

**MINIMISING POTENTIAL TAX AVOIDANCE BY STRENGTHENING TAX POLICY ON TRANSFER PRICING  
IN INDONESIA**

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**ABSTRACT**

This article examines transfer-pricing implementation and challenges in Indonesia since its first tax reforms in 1983. The OECD has been formulating guidelines, and the concept of the arm's-length principle, since 1979, lately through the Action Plan on Base Erosion and Profit Shifting ('BEPS') in July 2013. The government of Indonesia put serious effort into transfer-pricing issues in the late 2000s, when it identified high numbers of potential transfer-pricing abuses. This research takes a qualitative approach — the data was collected through a literature review and interviews. It shows that the arm's-length principle was adopted in Indonesia when tax reforms began in 1983, but its implementation didn't start until 2008 due to a lack of expertise in transfer pricing. Since its implementation, the tax authority has faced technical challenges due to a lack of competent experts. When Indonesia declared their commitment to implement transfer-pricing rules following the OECD BEPS Action Plan 2013, the tax authority should have followed global examples of transfer-pricing policy. In Indonesia, this policy implementation is still in progress, with many improvements required.

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## I INTRODUCTION

Transfer pricing is a global and growing issue whereby a transaction is conducted between divisions of a company (often a multinational enterprise comprised of multiple entities in different jurisdictions) with unfair pricing compared to a transaction between independent parties on the open market. In the context of tax, this transfer-pricing pattern has an impact on the return received by the company, and on the amount of tax that should be paid in a particular jurisdiction.<sup>1</sup> To optimise the income received after tax, multinational enterprises will seek a jurisdiction with the lowest possible tax rate for their income. This transaction pattern has led to the diminishing of the tax base. There has been a continuous effort by tax authorities to minimise such practices worldwide, including in Indonesia.

In the current context of globalisation, business activities are moving directly or indirectly across jurisdictions. A study conducted by Danny Darussalam Tax Center Indonesia found that, in 1970, there were only 10,000 multinational enterprises worldwide. However, by 2010, the number had increased exponentially to 103,786, controlling about 892,114 affiliated entities. In general, this growth is due to multinationals aiming to optimise their market power, by striving for excellence in ownership and location, and by gaining internalisation advantages.

According to a survey conducted by Ernst & Young in 2010 with 850 multinational enterprises in 24 countries, 40 per cent of respondents stated that the issue of transfer pricing is the most important issue in taxation.<sup>2</sup> This is why many consulting institutions have published information related to transfer pricing in recent years.<sup>3</sup> Moreover, research conducted by Christian Aid also revealed that up to 60 per cent of world trade transactions were conducted between entities within multinational enterprises.<sup>4</sup> This phenomenon is giving an important signal that the reasonable (arm's-length) transfer price needs to be properly evaluated.

In response to the growing issue of transfer pricing worldwide, the OECD has formulated guidelines related to the concept of the arm's-length principle.<sup>5</sup>

Indonesia is one of the countries in Asia that has adopted regulations of transfer pricing in its taxation system, since the beginning of its tax reformation marked by the enactment

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<sup>1</sup> R Feinschreiber (ed), *Transfer Pricing Methods: An Application Guide* (John Wiley & Sons, 2004) 3–4.

<sup>2</sup> Ernst & Young, *2010 Global Transfer Pricing Survey: Addressing the Challenges of Globalization* (2010). Then, a survey conducted by Ernst & Young in 2016 further confirmed the importance of the global transfer pricing issue: see Ernst & Young, *2016 Transfer Pricing Survey Series: In the Spotlight — A New Era of Transparency and Risk* (2016) <[https://www.ey.com/Publication/vwLUAssets/EY-2016-transfer-pricing-survey-series/\\$FILE/EY-2016-transfer-pricing-survey-series.pdf](https://www.ey.com/Publication/vwLUAssets/EY-2016-transfer-pricing-survey-series/$FILE/EY-2016-transfer-pricing-survey-series.pdf)>.

<sup>3</sup> RW McGee, 'Ethical Issues in Transfer Pricing' (2010) 7(2) *Manchester Journal of International Economic Law* 24.

<sup>4</sup> David McNair, Rebecca Dottey and Alex Cobham, *Transfer Pricing, and the Taxing Rights of Developing Countries* (Christian Aid, 2010) <[https://www.christianaid.org.uk/sites/default/files/2017-08/transfer-pricing-november-2010\\_0.pdf](https://www.christianaid.org.uk/sites/default/files/2017-08/transfer-pricing-november-2010_0.pdf)>.

<sup>5</sup> OECD, *OECD Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations 2017* (OECD Publishing, 2017). See also OECD, *Transfer Pricing and Multinational Enterprises* (OECD Publishing, 1979); OECD, *Transfer Pricing and Multinational Enterprises — Three Taxation Issues* (OECD Publishing, 1984); OECD, *Thin Capitalisation* (OECD Publishing, 1987).

of the *Income Tax Law 1983*. The government of Indonesia has realised the importance in preventing transfer-pricing practices as described in *Income Tax Law 1983* art 18(3).<sup>6</sup>

In this paper, the discussion on the implementation of tax policy in Indonesia will include a history, an overview of the previous policies, and the challenges now faced by the tax authority and taxpayers. Several previous studies have discussed the technical regulations related to transfer pricing in Indonesia,<sup>7</sup> the determinants of transfer-pricing decisions by manufacturing companies in Indonesia,<sup>8</sup> and other factors affecting the transfer-pricing behaviour of manufacturers.<sup>9</sup> Thus, this research contributes to the whole picture of Indonesian transfer-pricing policy.

Furthermore, this article will briefly discuss the implementation of transfer-pricing regulations in China, as a benchmark study for Indonesia's work in overcoming the issue of transfer pricing. This study shows that Indonesian transfer-pricing rules pay more attention to the technical aspects of assessment — such as comparability analyses, functional analyses and others — and that these aspects commonly become the main drivers of tax disputes. China, on the other hand, has paid considerable attention to other factors besides technical aspects, such as location savings, market premiums and the possibility of using other methods besides the common method.

