

Conference Paper

The Effect of Tunneling Incentive to Transfer Pricing Decision with Tax Minimization As a Moderating Variable

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Abstract

The aims of this research are to examine and to find empirical evidence about the effect of tunneling incentive to company decision of doing transfer pricing with tax minimization as a moderating variable. This study uses 145 manufacturing companies which listed in Indonesia Stock Exchange in 2012-2017 as the research population. Selection of sample in this study used purposive sampling method, and obtained 19 companies with 95 units analysis. Data analysis methods that used in this study are descriptive statistics analysis and inferential statistics analysis with absolute difference test in that moderated regression analysis. The result of this research indicates that tunneling incentive has positive and not significant effect to transfer pricing decision. Meanwhile, tax minimization significantly moderates the effect of tunneling incentive to transfer pricing. The conclusions of this research are tunneling incentive cannot determine the decision of transfer pricing in companies, then tax minimization can strengthen the relationship between tunneling incentive to transfer pricing decision.

Keywords: Transfer Pricing; Tunneling Incentive; Tax Minimization.

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1. Introduction

The company carries out tax planning in order to minimize the tax that will be paid so that after-tax profit is maximized. Tax planning will reduce the tax burden as optimally as possible to improve efficiency and competitiveness (Suandy, 2016:8). International phenomena show that currently one method of tax planning that is often used is through transfer pricing schemes by utilizing differences in tax rates between countries. In line with the results of Amidu (2019) study which proves that besides being used as a resource allocation, transfer pricing is also used as a mechanism for minimizing and avoiding international taxes. Transfer pricing is used by companies to maximize profits and minimize taxes, because taxes are considered as a burden that will reduce profits, this is reinforced by the study of Lo et al. (2010) conducted at the Shanghai Stock Exchange which states that the potential fraud from transfer pricing is used to increase

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company profits when the tax rate decreases. Hartati et al. (2014) defines transfer pricing as the price contained in each product or service from one division to another in the same company or between companies that have special relationships. Transfer pricing is allegedly an attempt to shift profits from one entity to another, so that the tax payable on the two entities involved will change. Lo et al. (2010) state that tax rates are an important reason when companies want to determine transfer pricing decisions. There are two transfer pricing categories, namely the determination of transfer prices for transactions carried out between divisions that are still in the same company or referred to intra-company transfer pricing, as well as transfer pricing between companies that have a special relationship called inter-company transfer pricing. Viewed from the area of affiliation, Inter-company transfer pricing is classified as domestic transfer pricing and international transfer pricing, where the difference is that domestic transfer pricing is carried out between companies in the same country while international transfer pricing is carried out between companies that have different state positions (Setiawan, 2014). The current phenomenon shows that due to differences in tax rates between countries, international transfer pricing is becoming a more popular mechanism to use. Companies that operating in Indonesia also seek to utilize transfer pricing scheme to divert potential taxes from Indonesia to other countries through various schemes. This phenomenon said by Mispiyanti (2015) can cause the fiscal authority in this case the Directorate General of Taxes (Direktorat Jendral Pajak) assumes that the purpose of transfer pricing is to avoid taxes. Susanti & Firmansyah (2018) also said that transfer pricing is often used in the case of shifting profits from companies in countries with higher tax rates to affiliated companies in countries with lower tax rates, so it can be concluded that from the government's view of transfer pricing it is believed will result in a reduced potential for tax revenue from a country. Regulations regarding transfer pricing have been made by the fiscal authority very comprehensively, but in reality, cases of tax violations have been found through a transfer pricing scheme. One international case is the case of Cameco Corporation (Canadian Mining and Energy Corporation), that mining company has \$ 2.2 billion tax dispute with Canadian fiscal authorities that emerged because Cameco Corp. sold uranium to a subsidiary established in Switzerland at a lower price with the aim of reducing profits in Canada (news.ddtc.co.id). Tax collection cases with transfer pricing mode also occur in Indonesia, one of which is the case of PT Adaro Energy (ADRO) which sells coal to Coaltrade Service International Pte. Ltd., at prices below market prices (kompas.com).

