

TRANSFER PRICING AND TAXATION DISPUTE RESOLUTION

Machfud Sidik

Sekolah Tinggi Perpajakan Indonesia, Jakarta, Indonesia

Abstract

Peranan MNE dalam perdagangan dunia makin meningkat secara drastis dari waktu ke waktu. Sengketa pajak khususnya terkait transfer pricing antara otoritas pajak dan MNEs menjadi issue internasional. Solusi sengketa ini memerlukan keseimbangan kepentingan antara MNEs dan otoritas pajak. Pertumbuhan MNEs menyajikan masalah perpajakan yang semakin kompleks baik bagi otoritas pajak maupun MNEs itu sendiri karena ketentuan perpajakan antar negara bervariasi. Isu-isu ini muncul terutama dari kesulitan praktis, baik bagi MNEs dan otoritas pajak, dalam menentukan penghasilan dan pengeluaran perusahaan atau bentuk usaha tetap yang merupakan bagian dari grup MNE yang harus diperhitungkan dalam yurisdiksi masing-masing negara, terutama kegiatan group MNE yang terintegrasi. Transfer pricing, untuk tujuan pajak, adalah harga transaksi antar perusahaan yang terjadi antara bisnis afiliasi. Proses transfer pricing menentukan jumlah penghasilan yang diperoleh masing-masing pihak dari transaksi tersebut. Wajib pajak dan otoritas perpajakan fokus secara eksklusif pada transaksi pihak terkait, yang disebut transaksi terkendali, dan tidak berdampak langsung pada transaksi pihak independen, yang disebut transaksi tidak terkendali. Transaksi, dalam konteks ini, ditentukan secara luas, dan mencakup penjualan, lisensi, leasing, layanan, dan bunga. Otoritas pajak perlu memusatkan perhatian yang lebih besar pada instrumen keuangan perdagangan global oleh kelompok MNEs. Indonesia telah memformulasikan ketentuan terkait transfer pricing sejak 1984 ketika digulirkannya reformasi perpajakan yang pertama. Namun pedoman teknis untuk menilai pemenuhan prinsip arm's length yang akan dilaksanakan oleh pemeriksa pajak baru dirumuskan pada tahun 2010 dan diberlakukan secara efektif pada tahun 2011 dan periode berikutnya terakhir melalui UU No 11/2020 dan RUU KUP 2021. Terdapat berbagai tantangan dalam pengimplementasian ketentuan transfer pricing yang ada saat ini, terutama terkait atas pembayaran penggunaan intangible, pembatasan pembayaran (bunga debt-to-equity ratio), pembayaran intragroup services yang pada dasarnya sudah diatur dalam ketentuan teknis transfer pricing dan pemeriksaan terkait harga jual dan harga beli atas intra-group trading pada dasarnya telah diatur dalam ketentuan domestik Indonesia. Selain itu, dalam pengujian transfer pricing, terdapat sengketa yang cukup besar yang diakibatkan oleh permasalahan teknis seperti (i) pemilihan metode pengujian transfer pricing (ii) pemilihan data pembanding (iii) proses audit yang tidak tepat. Seiring dengan berkembangnya lembaga keuangan lintas batas, kekhawatiran mengenai transfer pricing dan BEPS diperkirakan akan meningkat. Oleh karena itu sangat penting bahwa otoritas perpajakan Indonesia untuk memprioritaskan perekrutan personel terampil untuk mengatasi kompleksitas yang ditimbulkan oleh perdagangan global instrumen keuangan oleh kelompok MNE.

Keywords: transfer pricing, dispute resolution, arm's length transaction, OECD model, BEPs, CFC.

I. Background of The Study

The role of multinational enterprises (MNEs) in world trade has continued to increase dramatically over time. This in part reflects the increased pace of integration of national economies and technological progress, particularly in the area of communications. The growth of MNEs presents increasingly complex taxation issues for both tax administrations and the MNEs themselves since separate country rules for the taxation of MNEs cannot be viewed in isolation but must be addressed in a broad international context. These issues arise primarily from the practical difficulty, for both MNEs and tax administrations, of determining the income and expenses of a company or a permanent establishment that is part of an MNE group that should be taken into account within a jurisdiction, particularly where the MNE group's operations are highly integrated.