## II RESEARCH METHOD

This research used a qualitative paradigm and methodology. According to Creswell, qualitative research begins with assumptions, a point of view, the possible use of theory, and an examination of an existing social problem for individuals and social groups.<sup>10</sup> Data and information was collected through a literature study and field research. A series of in-depth interviews were conducted with relevant informants: workers for the tax authority, such as tax auditors for multinational enterprises under the Foreign Investment Tax Office; tax consultants from PricewaterhouseCoopers Indonesia and the MUC Consulting Group; and taxpayers whose main businesses operate both within the Indonesian territory and multinationally.

## III LITERATURE REVIEW

### *A Overview of the transfer-pricing concept*

Transfer pricing is basically the restructuring of a transaction between entities within a company, as a result of various combined market forces and internal policies, that causes

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<sup>6</sup> Danny S Darussalam and B Bawono Kristiaji (eds), *Transfer Pricing: Ide, Strategi dan Panduan Praktis dalam Perspektif Pajak Internasional* (Danny Darussalam Tax Center, 2013).

<sup>7</sup> MK Huda et al, 'The Problem of Transfer Pricing in Indonesia Taxation System' (2017) 7(4) *International Journal of Economics and Financial Issues* 139.

<sup>8</sup> A Susanti and A Firmansyah, 'Determinants of Transfer Pricing Decision in Indonesia Manufacturing Companies' (2018) 22(2) *Jurnal Akuntansi dan Auditing Indonesia*.

<sup>9</sup> YN Indriaswari and RA Nita, 'The Influence of Tax, Tunneling Incentive, and Bonus Mechanisms on Transfer Pricing Decision in Manufacturing Companies' (2017) 7(1) *The Indonesian Accounting Review* 69.

<sup>10</sup> JW Creswell, *Research Design: Qualitative, Quantitative and Mixed Methods Approaches* (Sage Publications, 2<sup>nd</sup> ed, 2002).

a difference in pricing if it is compared to a transaction on the open market carried out between independent parties.<sup>11</sup> It can also refer to the pricing of a transferred contribution to a company, including assets, services and funds;<sup>12</sup> or a rearrangement of the income between entities that make cross-jurisdiction transactions in an attempt to rearrange the tax base.<sup>13</sup> The United Nations state that there are two reasons why a company might have an interest in transfer pricing: first, the company is looking to pay minimal tax on its income; and second, the company would like to optimise its business structure by taking consideration of the most effective tax burden.<sup>14</sup>

The problems that face multinational enterprises regarding the practice of transfer pricing are: they must optimise their business strategies and internal policies with regards to pricing restructuring; they must use their resources efficiently; and they must provide reasons for their price setting if they are audited by the tax authority. Almost all multinational enterprises strive to achieve a balance between these three factors.<sup>15</sup> However, from a taxation perspective, the objective of transfer-pricing schemes is to minimise the overall tax burden of a multinational enterprise by taking advantage of the different tax rates in the country where the particular division resides, by setting higher or lower prices on transactions.

Moreover, the government of a country will always strive to protect their taxation base. This situation emphasises the need to set up fair and reasonable prices for both transactions conducted between independent parties and transactions between divisions of a company, for tangible and intangible goods, as well as cross-jurisdiction transactions.

The Tax Justice Network stated that:

[T]ransfer pricing is not, in itself, illegal or abusive. What is illegal or abusive is transfer mispricing, also known as transfer pricing manipulation or abusive transfer pricing. (Transfer mispricing is a form of a more general phenomenon known as trade mispricing ...)<sup>16</sup>

OECD *Model Tax Convention on Income and on Capital* art 9 regulates the special relations:

Where,

- 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

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<sup>11</sup> TP Ostwal, 'Chapter 1: An Introduction to Transfer Pricing' (United Nations, Geneva Meeting, 16 October 2012).

<sup>12</sup> L Eden, R Mackenzie and A dan Xilimas, *Transfer Pricing and Customs Valuation* (KPMG, 2011).

<sup>13</sup> Veronica Vragaleva, 'Tax Aspects of Transfer Price Regulation: Perspective of Implementation in the Republic of Moldova' (2015) 1(1) *Analele Universităţii Constantin Brâncuşi din Târgu Jiu: Seria Economie* 200.

<sup>14</sup> United Nations, *Transfer Pricing for Developing Countries* (Newsletter of Financing for Development No 2013/3, May 2013).

<sup>15</sup> Vragaleva (n 13) 203.

<sup>16</sup> 'Transfer Pricing', *Tax Justice Network* (Web Page) <<https://www.taxjustice.net/topics/corporate-tax/transfer-pricing>>.

- b) the same persons participate directly or indirectly in the management, control or capital of an enterprise of one Contracting State and an enterprise of another Contracting State

and in either case conditions are made or imposed between the two enterprises in their commercial or financial relations which differ from those which would be made between the independent enterprises, then any profits which would, but for those conditions, have accrued to one of the enterprises, but, by reason of those conditions, have not so accrued, may be included in the profit of that enterprises and taxed accordingly.<sup>17</sup>

A survey conducted by Ernst & Young in 2010 revealed that the most common transfer-pricing transactions are related to intra-group services (see Table 1).

**Table 1: Types of transfer-pricing practices<sup>18</sup>**

Types of transactions	Score (%)
Services	62.5
Transfer of intangible goods	50
Inter-company financing	32.4
Licenses of intangible property	30
Cost sharing/cost contribution arrangements	20
Imputed/increased compensation/indemnification payments for business charges	10
Other	5

### ***B The concept of tax regulation implementation on transfer pricing***

Based on the implementation practices in developing countries, Nakayama from the Fiscal Affairs Department of the International Monetary Fund stated that the many obstacles to implementing transfer-pricing regulations in developing countries include:<sup>19</sup>

- difficulty and incapability in performing transfer-pricing adjustments, which is caused by:
  - limited skills or numbers of experts in transfer pricing
  - limited data that can be accessed by the public
  - limited knowledge transfer related to the implementation of transfer-pricing guidelines in developing countries
- a lack of support for aggressive examination, sufficient mechanisms needed to perform the examination, and available workable dispute resolution mechanisms
- no significant increase in income from aggressive examination through the enforcement of transfer-pricing disclosure.