That selling price manipulation resulted in PT Adaro's profits being small so that the tax on sales proceeds in Indonesia was also small. Research on transfer pricing practices

that have been carried out is generally related with efforts to find factors that influence transfer pricing decision, one of the factors is tunneling incentive. However, studies that raise tunneling incentive variables as independent variables still show inconsistent results. Lo et al. (2010), Noviasatika et al. (2016), and Saraswati & Sujana (2017) prove that tunneling incentive has a positive effect on transfer pricing decision. Another case with the findings of Rosa et al. (2017) and Susanti & Firmansyah (2018) which prove that the tunneling incentive has a negative effect on transfer pricing decision. The inconsistency result of the study raises the presumption that there are factors that can strengthen or weaken the influence of the incentive tunneling variable on transfer pricing. Tax minimization was chosen as a moderating variable on the grounds that previous studies showed consistent results where tax minimization always showed a positive influence on transfer pricing. Such as the research of Hartati et al. (2015);

Nuradila & Wibowo (2018); Santosa & Suzan (2018); and Septiyani et al. (2018). The phenomenon that occurs also shows that the transfer pricing decision is inseparable from efforts to minimize taxes. This is a consideration of the use of tax minimization as a moderating variable. The purpose of this study is to analyze and find empirical evidence of the influence of tunneling incentive variables on company decisions to transfer pricing and to prove whether tax minimization can moderate the influence of tunneling incentives on transfer pricing. The originality of this research can be seen from the use of tax minimization as a moderating variable and the proxy of transfer pricing measurement using relative share of RPT, which is still not widely used by previous research. The observation period is also updated, which is from 2012 to 2017.

2. Literature Review

2.1. Agency Theory

Agency Theory is used by the author to understand the concept of tax minimization and tunneling incentive. Submission of authority from principals to agents will cause problems because of the asymmetry of information between principals as shareholders and agents as company managers (Jensen & Meckling, 1976). Conflicts arising from information mismatches, causing managers to have more information about the company than shareholders, if it is assumed that they acts for the purpose of maximizing his own interests, then the agent will tend to hide some information that is not known by principal (Septiyani et al., 2018), this is what is called the term information asymmetry. The conflict described by agency theory according to Claessens & Djankov (1999) can

also occur between majority shareholders and minority shareholders if an entity has a concentrated ownership structure, in the sense that one party has control over the company. The controlling or majority shareholder, with information that is higher than the minority shareholders, will have the ability to transfer the company's assets and profits for personal gain. Wealth will be transferred using a transfer pricing scheme so that profits will be small and minority shareholders will not receive dividends. This arises because of the different interests between the two, where the majority party wants the highest individual profit compared to the overall profit of the company. Agency Theory also explains the emergence of corporate tax minimization motives. Efforts to minimize taxes are likely to be carried out for the personal benefit of managers, where company managers try to maximize compensation through high profits, but on the other hand shareholders want to reduce tax costs through low profits. This is where the agency problem arises where the manager's interests differ with the shareholders.

2.2. Tunneling Incentive and Transfer Pricing

Research conducted by Claessens et al. (2000) show that the structure of corporate ownership in ASEAN countries including Indonesia tends to be concentrated, such ownership structures lead to the formation of controlling shareholders and minority shareholders. PSAK No. 15 states that a party can be said to be a controlling shareholder if it has shares or equity securities of 20% or more. The existence of controlling shareholders according Marfuah & Azizah (2014) also caused the emergence of agency conflicts where with the authority and information held, controlling shareholders were able to divert the company's wealth to obtain private benefits without regard to the rights of minority shareholders. Conglomerate companies are owned by majority shareholders who also own shares in other related companies, this causes tunneling activities to provide benefit to majority shareholders (Susanti & Firmansyah, 2018). Mutamimah (2009) states that tunneling incentive is a behavior of majority shareholders who transfer company assets and profits for their own benefit, but minority shareholders also bear the costs that used by majority shareholder to transferring assets and profits. Chan et al. (2016) in his research stated that tunneling was caused by the majority ownership of controlling shareholders and inadequate corporate governance. Mispiyanti (2015) states that transfer pricing transactions can be used by controlling shareholders to conduct tunneling. Tunneling is an activity of transferring company's property, tunneling practices including transactions between companies and owners through asset sales, transfer price contracts, excessive executive compensation, lending, dilutive share issuance or

other financial transactions that cause losses to non-controlling shareholders. If more and more tunneling activities are carried out, then the transfer pricing activities will also increase, so that these two determinants have a linear relationship. Tunneling incentives in this study are measured by the level of foreign ownership. Septiyani et al. (2018) states that the existence of a large foreign share- holder causes foreign shareholders to have greater control over decisions within the company and can abuse the right to control for private purposes. Through the transfer pricing mechanism, foreign controlling shareholders with their control can sell products from companies that they control to their private companies abroad at prices below the market price. Agency theory describes an asymmetrical relationship where the control- ling shareholder wants personal gain and sacrifices the rights of minority shareholders to achieve that goal. Previous studies such as Noviastrika F et al. (2016) and Saraswati & Sujana (2017) who examine tunneling incentive as a variable affecting transfer pricing provide empirical evidence that the tunneling incentive has a positive effect on transfer pricing. H1: Tunneling incentives have a significant positive effect on the decision of transfer pricing.

