Conference Paper

Arm's Length Principle Analysis on Tax Avoidance through Transfer Pricing Post-Pandemic (Covid-19): A Proposed Study

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Abstract.
The Covid-19 pandemic has forced society to adapt to technological advancement and decision-making behavior in corporate management. In response, companies implemented transfer pricing strategy to ease the tax burden in order to optimize expenditure efficiency and maximize profitability. Besides its commonality among multinational companies, researchers observed that transfer pricing had been utilized significantly between related domestic companies, which may bring potential loss of state tax revenue. On the other hand, in principle, transfer pricing is legal and tax-wise permitable as long as it applies the arm's length principle. This research was conducted in the form of case study with the objective to analyze the application of arm's length principle on tax avoidance activity through transfer pricing between domestic companies by exploring its theoretical model. The analysis comprises five methods, namely the price comparison method between independent parties, the resale price method, the cost-plus method, the profit-sharing method, and the transactional net profit method. The evaluation of a company's arm's length principle can be utilized as a basis for recommendation, both for related companies to optimize tax planning and for policymakers to mitigate the risk of losing state revenue. This study is imperative in understanding post-Covid-19 impact on corporations as a mean of adaptation and going concern– specifically on how transfer pricing among specially-related domestic companies have become a cost-cutting effort. This study is expected to bring guidance for the following researches and contribution for government in overcoming the potential rise of domestic transfer pricing postpandemic.

Keywords: arm's length principle, domestic company, transfer pricing, tax avoidance

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1. Introduction

The phenomenon of globalization in today's business world indirectly encourages the outbreak of conglomeration and divisionalization / departmentation of companies. Globalization has had an impact on the increasing number of *transnational transactions or cross-border transactions*. With this conglomerate business, we know various names

of well-known group companies that penetrate the business world nationally, regionally and internationally (*multinational corporations*). Subsequently these companies formed holding companies to coordinate their business. In such enterprises, usually most of the business activities take place among themselves. In determining prices, rewards, and so on between them are usually determined based on the *transfer pricing* policy determined by the *holding company* which can be the same or not the same as the market price [1].

This transfer pricing practice used to be only carried out by companies solely to assess performance between members or divisions of the company, but along with the times, the practice of *transfer pricing* was also used to minimize the amount of tax that must be paid [2].

Currently, many multinational companies are doing *transfer pricing* in order to get around tax obligations. The purpose of writing this article is to try to explain aspects of *transfer* pricing in terms of accounting and taxation angles as well as the problems of *tax avoidance* practices and frauds that are rampant due to unreasonable *transfer pricing* practices.

1.1. Formulation of Research Problems

Based on the background description, the problems in this study are as follows:

1. What is the meaning of *transfer pricing* and its risks to state revenue?
2. What is the form of *transfer pricing* in Indonesian Tax Regulations?
3. How to mitigate and minimize the risk of loss of state revenue from *abuse of transfer pricing* practices?

1.2. Research Objectives

1. To analyze a form of *transfer pricing* and its risks to state revenues.
2. To explain *transfer pricing* in Indonesian Tax Regulations.
3. To explain the form of mitigation and how to minimize the risk of loss of state revenue from the practice of *abuse of transfer pricing*.

1.3. Research Contributions

1.3.1. For companies

1. Optimizing tax planning, especially those related to tax avoidance.
2. Contribute to the evaluation of domestic *transfer pricing* actions, so that there is certainty about their fairness.

1.3.2. For policymakers:

1. As an evaluation material for tax regulations that make room for tax avoidance.
2. As a means of mitigating the risk of losing potential state revenue.

2. Theoretical Review

2.1. Tax Planning Theory

Basically, taxes are a cost that must be incurred by the community. Therefore, people tend to do various ways to avoid these costs. This gave rise to a theory, namely the theory of tax planning. According to Hoffman [3], tax planning can be defined as the ability of a taxpayer to organize his financial activities in such a way as to minimize the tax costs that must be incurred.

This tax loophole creates problems for tax authorities because with tax planning, the amount of tax owed by taxpayers will be smaller and cause potential taxes to be lost.