<sup>17</sup> OECD, *Model Tax Convention on Income and on Capital* art 9 (18 December 2017).

<sup>18</sup> Ernst & Young, *2010 Global Transfer Pricing Survey* (n 2) 14.

<sup>19</sup> K Nakayama, 'Transfer Pricing for Developing Countries' (Expert Group Meeting on Practical Transfer Pricing Issues for Developing Countries, Fiscal Affairs Department, International Monetary Fund, 14 March 2012). See also Caroline Silberstein, *Transfer Pricing and Developing Economies* (OECD Publishing, 2013) <<https://www.oecd.org/site/oecdgfd/44562250.pdf>>.

Nakayama further formulated several principal aspects of how transfer-pricing disclosure policy can be performed in developing countries:<sup>20</sup>

- The implementation of the arm's-length principle — Silberztein at the OECD gives the arm's-length principle this definition: '[T]he condition of transactions between enterprises that belong to the same MNE group should not be different from what they would be if the parties were independent'.<sup>21</sup> Therefore, there is a need for general guidelines from the tax authority concerning the information (which must be comparable, and publicly accessible) that companies must make available, such as: geographical adjustments; location savings; non-competitive business arrangements; risk stripping (contract manufacturer, commissioner) that supports business activities; policies on safe harbour; and how information should be documented.
- Tax administration — there is a need for a special unit within the internal tax authority that deals with transfer pricing (for instance, a large taxpayer office), where the implementation is done by tax officers with sufficient experience in international transaction auditing. Moreover, the auditor team should comprise team members with other expertise besides taxation, including law, economics, accounting and even engineering. Furthermore, there needs to be quality control for transfer-pricing assessments and post-assessment reviews. This implementation will require a high level of capability in the tax administration.
- Dispute resolution — dispute resolution mechanisms facilitate and eliminate the massive and aggressive disputes related to conflicts in tax avoidance. This is expected to open the way for mutual agreement procedures.
- Advance Pricing Agreements ('APAs') — APAs are a reliable way to decrease the potential for tax avoidance and minimise other disputes from a transfer-pricing audit. However, this mechanism is time-consuming and requires a large amount of resources.

## IV DISCUSSION

### *A Brief overview of transfer-pricing rules in Indonesia*

Transfer pricing has been a particularly important issue in the Indonesian tax system since 2005. The issue emerged when the Ministry of Finance, specifically the Directorate General of Taxes ('DGT'), received information that there were 750 foreign capital investment enterprises that did not pay their taxes due to long-term losses. Following that, an examination was conducted to reveal if their transaction prices were reasonable.<sup>22</sup> Since the enactment of the *Income Tax Law 1983*, transfer-pricing policy has been adopted as set out in art 18(3):

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<sup>20</sup> Nakayama (n 19) 5–9.

<sup>21</sup> Silberztein (n 19).

<sup>22</sup> Study Group on Asian Tax Administration and Research, 'Recent Development: Transfer Pricing in Indonesia' (Working Paper, 2012).



Special relation as meant ... in the case where Taxpayer is a corporation (a.1) relations between two or more Taxpayers under the same ownership or control, directly or indirectly (a.2) relations between Taxpayers that possess 25% or more investment on the other party, or relations between Taxpayers that possess 25% or more on the two or more other parties, as well as relations between two or more that was last mentioned.

The Study Group on Asian Tax Administration and Research recently recorded that, although transfer-pricing policy was formulated in the *Income Tax Law* in 1983, there is still no institution with sufficient capability to cover the examination of taxation of business transactions between entities with special relations. Therefore, the regulations stated in art 18(3) were not implemented until the DGT stipulation KEP-01/1993 (on guidelines for auditing business entities with special relations) and the DGT Circular Letter SE-04/1993 (on guidelines for transfer-pricing dispute settlements) were enacted. Kurniati states that the policies have significant shortcomings, and that they are not supported by explicit guidelines for taxpayers. Moreover, the regulations have not taken into account internationally recommended aspects in relation to comparability analysis, and other factors that are vital in implementing the arm's-length principle.<sup>23</sup>

Meanwhile, policies on obligatory documentation relating to transfer pricing were enacted in 2001, where particular corporate taxpayers must report their transactions between entities with special relations on their corporate income tax return. *Income Tax Law 2000* art 18(3) states: 'Directorate General of Taxes has the authority to redefine income and deduction as well as debt as capital to calculate the amount of taxable income for taxpayers with special relations with other taxpayers according to the arm's length principle that is not influenced by special relations'. APAs were first introduced at this time, but the revisions in *Income Tax Law 2000* have not significantly improved the transfer-pricing issue, due to the lack of guidelines available for taxpayers to implement the arm's-length principle.

Moreover, regulations under the Indonesian formal tax law, *Undang-undang Ketentuan Umum dan Tata Cara Perpajakan (General Provision and Procedure Law) 2007*, state that there is an obligation to report transactions between entities with special relations, and to report the transactions on the corporate income tax return. Furthermore, minor revisions to the *Income Tax Law 2008* stated that the DGT would perform intensive assessments in response to the enormous numbers of businesses participating in transfer-pricing practices. This change marked the restructuring of the DGT to form special units to tackle the issue of transfer pricing.

A Study Group on Asian Tax Administration and Research working paper described that, in 2009, the government regulated the transaction disclosure for parties with special relations through filing and reporting the documents attached to the corporate income tax notification letter, covering:

- detailed information on all entities with whom the corporate taxpayer has a special relationship, along with details of their transactions (Form 3A)

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<sup>23</sup> Based on research by Stania Kurniati regarding the motivation behind transfer-pricing practices in Indonesia. Stania Kurniati, 'Pengaturan Praktik Transfer Pricing di Indonesia' (Master Thesis, Fakultas Hukum Universitas Indonesia, 2014).