2.3. Tax Minimization as A Moderating Variable

Tang (2016) states that tunneling can be one of the tax avoidance incentives. Companies can save taxes by diverting profits from companies in countries that have high tax rates to countries with low tax rates. If a company has indicated tunneling practices, they will sacrifice the rights of minority shareholders by transfer pricing, this will be strengthened by the presence of tax minimization motivation. Lo et al. (2010) also found that ownership concentration in China had an effect on transfer pricing decisions, where companies were willing to make tax savings for tunneling to affiliated companies. Agency theory explains that this tax minimization occurs because of the asymmetrical information between the manager as an agent that can affect various matters relating to company performance, including company policy regarding taxes. Companies in an effort to minimize the tax burden will transfer profits to the country with a lower income tax rate through a transfer pricing scheme by manipulating the price of the transaction. This will strengthen the efforts of controlling shareholders in conducting tunneling incentive or transfer of assets and profits to affiliated companies abroad, so that it can be said that tax minimization strengthens the influence of tunneling incentive towards transfer pricing. H2: Tax minimization significantly moderates the effect of tunneling incentive on the decision of transfer pricing.

The explanation of the framework can be summarized in Figure 1 as follows:

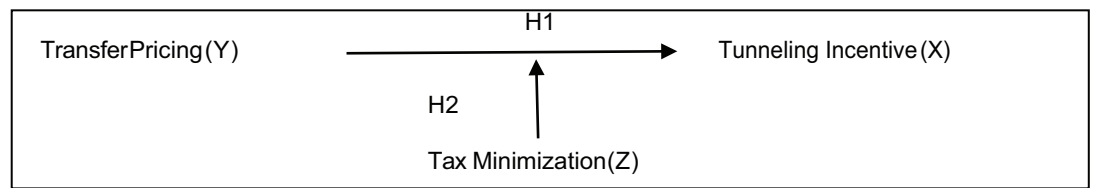


Figure 1: Model thinking frame. Source: Processed from various sources, 2019.

3. Research Methods

3.1. Type of Research, Population, and Samples

This research is a quantitative study using secondary data in the form of time series data. The population in this study are manufacturing companies listed on the Indonesia Stock Exchange in the period 2012-2017 (six years) consisting of 145 companies. Manufacturing companies were chosen as samples with the consideration that according to Santoso (2004), investors who carry out foreign investment (Penanaman Modal Asing) generally choose manufacturing companies so that they are said to have a substantial relationship with overseas companies. In addition, the research gap was found in research that using manufacturing companies on the Indonesia Stock Exchange as its object. Data sources are in the form of annual reports and financial reports, the authors obtain data by accessing it through the IDX official website (www.idx.co.id) as well as through the company's related websites. The sampling technique uses purposive sampling technique that is a sampling technique that applied when the researcher has a specific goal related to a number of populations or data sources needed (Wahyudin, 2015:126). The sampling process produced 19 companies with 95 units of analysis after deducting outlier data. The criteria and identification of research samples are explained in the Table 1.

3.2. Operational Definition and Measurement of Variables

The independent variable used in this study is tunneling incentive and then transfer pricing act as the dependent variable. Tax minimization is presented as a variable that moderates the relationship between tunneling incentives to transfer pricing. Operational definitions of variables can be seen:

Transfer pricing can be defined as the price contained in each product or service from one division to another in the same company or between companies that have a special relationship (Hartati et al., 2014). It has become an international issue that transfer pricing is one method of tax avoidance carried out by companies, especially those who

TABLE 1: Identification of Samples.

