p. 44), and Infanti (2002, p. 1139). Zweigert and Kötz (1992, p. 44) suggest that in performing a comparative law, the comparatist must employ 'a higher concept' to examine different solutions suggested in the compared countries. Infanti (2002, p. 1139) advice comparatist to use 'superior to all others' to examine the two countries being evaluated. While Barker (2004, p. 708) considers criteria of 'ought to be' of the countries undertaken for analysis. For instance, the higher concepts are efficiency, fairness, and acceptance by the people (Barker, 2004). However, this paper considers Baistrocchi's (2013) network theory to evaluate superiority in Indonesia and China.

In his article entitled "The International Tax Regime and the BRIC World: Elements for a Theory" Baistrocchi (2013) introduces a network theory for the analysis of international tax regime. Baistrocchi's theory is presented in an analysis of how BRIC countries construct their international tax regimes. His network-market theory aims to illuminate the core driving forces of on-going trends in the global convergence of international tax regimes. In his view, an international tax standard is a network product that provides an incentive for users to join and stay in the existing network.

Baistrocchi (2013) explains the static and dynamic dimensions on the logic of two-sided platform, i.e., a dual seller that operate in interdependent markets. Under static dimension, international tax regime could be explained as follows. First, the OECD Model Tax Convention is the 'soft law' of international tax with its function to minimise transaction costs in producing soft law. Second, the OECD Model Tax Convention and related documents when are adapted to country's tax law, they become international tax 'hard law.' Third, countries are engaged in international tax competition. Fourth, the OECD Model fulfills the standard features of all network markets, i.e., network externalities, expectations, and lock-in effects. Fifth, the OECD compatible standard is able to eliminate incompatible standards such as the Andean Model.

Furthermore, under static dimension, Baistrocchi (2013) introduces the framework to analyse international tax regime that consists of eight architectures. First is the mission, users, and feedback to minimise transaction cost. Second is the cross-side network effects; i.e., the more MNEs use the OECD-based tax treaty network for searching locations of investments, the countries have the incentives to use the OECD model for their tax treaty network. The third is same-side network effects; i.e., the more countries use the OECD Model as the soft law for their tax treaty network, the more they have the incentive also to use the OECD Model. Fourth is two distinct user's demands; i.e., countries normally wish to maximize inbound FDI whereas MNEs would rather maximize their after-tax income. Fifth is the core vehicles for minimising search costs. For instance, the OECD model is a global benchmark of tax treaty network. MNEs consider country's deviation from the OECD model that are potential targets for investments location. Sixth is entry usage fees. For example, the country faces substantial costs to negotiate and conclude tax treaties. Cost related to usage fee is the potential tax revenue loss by adopting asymmetric

tax treaties. Seventh is the platforms and competition. In this regard, the United Nations tax treaty model similar to the OECD model in order to increase the tax jurisdiction of source countries with regard to residence countries. Last is the negative network effects, such as harmful tax practices by international taxpayers and countries.

Transfer pricing regime adopted in Indonesia and China are evaluated against criteria to determine whether the two transfer pricing regimes are 'superior' to the other. Using Baistrocchi's (2013) network theory, this paper considers four evaluative criteria as follow:

(1) The adoption of internationally accepted tax regime to domestic legislation in the form of signing tax treaties with other jurisdictions
(2) The effect of country's transfer pricing reform to inbound Foreign Direct Investment
(3) Tax revenue collected from transfer pricing audit
(4) Country's respond to resolve transfer pricing dispute

The four evaluative criteria are summarised in Table 6 below

Table 6. Summary of Finding Based on Superiority Criteria

No.	Criteria	Indonesia	China
1	Tax treaties	76	102
2	Foreign Direct Investment	US $ 3.6 billion	US $ 170.5 billion
3	Tax revenue collected from transfer pricing audit	-	RMB 34.6 billion in 2012 compared to RMB 460 million in 2005
4	Transfer pricing disputes	286	-

Sources: DGT, SAT, the OECD

First, a superior approach to the transfer pricing regime would examine country's adoption of the internationally accepted tax regime to domestic legislation and tax treaties. In an attempt to allocate income of MNEs operate in more than two tax jurisdictions, country adopts the internationally accepted transfer pricing regime and signing double tax treaties with treaty partners. Indonesia and China have adopted the OECD Transfer Pricing Guidelines into their tax legislation and co-operated to deal with the issue of MNES' profit allocation. This paper argues that the number of tax treaties signed by

countries represents their transfer pricing regimes' acceptance by other countries. Indonesia has signed 76 tax treaties (Directorate General of Taxes, 2017), while China has a larger amount of tax cooperation by signing 102 tax treaties with other countries (State Administration of Taxation, 2017). An analysis of China's tax treaties found that although China has developed location-specific advantage regime, other countries do not disengage tax treaties with China.

Second, a superior approach to transfer pricing regime would examine the effect of transfer pricing to inbound foreign direct investment. It examines as to whether transfer pricing regime influences an increase or decrease of foreign direct investment. FDI data gathered from the OECD (2017b) finds that FDI in Indonesia is the US $ 3.6 billion, while FDI in China reaches the US $ 170.5 billion. The data reveals that FDI in China is bigger than in Indonesia. Moreover, an analysis of China's inbound FDI in the last ten years shows that the number of FDI is increasing substantially (OECD, 2017b). The data imply that the introduction of China's unique transfer pricing regime does not affect inbound foreign direct investment in China.