- responses to various questions that are complementary to the income tax notification letter and various transactions conducted between parties/entities with special relations — this document identifies whether the transactions are fair (Form 3A-1)
- detailed information pertaining to transactions between entities that are residents of tax havens (Form 3A-2).

Furthermore, in 2009 the DGT also published a circular letter concerning guidelines for comparing the transfer prices of several targeted industries that had potential to be audited for transfer-pricing practices.

As implementation guidelines for transfer-pricing documentation and examination, the DGT in 2010 published regulations for examining transaction pricing fairness: PER-43/2010 on the implementation of the arm’s-length principle on transactions between taxpayers with special relations; and PER-69/2010 on APAs. In 2011, PER-43/2010 was revised to PER-32/2011, which states that a fair price examination can use the most appropriate assessment method, and doesn’t need to follow the hierarchy of techniques. These regulations were mainly adoptions of the OECD’s guidelines — however, a lack of detail around their execution has often led to different interpretations.

In 2013, the government released the Ministry of Finance No.17/PMK.03/2013 regulation on investigation guidelines. Later, the DGT published regulation PER-22/PJ/2013 on inspection guidelines for taxpayers with special relations, as an advanced technical rule. This policy provides descriptions of special relations, and steps for conducting an examination of transfer-pricing practices. This regulation has had insignificant implementation. Table 2 shows the history of the regulation of transfer pricing in Indonesia.

**Table 2: The history of transfer-pricing regulations in Indonesia<sup>24</sup>**

Year	Description
1983	Regulations concerning transfer pricing were contained in <i>Income Tax Law 1983</i> art 18(3).
1993	A DGT decree (KEP-01) was published as a guideline to audit transactions between entities with special relations. This was followed by a DGT Circular Letter (SE-04) to instruct on tackling transfer-pricing issues. Traditional methods were examined, such as comparable uncontrolled transactions (‘CUPS’), the resale price method (‘RPM’) and the cost-plus method (‘CPM’).
2001	The revised <i>Tax Income Law 2000</i> art 18(3) described fair price examination methods, such as CUP, RPM, CPM, profit split, transaction net margin method, and others.
2007	A regulation was published to reveal transactions made under special relations on income tax annual notifications.

<sup>24</sup> Information sourced from a compilation of tax regulations on transfer pricing in Indonesia, as cited in the table.



2008	There was a minor change in the transfer-pricing regulation contained in the <i>Corporate Income Tax Law</i> .
2010	Various regulations were published concerning the examination of transactions conducted between entities with special relations:
	PER-43 The Implementation of the Arm's Length Principle on the Transactions between Taxpayers and Parties with Special Relations
	PER-48 on the Mutual Agreement Procedure
	PER-69 on the Advance Price Agreement
2011	PER-32/2011 revised PER-43, to regulate the selection of the examination method for fair price or profit.
2013	PER-22/PJ/2013 was enacted on the Guidelines for Examination of the Taxpayers with Special Relation.
2015	No.7/PMK.03/2015 concerning the Procedure for Advance Pricing Agreement
2016	Ministry of Finance Regulation No. 213/PMK.03/2016 was the basis for adopting the OECD Base Erosion and Profit Shifting ('BEPS') Action Plan 13 recommendations.

In reality, PER-43, which was published and revised to PER-32, was the first policy on transfer-pricing practices in Indonesia that provided steps for documenting prices on transactions with taxpayers' affiliated agencies. This policy also regulates the comparability analysis, the selection of the transfer-pricing method, fair price determination, other transfer documentation formats, as well as other aspects required by taxpayers and tax officers as guidelines.

According to the research by Kurniati on the implementation of transfer-pricing policies in Indonesia, particularly PER-43/2010 with the latest revision in PER-32/2011, various notes are revealed:<sup>25</sup>

1. Special relations: transfer-pricing regulations and the *Income Tax Law* in Indonesia adopted the OECD description of special relations, stating that two entities are considered to have special relations if one entity invests in the other directly or indirectly with 25 per cent minimum shares.<sup>26</sup>
2. The scope of transfer-pricing regulations: PER-43 contains details of transactions conducted by taxpayers with other parties under special relations; PER-32 focuses on transactions where there is a potential or motivation to generate profit from the different tax rates. This is not explicitly mentioned in the OECD *Model Tax Convention*.<sup>27</sup>

<sup>25</sup> Kurniati (n 23) 63–79.

<sup>26</sup> OECD, *Transfer Pricing Guidelines for Multinational Enterprises and Tax Administration* (OECD Publishing, 2010) <<http://www.oecd.org/ctp/transfer-pricing/transfer-pricing-guidelines.htm>>.

<sup>27</sup> OECD, *Model Tax Convention on Income and on Capital* (n 17).

3. The arm's-length principle: regulations in Indonesia adopted the arm's-length principle as a comparability analysis principle.
4. Comparability analysis: according to the OECD, 'comparable' refers to there being no material differences in the conditions of a transaction between affiliated parties and those of a transaction between independent parties.<sup>28</sup> If such differences exist, they can be eliminated with an accurate adjustment. The Indonesian regulations do not provide a clear distinction between 'equal' and 'comparable', as the two words are often used interchangeably. In contrast to the OECD, the transfer-pricing regulations in Indonesia do not yet provide step-by-step instructions for conducting comparability analyses that could facilitate taxpayers in implementing the arm's-length principle expected by the policy.
5. The selection of comparability analysis method: the OECD recommends selecting the most appropriate method. Initially, PER-43/2010 regulated that the method should be selected by hierarchy, but later on was revised (in PER-32) to recommend using the most appropriate method.<sup>29</sup>
6. Service delivery: the OECD suggests that the fairness of a service delivery transaction is examined through its economic value, which could increase the position or commercial capacity of the service consumer.<sup>30</sup> The Indonesian regulations fully adopt this OECD regulation. PER-32 also mentions, however, that the transaction does not satisfy the arm's-length principle if it occurs only because of the existence of shareholders on a particular corporate ownership in one or several entities of the same company, similar to activities conducted solely upon the arrangement of a shareholders' meeting.
7. The cost contribution agreement: Indonesian regulations fully adopt the OECD guidelines, which emphasise the fair contribution values according to the transfer-pricing analysis. The Indonesian regulation PER-32 only emphasises the OECD principle, without describing the steps to be conducted to examine the fairness of the transactions.
8. The transfer-pricing documentation adopts the descriptions contained in the OECD guidelines.