No	Criteria	Amount
1	Manufacturing company listed on the Indonesia Stock Exchange in 2012-2017	145
2	Manufacturing companies that did not delisting during 2012-2017	(3)
3	Companies with positive profit values in 2012-2017	(36)
4	The company does not receive tax benefits and non-zero tax values for the period 2012-2017	(4)
5	Companies publish Annual Report for the period 2012-2017	(0)
6	The annual report of the company is presented using Rupiah	(25)
7	Fiscal year in the annual report ends on 31 December	(0)
8	The company discloses data on foreign ownership shares and total outstanding shares in a row during the period 2012-2017	(0)
9	Companies are controlled by foreign companies with share ownership of 20% or more	(49)
10	The Company discloses the related relationships of assets and liabilities in a row during the period 2012-2017	(10)
	Number of sample companies Number of research analysis units (6 years x 19 companies)	114
	Data outliers are eliminated from the sample	(19)
	The final number of research analysis units during 2012-2017	95

Source: Secondary data processed, 2019

have affiliations. Suandy (2016:78) calls transfer pricing as a systematic manipulation of prices with the aim of reducing artificial profits, making it as if the company has suffered a loss, and avoiding taxes or duties in a country.

Related Party Transaction of Assets and Liabilities (RPTAL) = Aset RPT + Liabilitas RPT Ekuitas x 100% (Utama, 2015)

Tunneling Incentive, a behavior of majority shareholders who transfer company assets and profits for their own benefit, but minority shareholders bear the costs they charge (Mutamimah, 2009).

$$\text{Foreign Ownership} = \frac{\text{Total foreign ownership}}{\text{Total outstanding shares}} \times 100\% \text{ (Marfuah\& Azizah, 2014)}$$

Tax minimization can be interpreted as a company's strategy to reduce tax burden in terms of improving efficiency and maximizing post-tax profit. Tax minimization can be done through various schemes, such as transfer pricing, postponement of tax payments, utilization of compensation etc.

Effective Tax Rates = Total tax expenses Pretax income x 100% (Santosa & Suzan, 2018)

3.3. Data Analysis Technique

Quantitative analysis techniques are used as data analysis methods in this study. The analytical tools used in this study are descriptive statistics analysis and inferential statistics analysis using absolute difference test to test the effect of moderating variable, namely by assessing the absolute difference from the independent variable with the moderating variable. IBM SPSS Version 23 is used as a testing tool. Below is the absolute difference test regression formula used in this study:

$$\hat{Y} = \alpha + \beta_1 X_1 + \beta_3 |X_1 - Z|$$

Notes: \hat{Y} = Transfer pricing α = Constanta $\beta_1 - \beta_3$ = Regression Coefficient

X_1 = Tunneling incentive (Standardized) Z = Tax minimization $|X_1 - Z|$ = Absolute of $X_1 - Z$

4. Results and Discussion

4.1. Descriptive Statistics Analysis

The data of this study were processed and analyzed using descriptive statistics to see the smallest, largest, mean, and standard deviations for each variable, this study also used inferential statistics. Testing the two proposed hypotheses is done by moderating regression analysis of the absolute difference test method which is first through the classic assumption test. The results of testing the descriptive statistics for tunneling incentive, transfer pricing, and tax minimization variables are presented in Table 2 below:

TABLE 2: Descriptive statistics.

Variable	Minimum	Maximum	Mean	Std. Deviation
Tunneling Incentive	0,325837	0,926608	0,6317971	0,1803510
Tax Minimization	0,141880	0,459420	0,2571506	0,0494221
Transfer Pricing	0,000391	0,374586	0,1009539	0,1031521

Valid N 95 Source: Data processed, 2019

The descriptive statistical data above shows that sample companies have an average of foreign ownership for about 63.17% seen from the tunneling incentive variable, this indicates that the controlling shareholders from foreign parties are quite high. Average value (mean) of Tax minimization variable is equal to 0.25715, indicating that the average level of effective tax rate (ETR) of the sample company is 25.7% which is calculated from the ratio of current tax expense to pre-tax profit. The ETR proxy shows how much transfer pricing influences a large economic effect on corporate taxes (Klassen, 2017). The average value of transfer pricing variable with 95 units of analysis is 0.10095

which indicates that 10% of asset and liability transactions are categorized as transfer pricing transactions with related parties. Tunneling incentive and transfer pricing have a standard deviation value that is smaller than its mean value. The standard deviation value that is smaller than the average value shows that the sample is in the area of the average calculation, so it can be said that the value of each variable is quite good because the data is not heterogeneous. According to the Gauss-Markov Theorem, Ordinary Least Square research must meet the BLUE criteria, namely Best; Linear; Unbiased; and Efficient estimator. For that the regression model must go through the classic assumption test which consists of a normality test; multicollinearity test; heteroscedasticity test; and autocorrelation test. The classic assumption test results show that this research has proven normal data distribution, free from the symptoms of multicollinearity and autocorrelation, and has homogeneous data so that it can be said that this study has a proper regression model and hypothesis testing can be continued.