2.2. Definition of Transfer Pricing

In tax laws and regulations in Indonesia, the term *transfer pricing* is contained in:

1. Regulation of the Director General of Taxes Number PER-32 / PJ / 2011 concerning amendments to the Regulation of the Director General of Taxes Number PER-43 / PJ / 2010 concerning the Application of the Principles of Fairness and Normality of Business in Transactions Between Taxpayers and Parties Who Have a Special Relationship.
2. Regulation of the Director General of Taxes Number PER-69 / PJ / 2010 concerning Transfer Price Agreement *(Advance Pricing Agreement).*
3. Regulation of the Minister of Finance Number 7 / PMK.03 / 2015 concerning Procedures for the Formation and Implementation of the *Advance Pricing Agreement*.

In these regulations, the definition (*transfer pricing*) is the determination of prices in transactions between parties who have a Special Relationship.

2.3. Purpose of Transfer Pricing

The purpose of transfer pricing is first to circumvent the amount of profit so that tax payments and dividend distribution are low. Second, inflating profits to polish (window-dressing) financial statements . The country is at a disadvantage of trillions of rupiah due to the company's *transfer pricing* practices

2.4. Transfer Pricing Determination Method

Methods in determining *transfer pricing* include:

2.4.1. Traditional methods

1. Comparable Uncontrolled Price Method (CUPM)

The comparable *uncontrolled* price method or CUPM for short is a method of determining the transfer price carried out by comparing the price in a transaction carried out between parties who have a special relationship with the price in a transaction carried out between parties who do not have a special relationship under comparable conditions or circumstances.

1. Cost-Plus Method (CPM)

   The fair market price is determined by adding the same level of fair gross profit obtained from transactions with parties who do not have a special relationship or the level of fair gross profit obtained by other companies from transactions comparable to parties who do not have a special relationship to the cost of goods sold that are in accordance with the principles of fairness and normality of business.

2. Resale Price Method (RPM)

   The resale price method or RPM for short is a method of determining the transfer price carried out by comparing the price in a product transaction carried out between parties who have a special relationship with the resale price of the product after deducting fair gross profit, which reflects the function, assets and risks, for the resale of the product to another party who does not have a special relationship or *resale* products that are carried out under reasonable conditions.

2.4.2. Transactional Profit Method

1. Profit Split

   This method is used when the comparison data is not complete enough. The profit from transactions between parties who have a special relationship can be known by conducting a function analysis of the business activities carried out.

2. Transactional Net Margin Method (TNMM)

   This method is also used if the comparison data is not complete enough. Comparing net profit with Cost of Goods Sold (COGS). Sales or assets used to generate such net profit, after which the net profit on transactions between parties who have a special relationship.

2.4.3. Other Methods

The OECD Guidelines do not allow other methods of determining fair market prices because they do not reflect the actual fair market price. This method consists of a global split method and also a formulary apportionment method.

2.5. Affiliation or Special Relationship

In Article 18 paragraph (4) of the Income Tax Law, it is stated that the special relationship as referred to in paragraphs (3) to paragraphs (3d), Article 9 paragraph (1) point f, and Article 10 paragraph (1) is considered to exist if:

1. Taxpayers have direct or indirect capital participation of at least 25% (twenty-five percent) in other taxpayers; the relationship between taxpayers and participation of at least 25% (twenty-five percent) in two or more taxpayers; or the relationship between two or more taxpayers referred to last;

2. The Taxpayer controls another Taxpayer or two or more Taxpayers are under the same control either directly or indirectly; or

3. There are family relationships both inbred and cemented in a straight lineage and/or sideways one degree.

2.6. Arm's Length Principle

According to Nurhayati [4], transactions that occur between companies that have a special relationship often use unreasonable prices. Companies that have a privileged relationship can determine the transaction price that is considered the most profitable for the company and often the price does not match the market price. Transaction prices that do not match the market price can be detrimental to the tax authorities because there is a potential for lost taxes. This prompted the emergence of a principle called *the arm's length principle*.

To prevent tax avoidance due to *non-arm's length price*, the Director General of Taxes establishes guidelines for determining transfer prices in Indonesia which are regulated in the Regulation of the Director General of Taxes Number PER-43 / PJ / 2010 as amended by Regulation of the Director General of Taxes Number PER-32 / PJ / 2011. This rule discusses the application of *arm's length principles* related to transactions between taxpayers and parties who have a special relationship. This rule requires taxpayers to use fair market value in transacting with related parties [5].

3. Conclusions and Discussions

There is a large potential for tax revenue to be lost due to the negative practice of transfer pricing. To overcome the practice of tax enforcement or the practice of shrinking the value of taxes in transfer pricing, certainty is needed in the application of the Principles of Fairness and Business Normality for fiscus and taxpayers.

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