In summary, according to various studies concerning the implementation of transfer-pricing regulations in Indonesia, the Indonesian regulations have adopted most of the OECD guidelines without any proportional adjustment in consideration of the economic

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<sup>28</sup> OECD, *Transfer Pricing Guidelines 2010* (n 26) ch 3.

<sup>29</sup> According to OECD, *Transfer Pricing Guidelines 2010* (n 26), there are two general categories of assessment methods: the 'traditional transaction methods', consisting of CUP, RPM and CPM; and the 'transactional profit methods', consisting of the transactional net margin method and the profit split method. Following the OECD, *Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations* (OECD Publishing, 1995), selection of a transfer pricing assessment method was based on hierarchical principles, from the traditional methods down to the transactional profit methods. Since 2010, following the OECD *Transfer Pricing Guidelines 2010*, the selection of assessment method has been based on that most appropriate to a particular case.

<sup>30</sup> OECD *Transfer Pricing Guidelines 2010* (n 26) ch 7.

conditions and tax systems applicable in Indonesia. Moreover, the Indonesian regulations are not equipped with technical guidelines, which would be the first step to successful implementation of these regulations.

## ***B The challenges of implementing transfer-pricing rules in Indonesia***

### *1 Comparability analysis and the transfer-pricing audit process*

In a self-assessment system, as adopted by Indonesia, the tax administrator has the authority to audit the transfer-pricing documentation reports, to determine whether they are reasonable or not in the context of the arm's-length principle, by using comparable data as an analysis tool. According to research by Irawan et al, transfer-pricing disputes in Indonesia began with the difference between the comparable data used by taxpayers and that used by the tax administration to assess the reasonability of transactions.<sup>31</sup> The number of transfer-pricing cases seen in the tax court during 2012–13 due to the difference between comparable data used was high (see Table 3).

**Table 3: Transfer-pricing disputes, by subject, in Indonesian tax court 2012–13<sup>32</sup>**

<b>Subject of dispute</b>	<b>2013 (%)</b>	<b>2012 (%)</b>
Documentation availability	1	0
Method of transfer pricing examination	9	16
Debt-to-equity ratio	9	8
Related party	17	5
Comparable data and arm's-length range	26	37
Substantial material dispute	44	34

An acceptable comparable dataset should meet the OECD's standard, wherein it should cover a wide range of transaction characteristics, economic conditions, business strategies and FAR (function, asset and risk) analyses, as well as other appropriate factors to justify that the data is reliable and valid.

However, several problems are commonly found when taxpayers are required to supply comparable data during the tax audit process:<sup>33</sup>

- From a taxpayer perspective, tax auditors often do not really understand the nature of the taxpayer's business (the production process, the products and services produced), and insufficient comparable data used by tax auditors, and a lack of substantial discussion between auditors and taxpayers during the tax audit period, can lead to massive disputes. If the taxpayer produces products with highly specific

<sup>31</sup> Romi Irawan, F Kihonia and B Bawono Kristiaji, 'Analisis Kesebandingan in Darussalam' in Darussalam and Kristiaji (eds) (n 6) 133.

<sup>32</sup> Sourced from 'Tren Perdagangan Global dan Isu Transfer Pricing dalam: Proyek BEPS' (May 2016) 38 *Inside Tax* 69 <<https://ddtc.co.id/uploads/pdf/InsideTax-38th-Edition.pdf>>. The table is recreated by the author.

<sup>33</sup> This information is the summary of interviews with tax auditors from the DGT who are engaged in Foreign Investment Tax Offices, and tax consultants from PricewaterhouseCoopers Indonesia and the Center for Indonesia Taxation Analysis.

characteristics, they often cannot find the appropriate comparable data to make the tax audit fair. From the tax auditor’s perspective, the taxpayer has not understood the transfer-pricing regulations and has under-disclosed transfer-pricing documentation.

- There is often a lack of reliable, comparable data available to be accessed by the tax auditor.
- The DGT has not released sufficient official guidelines on the selection of data to be used as comparable data for the purpose of transfer-pricing audits. In many cases, the tax auditor selects the data manually, based on their own justification.
- The tax auditor often has insufficient transfer-pricing knowledge for their analysis of controlled transactions compared with uncontrolled transactions in comparable circumstances, affected by direct and indirect factors.
- The tax auditor and the tax auditing team often lack supporting knowledge, for example, quantitative analysis and language fluency, to accomplish their technical work.
- Tax auditors have to meet transfer-pricing audit targets, as assigned by the DGT, which has led to messy and insufficient audits being performed.

There have been similar findings about transfer-pricing audits in Indonesia in other studies.<sup>34</sup> Table 4 shows a summary of findings with regards to transfer-pricing audit challenges.

**Table 4: The challenges of transfer-pricing audits<sup>35</sup>**

Challenges due to the DGT internal targets	Limited time to perform tax audits, and therefore findings are made that are unreliable and invalid.
Challenges due to the DGT work-management issues	<ul style="list-style-type: none"> <li>• Lack of time allocated for substantial discussions during the audit.</li> <li>• Lack of tax auditor transfer-pricing knowledge and other essential supporting knowledge to understand the taxpayer’s business process and to deal with the tax audit work.</li> <li>• Work overload faced by the tax auditor to accomplish targets set by the DGT.</li> <li>• Lack of reliable and comparable data, references and access to information.</li> </ul>
Challenges due to taxpayer behaviour	Reluctance to fully disclose information.

## 2 Availability of APAs

For countries that implement a self-assessment system, the availability of APAs is essential to minimise potential transfer-pricing disputes. APAs are intended to align the understanding of the taxpayer and the tax authority in determining the reasonable price

<sup>34</sup> Abdul Haris Mudammadi, Zahir Ahmed and Ahsan Habib, ‘Multinational Transfer Pricing of Intangible Assets: Indonesian Tax Auditors’ Perspectives’ (2016) 24(2) *Asian Review of Accounting* 313.