4.2. Hypothesis test results

Testing the hypothesis using absolute difference test shows that the tunneling incentive has no effect on transfer pricing, and then tax minimization is able to strengthen the influence of tunneling incentives on transfer pricing. The test results for the two hypotheses proposed can be explained briefly in Table 3.

TABLE 3: Hypothesis Testing Result.

No	Hypothesis	$\hat{\rho}^2$	Sig	Conclusion
1.	H1: Tunneling incentive has a positive significant effect on the ownership of transfer pricing.	-0,005 d	0,608	Rejecte
2.	H2: Tax minimization significantly moderates the effect of tunneling incentive on the decision to transfer pricing	0,0310	0,043	Accepted

Processed from varios, 2019

4.2.1. Effect of Tunneling Incentive on Transfer Pricing Decision

Foreign ownership is used as a proxy to measure tunneling incentive variables in this study with the assumption that the higher foreign ownership, the expropriation rate will also be high which leads to increased tunneling activities abroad. The results of testing indicate that the first hypothesis which states the tunneling incentive has a significant positive effect on the decision to make transfer pricing is rejected. The high

value of foreign ownership in sample companies with an average of 63.17% does not affect the company's transfer pricing decision. The non-influential cause of this variable is allegedly due to foreign ownership which tends to transfer pricing not in the form of assets and liabilities such as transfer pricing proxy in this study. In addition, it can also occur because more and more companies are carrying out the Advance Pricing Agreement process in accordance with the Law of Income Tax Article 18 paragraph 3a, so that companies are more careful in carrying out foreign transactions even if they have child-parent relations. Chan et al. (2016) states that tunneling is caused by the majority ownership of controlling shareholders and poor corporate governance, the insignificance of tunneling incentive can also occur due to the implementation of good corporate governance. The results of this study contradict the implications of agency theory which states that the discretion/expropriation efforts that can be carried out by controlling shareholders is through transfer pricing in an effort to transfer the company's wealth. The results of the research which indicate that the tunneling incentive is not influential on transfer pricing supports the research of Rosa et al. (2018) which states that the tunneling incentive has a negative effect on transfer pricing. This study does not support the results of the research by Noviasatika F et al. (2016) and Saraswati & Sujana (2017) which state that tunneling incentives have a significant positive effect on the company's decision to transfer pricing. The difference with the results of previous studies is likely to occur due to differences in years of observation, as well as differences in proxy transfer pricing, where previous studies still use proxy dichotomy.

4.2.2. Tax Minimization Moderates the Effects of Tunneling Incentive on Transfer Pricing

The result of absolute difference test shows that the second hypothesis which states tax minimization significantly moderates the effect of tunneling incentive on the decision to conduct transfer pricing is accepted. Transfer pricing is often associated with the practice of corporate tax minimization. This study proves that efforts to transfer assets and profits to foreign countries with a transfer pricing mechanism will be stronger if the company also has a tax minimization motive by diverting profits to countries with lower tax rates. The company can make tax savings by transferring company profits in Indonesia to foreign companies that have ownership of the company in Indonesia. Agency theory supports the results of this study where the effort to minimize taxes with ETR is an agency problem for differences of interests among parties, in this case according to Yuniasih et al. (2012) is the difference of interests between majority shareholders and minority

shareholders, one side of the company wants a small tax by transferring wealth through transfer pricing that strengthens the purpose of majority shareholders to tunneling incentive and transfer wealth through transfer pricing for their own benefit, on the side other, the transfer of wealth and minimization of profits makes minority shareholders not receive dividends.

5. Conclusion

Tunneling incentives do not significantly influence the company's transfer pricing decisions. This research indicates that tax minimization is able to significantly moderate the influence of tunneling incentives on transfer pricing variables. Suggestions for further research include to include other non-tax factors which are indicated to be able to influence transfer pricing. The measurement of tunneling incentive with the proxy percentage of foreign ownership has not been sufficiently representative describing the intensity of the transfer of wealth to the majority shareholders so that further research is expected to use a more representative tunneling incentive proxy such as the number of sales contracts with affiliated parties. Future studies are expected not only to measure transfer pricing with RPT assets and liabilities but also with RPT sales and expense, and are expected to take samples in the year after the enactment of PMK Number 213 / PMK / 03 of 2016 about the types of documents and additional information that must be kept by mandatory taxes that make transactions with parties that have special relationships.

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