Third, a superior approach would like to examine that MNEs profits are taxed in the location of economic activity. In this regard, transfer pricing regime is to ensure that more revenue will be collected from tax audit on transfer pricing. This paper argues that the determination of profit allocation in a country could be seen from the amount of tax revenue that was able to collect by tax authority through performing tax audit on transfer pricing. In Indonesia, there is no specific study undertaken and specific data available about the amount of tax revenue collected from tax audit on transfer pricing. Although a number of tax scholars argue that there is a decline in tax revenue from cross-border transactions [see, e.g., Mulyani (2010), and Muhammadi et al. (2016)], the exact empirical data is not available. In China, tax revenue collected from transfer pricing audit has increased significantly from only RMB 460 million in 2005 to RMB 34.6 billion in 2012 (Markham & Liao, 2014, p. 721).

Fourth, a superior approach considers how the country deals with transfer pricing disputes. This paper argues that the more complex a transfer pricing regime is, the more disputes filed in Tax Courts. Section 3.4 has discussed the transfer pricing evolutionary

path in Indonesia and China [see Table 2 for detail]. According to Baistrocchi (2013) classification, Indonesia and China are in the latest stage of transfer pricing development: using mutual agreement procedure, advance pricing agreement, and alternative dispute resolution in resolving transfer pricing disputes. However, in Indonesia, the number of transfer pricing disputes have increased. According to data gathered from Indonesian Supreme Court (2017), the number of transfer pricing disputes are 286 cases. In China, a number of transfer pricing disputes are not available. A study conducted by Li (2012), China's approach to transfer pricing disputes is through consensuses-based dispute resolution.

4. CONCLUSIONS

In searching for alternative transfer pricing which is easy to administer for developing countries, this paper examines Indonesia's position and explores comparative jurisdiction of China. In doing the analysis, this paper undertakes comparative tax research of Indonesia and China using Zweigert & Kötz (1992) five suggested comparative steps. The identification phase provides understanding about similarities of Indonesia and China in addressing aggressive transfer pricing by MNEs operate in their tax jurisdictions. In selecting comparable jurisdiction, this paper identifies four criteria: the legal system adopts the civil law, considered as developing nations, capital import countries, and country practice of the UN Transfer Pricing Manual for Developing Countries.

In descriptive phase, this paper has discussed the comparison of two countries' transfer pricing regimes into three themes: country's legal system and social background, historical context including the historical development of each country's transfer pricing regime, and legal framework for transfer pricing including the adoption of the arm's-length principle, transfer pricing treatment on taxable income, transfer pricing treatment on deductible expenses particularly royalty payments of intangible property. In identification phase, this paper revealed similarities and differences emerging from the two compared countries. Indonesia and China share similarities regarding their transfer pricing regimes refer to the OECD Transfer Pricing Guidelines. The difference lies in the interpretation of the arm's-length principle.

In explanatory phase, this paper introduces Indonesia into the comparative analysis in order to determine where Indonesia is located in approaching aggressive transfer pricing. Indonesia's transfer pricing regime is closer to the OECD Transfer Pricing Guidelines. While China interprets the OECD Transfer Pricing Guidelines by introducing the location-specific advantage. China's approach is then evaluated to determine its superiority to Indonesia. Evaluating Indonesia's and China's approaches against the superiority criteria will show both strengths and weaknesses of Indonesia's approach to against China's approach. An analysis using superiority criteria revealed that theoretically, China's location-specific advantage by asking additional remuneration for MNEs operate in China which is able to increase corporate tax revenue [see Table 3 about an illustration of Indonesia's and China's transfer pricing regimes]. At the same time, China is able to maintain 102 tax treaties with other countries, maintain Foreign Direct Investment more than the US $ 170 billion in 2016, and increase tax revenue from transfer pricing audit from only RMB 460 million in 2005 to RMB 34.6 billion in 2012. While Indonesia has sign 76 tax treaties, FDI US $ 3.6 billion in 2016; Indonesia recognises the problem in increasing number of tax disputes to Tax Courts due to the complexity of transfer pricing rules and unavailability of a reliable comparable data in implementing the arm's-length principle.

In summary, this paper offers insights from China that could potentially inform Indonesia's policymakers to consider the location-specific advantage to address aggressive transfer pricing. The location-specific advantage regime considers country's unique factors such as infrastructure, cheap labor, and marketplace that are beneficial to MNEs. Thus, Indonesia might need to consider its specific economic, legal system, and social background in considering its transfer pricing regime. In interpreting the OECD Transfer Pricing Guidelines, Indonesia needs to consider location-specific advantage as an alternative transfer pricing regime. It is suggested that by implementing the location-specific advantage, Indonesia will be able to implement a transfer pricing regime that represents a fair allocation of income, is easy to administer and which will increase corporate income tax revenue. For MNEs operating in Indonesia, the new transfer pricing regime will make it easier for them to report their cross-border transactions, and to minimise disputes with the tax authority.

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