<sup>35</sup> See above n 33 and accompanying text.

of transactions between related parties. In Indonesia, APAs were introduced in *Income Tax Law 2000*, however, the technical guidelines (DGT regulation PER-69/PJ/2010) were not released for another 10 years. An APA is valid for three years, and each year the taxpayer has to submit an annual compliance report. The APA is subject to review at the end of the third year. Table 5 shows the progress of APAs concluded up until 2018.

**Table 5: Indonesia APA progress<sup>36</sup>**

Year	Request received	Request closed	Ending balance
Pre-2016	14	0	14
2016	25	3	36
2017	2	3	35
2018	13	15	33

'Request received' refers to how many APA applications were received in that year. 'Request closed' shows how many applicants reached an agreement in that year — the DGT states that there are two types of agreement indicated by 'request closed': agree to agree, and agree to disagree. 'Ending balance' indicates how many applicants were still in discussion with the DGT at the end of that year and would be carried forward into the next.<sup>37</sup>

Based on empirical research, there are several factors, both internal and external of the tax authority, that lead to obstacles to concluding APAs in Indonesia:

- Internal factors:
  - No regulation on the timeframe for APA application approval, and no strong regulation ensuring that information submitted to the tax authority will be kept restricted. The people appointed to deal with the APA process are not engaged based on standardised operating procedures, and therefore the negotiation process commonly raises tensions, for example, about the determination of the roll-back period.
  - A lack of expertise and competence in dealing with transfer-pricing issues, and insufficient knowledge about taxpayers' business processes. No specific body within the tax authority has been designed, and therefore it is not well prepared for engaging with this problem.
  - A lack of coordination with other related institutions.
- External factors: the amount of time and resources it takes to apply for an APA, added to by a lack of certainty regarding the approval time of an APA application.

As a G20 member, the government of Indonesia signed the OECD BEPS Action Plan, particularly Action Plan 13 as a minimum standard, on 12 May 2016.<sup>38</sup> It then adopted the plan into its domestic regulations, in Ministry of Finance regulation No.7/PMK.03/2015 regarding the formation and implementation of an APA, and

<sup>36</sup> 'APA MAP', *Direktorat Jenderal Pajak* (Web Page, 2018) <<https://pajak.go.id/id/apa-map>>.

<sup>37</sup> Author interview with the DGT (March 2019).

<sup>38</sup> Trade Union Advisory Committee, OECD, *The Case for Making Country-by-Country Reporting Public* (OECD Publishing, 27 June 2016).

No.213/PMK.03/2016 ('PMK-213') on the types of document and/or additional information that should be kept by taxpayers who conduct transactions with parties under special relations.

### 3 *The adoption of BEPS Action Plan 13 country-by-country report in Indonesia*

With regards to the country-by-country reporting of transfer-pricing documentation, the OECD recommends that countries who participate and agree to the adoption of BEPS Action Plan 13 regulate the reporting of cross-jurisdictional transactions between divisions of a multinational enterprise using particular criteria.

The Ministry of Finance regulation PMK-213 was published in 2016 to regulate the types of documents and/or additional information required to be kept by taxpayers who conduct transactions with other parties under special relation (and the regulation includes implementation guidelines). This regulation later became a mandate for the DGT to implement regulation of transfer-pricing documentation.

The regulations in PMK-213 emphasise the obligation for three types of documentation:

- Master file: A document providing general information on the multinational company's business activities and its transfer-pricing determination policies.
- Local file: A document containing information on business activities, finances, and any affiliated transactions, including analyses of the inter-affiliate transactions.
- Country-by-country report: Documents compiled according to the format attached to the PMK-213. Each country report is a transfer-pricing document that contains income allocations, tax paid and business activities of all divisions of the enterprise, presented in special tables according to the appropriate international standard, and shared with other countries following the international tax agreement. Through this reciprocal information sharing, Indonesia will receive information from Indonesian taxpayers and their parent entities who reside in foreign countries pertaining to the countries/jurisdictions where the parent entities are located.

Each country report provides:

- information on income allocation, the tax paid and the business activities by each country/jurisdiction of all the divisions of the enterprise, within or outside the country
- lists of the entities and their main business activities by each country/jurisdiction
- relevant descriptions of each point.

The entities covered in each country report, which is called the constituent entity, consist of:

- the ultimate parent entity ('UPE')
- each entity within the parent entity included in the consolidated financial report of the parent entity (UPE or non-UPE) for financial reporting purposes
- each entity within the parent entity that is not included in the consolidated financial report of the parent entity considering their scale of business or materiality
- the permanent establishment.

Table 6 shows the rules for the entity in documenting transfer pricing.



**Table 6: BEPS Action Plan 13 adoption in Indonesia transfer-pricing rules<sup>39</sup>**

<b>Parent and local documents</b>	
Transactions with parties under special relations with threshold limit	
<b>Types of transactions</b>	<b>Threshold limit</b>
Gross turnover in the previous year	More than IDR50,000,000,000
Transactions of tangible goods delivered in the previous year	More than IDR20,000,000
Transactions of services, royalties and other deliveries	More than IDR50,000,000
Transactions between parties with special relations located in the country with the lower tax rate	None
Taxpayers that are the parent entity, with IDR11 trillion gross consolidated turnover are also obliged to document transfer prices.	
The minimum information that should be available in the parent entity's document: <ol style="list-style-type: none"> <li>1. ownership structure and charts, country/jurisdiction of each entity</li> <li>2. business activities conducted by the enterprise</li> <li>3. intangible assets owned by the enterprise</li> <li>4. the financial and cost activities of the enterprise</li> <li>5. consolidated financial report of the parent entity and tax information pertaining to transactions between entities.</li> </ol>	
The minimum information required in the local entity's document: <ol style="list-style-type: none"> <li>1. identity and the business activities</li> <li>2. affiliated and independent transactions</li> <li>3. the implementation of the arm's-length principle</li> <li>4. financial information of the taxpayers</li> <li>5. events/incidents/non-financial facts that influence the price and profit determination level</li> <li>6. consolidated financial report of the parent entity and tax information of the affiliated transactions.</li> </ol>	
<b>Each country report</b>	
Conducted by parent entities with a minimum IDR11 trillion gross consolidated turnover.	
If the parent entity is located in a foreign country, the entity in Indonesia is obliged to provide each country report, if the parent entity's jurisdiction: <ul style="list-style-type: none"> <li>• does not require delivery of country reports</li> </ul>	

<sup>39</sup> Sourced from PGN Grup, *PMK No.213/PMK.03/2016: Penerapan dan Implikasinya bagi PGN Grup* (Presentation by Indonesia State Owned Enterprises on gas distribution, Jakarta, 2 February 2017) <[http://www.iaiglobal.or.id/v03/files/file\\_publikasi/Implikasi%20PMK%20213%20bagi%20PGN%20Grup%20Revisi%20Final.pdf](http://www.iaiglobal.or.id/v03/files/file_publikasi/Implikasi%20PMK%20213%20bagi%20PGN%20Grup%20Revisi%20Final.pdf)>.

- does not have an agreement with the Indonesian government on tax information sharing

has an agreement with the Indonesian government, but the country reports are not received from the foreign country.

The contents of each country report must include:

1. information on income allocations, tax paid and business activities of all entities of each country, including:
  - name of the country/jurisdiction
  - gross income earned, delineated from the group entity earnings and separated from the third party earnings
  - profit/loss before tax (including income and non-operational costs)
  - income tax deducted/collected/paid
  - income tax payable, not included in deferred tax
  - capital
  - accumulated retained profit
  - the number of permanent employees
  - the number of assets, cash and cash equivalent
2. list of the entities and their business activities by country

working papers on the information used to compile the report.

An interview between MUC Consulting Group and the Indonesian tax authorities revealed that there is a significant number of multinational companies based in Indonesia that should deliver the country-by-country report.<sup>40</sup> According to a rough estimation, there are hundreds of corporate taxpayers that are required to compile and deliver the report. This should encourage corporate taxpayers to be more transparent and show that the transactions conducted within their enterprise have followed the arm's-length principle. By doing this, the tax authority will be able to determine whether the affiliated transaction prices or profits are fair, and whether the level of tax payment is appropriate.

Furthermore, the tax authority states that the country-by-country report is applicable to entities with a parent entity located in a country/jurisdiction without a tax information sharing agreement with the Indonesian government. The Indonesian government could also request that the entity delivers the report if it is not received from a partner country that has signed the tax information sharing agreement. This is recognised as a secondary filing mechanism. If the entities that are obliged to deliver the reports fail to do so, they will be charged according to the applicable tax regulation.

Entrepreneurs appreciate the government's policy in adopting the BEPS Action Plan 13, particularly concerning the country-by-country reporting. The positive impact of this policy is that it initiates a transparency culture, and encourages monitoring of transactions more carefully according to the arm's-length principle. However, at the beginning of this policy enactment, taxpayers encountered challenges in delivering the reports, due to the lack of time between the policy announcement and the time for delivery. Moreover, the taxpayers' compliance costs increased as a result of the obligation to deliver the reports annually. Adding to the challenge, the PMK-213 regulation does not

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<sup>40</sup> Interview with MUC Consulting Group (DGT, September 2018).

state whether the transfer-pricing documentation obligation is applicable to cross-border economic activities. This means that the policy covers domestic transactions, while the transfer-pricing determination in the context of tax obligation would be more relevant if conducted by domestic taxpayers or permanent establishments with foreign country taxpayer affiliates.<sup>41</sup>

This becomes more significant for national enterprises, such as state-owned enterprises ('SOEs'), in which most entities are located within one country. These companies have a very low possibility of conducting transfer pricing merely to avoid tax. On the other hand, for an entity, particularly within a SOE, to fulfill their reporting obligations, an adjustment is required to the price determination in transfer-pricing documentation, and a special team is needed to perform various functions.<sup>42</sup> This has led to technical challenges. Cost of compliance will increase due to the unavailability of comparable data that is generally applicable and standardised, as recommended by the OECD, to fulfill the fair documentation obligation. Moreover, there is no explanation of safe harbour provisions that differentiate corporate taxpayers from the low-risk sector, which will eventually lead to an increase in material and non-material costs paid by the taxpayers, particularly the non-compliant taxpayers. Furthermore, keeping the information confidential and encouraging taxpayers to fulfill their obligations according to the policy has become another challenge for the tax authority.<sup>43</sup> A brief description below provides a case study on how China implemented transfer-pricing policy and adopted the BEPS Action Plan into their domestic policies. This could become a benchmark for the government of Indonesia to aspire to and improve their domestic policies.

#### *4 Lesson learned: Transfer-pricing regulations in China*

China is a G20 member and a member of BRICS (Brazil, Russia, India, China and South Africa), which has implemented transfer-pricing policy and adopted the BEPS Action Plan 13. From a law perspective, like Indonesia, China also committed to the civil law, where the law system is affected by various customs. From an economic perspective, China is a capital-importing country with an enormous population and a vast area.

Research conducted by Wardhana reveals that, historically, there were three transfer-pricing policy implementation stages in China. The first stage was the pilot programme, started in the 1980s, followed by transfer-pricing legislation development in the 1990s, and a very strict transfer-pricing regime in 2007. The policy development during the pilot programme era was a response to the openness of investment opportunities that occurred in 1988, where the policy was aimed to minimise the aggressive tax planning and profit shifting from China to other countries.<sup>44</sup>

At the second stage, the China State Tax Administration released a national policy, targeted to each local government's authority, to implement the transfer-pricing policy. During this stage, transfer-pricing legislation was introduced, as part of the income tax

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<sup>41</sup> Center for Indonesia Taxation Analysis, 'Transfer Pricing Public Discussion' (January 2017).

<sup>42</sup> PGN Grup (n 39).

<sup>43</sup> M Darmawan Saputra, 'Implikasi BEPS 13 Terhadap Aturan TP Doc di Indonesia' (Danny Darussalam Tax Center, 20 February 2017).

<sup>44</sup> A Wardhana, 'Legislative Reform Proposals to Address Aggressive Transfer Pricing: A Comparative Study of Indonesia and China' (Dissertation Research, Queensland University of Technology, 2017).

policy, known as the *Income Tax Law of the People's Republic of China for Enterprise with Foreign Investment and Foreign Enterprises*, which was implemented in 1991. Also during this stage, the arm's-length principle was introduced, along with how to conduct the adjustment on the transfer pricing if it did not follow the applicable policies. The transfer-pricing policy included complete guidelines and how to implement the policies by each party. Wardhana emphasised that, in this period, the transfer-pricing policy in China was sufficiently comprehensive.<sup>45</sup>

During the perfection era in 2007, the transfer-pricing policy in China adopted the adjustment of cost-sharing arrangements, thin capitalisation, controlled foreign corporations and general anti-avoidance rules. The China tax authority also provided statistical data to monitor multinational corporate business activities, profit reporting according to the regional location, types of industries, and multinational company entities that generated low income from China. Although the government of China adopted the OECD policy on transfer-pricing documentation, the government also modified the domestic policy due to their vast geographical area, the variation of the economic conditions, and the variation of the types of markets. The available comparable data was arranged to fit these conditions. China was one of the countries that had a decent transfer-pricing policy at that moment, despite the various challenges pertaining to the technical issues on transaction auditing, such as price quantification and allocation in relation to location-specific advantages.

Like Indonesia, China has also adopted the BEPS Action Plan 13 into their domestic policy, including the master file, local file and country-by-country reporting documentation policies. Ernst & Young of China published that the issues concerning the implementation of country-by-country reporting in China are around value chain analysis, location-specific advantages, and effective tax rate disclosures. However, the government of China has adjusted the criteria around the types of entities that are obliged to document their reports completely or in part, according to an examination of the purpose of each entity, as well as the contents of each report. For example, for the local file submission, the tax authority requires entities that are part of a multinational enterprise to disclose their contribution to their enterprise's global value chain. Thus, this obligation leads entities to provide information about the amount of profit attributed to the multinational enterprise, and show the China division's value creation and contribution to location-saving advantages.

In addition, the China tax authority strongly encourages China-based entities of a multinational enterprise to provide analysis and adjustment based on the creation of local intangibles and contribution to location-saving advantages to the value of the enterprise's intangibles and restructuring activities during the year. Certain entities are obliged to disclose the flow of goods and funds, and the flow in relation to value creation, and whether it contributes to initial goods design, development processes, production, marketing, delivery or after-sales services. This requirement is part of the tax authority's

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<sup>45</sup> Ibid.

efforts to guide the taxpayer to perform more transparent disclosure on cross-border transactions between related parties.<sup>46</sup>

## V CONCLUSION

Transfer pricing is a global issue that has become a concern for many countries, particularly with regards to minimising tax base erosion and avoiding profit shifting, which is commonly conducted by multinational companies. Various theories and methods to examine the practice of the arm's-length principle have been published and introduced by various institutions from academic and non-academic sectors. This represents how it affects the tax system, particularly related to the fairness of the amount of tax that should be paid by a business entity in a particular jurisdiction.

The transfer-pricing policy in Indonesia is not a new thing. Since the tax reforms in 1983, Indonesia has included this policy in its *Income Tax Law*. However, how to implement this policy in the practices of taxpayers and the tax authority remains a material discussion between stakeholders. The technical guidelines of transfer-pricing implementation in Indonesia were only published in 2010, with revisions in 2011, in response to the increased popularity of transfer-pricing practices, which were reducing the tax base in Indonesia. However, the policy was not yet developed with a strong legal basis, but only in the form of a regulation of the DGT, despite the vital function of the tax for government finances.<sup>47</sup> The Indonesian government's efforts to tackle transfer-pricing issues have been admirable, but the government still needs to improve tax regulations so that the issue attains more consideration and significance within the Indonesian tax system.

Indonesia's commitment, as a member of G20, to adopting the BEPS Action Plan 13, followed by the enactment of PMK-213 on transfer-pricing documentation reporting, should also be appreciated. However, there are still many things to consider for further improvement. What modifications are needed concerning the adoption of the BEPS Action Plan into Indonesian domestic regulations can be taken from what has been done by the government of China, such as considering other factors besides technical aspects, for instance, location savings, market premiums and the possibility of using other methods besides the common method. Should the tax authority adapt its structure and focus on the skills development of its workers, to aid in implementation of PMK-213? Should transfer-pricing documentation between affiliated taxpayers located within the same country be necessary? Should there be a space for safe harbour and low-risk transaction policies, as well as the availability of standardised comparable data prepared by the government? Should the government provide more detailed instructions on how

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<sup>46</sup> KPMG International Tax Review, *China: Looking Ahead* (Tax Reference Library 111, 6<sup>th</sup> ed, 2018) 18–23 <<https://assets.kpmg/content/dam/kpmg/cn/pdf/en/2016/12/China-Looking-Ahead-ITR-201601.pdf>>.

<sup>47</sup> The Indonesia legislation system has a hierarchy, and the higher the placement of a rule in the hierarchy, the more importance it has. The hierarchy is as follows: (i) laws and government regulations in lieu of a law; (ii) government regulations; (iii) presidential regulations; (iv) minister regulations; (v) provincial regulations; and (vi) regional/local government regulations (refers to Law No 12 2012, concerning drafting the rule or 'Pembentukan Peraturan Perundang-undangan'). The DGT regulations are only the technical implementation guidelines of the Ministry of Finance regulations. Before the release of PMK-213 in 2016, transfer pricing rules were governed only by the DGT, even though transfer pricing is one of most important issues to Indonesian government revenue sustainability.

to implement the policies in a systematic way? The availability of more comprehensive policies, under the appropriate law, will ensure enforcement for taxpayers and the tax authority. This could reduce taxpayers' compliance costs and improve compliance to transfer-pricing documentation delivery, while minimising potential disputes.

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