Transfer pricing, for tax purposes, is the pricing of intercompany transactions that take place between affiliated businesses. The transfer pricing process determines the amount of income that each party earns from that transaction. Taxpayers and the taxing authorities focus exclusively on related-party transactions, which are termed controlled transactions, and have no direct impact on independent-party transactions, which are termed uncontrolled transactions. Transactions, in this context, are determined broadly, and include sales, licensing, leasing, services, and interest.

Transfer-pricing disputes between tax authorities and multinational enterprises (MNEs) are the most important issue in international taxation today. Their resolution requires a balancing of the respective interests of both parties. The intensity of transfer pricing disputes continues to escalate on the back of rapidly evolving transfer pricing reform, public scrutiny of multinational enterprises (MNEs), and access to greater resources by revenue authorities globally to enforce what has become an increasingly political issue. On the one hand, tax authorities seek to subject MNEs to an appropriate level of taxation on their global income and to achieve an appropriate allocation of that income among the jurisdictions involved. On the other hand, MNEs wish to conduct their activities and preserve their role as the major driving force in the world economy without being subjected to double taxation. They expect to be able to operate within a world tax structure that offers them a reasonable degree of certainty coupled with uniform and equitable results. Transfer Pricing and Dispute Resolution addresses the complexity, valuation and administrative nuances, and cultural impacts of resolving this significant cross-border issue when tax disputes arise. Authorities worldwide increasingly consider transfer pricing as an area to focus on. As a result, tax authorities are increasing the resources that they can bring to bear on transfer pricing issues, and are improving their knowledge in this area. According to a global transfer pricing survey, the majority of tax authorities focus on the following aspects of transfer pricing: transactions with perceived tax havens and blacklisted countries, service transactions, financial transactions and intangibles. On the other hand, in the current economic climate, taxpayers are faced with reduced profits or losses and have decreased budget and resources to meet tax requirements. As a consequence of this increasing focus on transfer pricing and the current economic climate, taxpayers have been more likely to be the subject of tax audits. Events mentioned by authorities as the most common reasons for launching an audit are

a sudden reduction in taxable profits and business restructuring and indirect tax challenges.

The world's major tax systems, which apply to MNEs, have generally united under the umbrella of the arm's-length principle as the main substantive standard applicable to transfer pricing. However, important differences exist between jurisdictions regarding the specific methods that should be used to determine acceptable transfer prices for transactions within MNE groups. The mutual agreement procedure should include one or more of the following techniques, according to the preferences of the treaty parties. At the first level, the competent authorities and domestic tax administrations would encourage taxpayers to conclude APAs in order to resolve transfer-pricing issues in advance and on a case-by-case basis. At the second level, the SEP should be specifically included in treaties in order to facilitate information sharing between collaborating tax authorities, and specifically the exchange of audit information pertaining to MNEs. At the third level, agreement on some limited safe harbours within the arm's-length norm is desirable. At the fourth level, all treaties should include recourse to compulsory and binding arbitration, subject to the taxpayer's consent, to eliminate double taxation when the competent authorities cannot reach agreement in a given case. Such recourse should be used after a defined period from the time the case was referred to the competent authorities. In some jurisdictions advance pricing arrangements (APAs) and mutual agreement procedures (MAP) can provide an alternative means of preemptively preventing or resolving a dispute. MAP can provide a balanced perspective with input from a counterparty jurisdiction that can give rise to satisfactory outcomes on a multilateral basis.

Transfer prices are significant for both taxpayers and tax administrations because they determine in large part the income and expenses, and therefore taxable profits, of associated enterprises in different tax jurisdictions. Transfer pricing issues originally arose in transactions between associated enterprises operating within the same tax jurisdiction. It is further proposed that the OECD (Organization for Economic Co-operation and Development) model for binational tax treaties should be amended to include a compulsory and binding arbitration mechanism. The other noted mechanisms could be recommended or mentioned in the commentary on the OECD model. The main issues in the international tax area have been, basically how the global income of MNE groups should be allocated, what is the proper standard (norm) to be applied; and how this allocation process can be coordinated within the frameworks of national policies and domestic laws of the various participating countries to the satisfaction of all concerned. The overriding concern is how to protect national revenues and at the same time accommodate the needs of MNEs themselves, so that they can continue to operate at optimal capability without being subjected to double, or even multiple, taxation on their global income. It follows that, in order to meet these objectives, there is a need for a worldwide consensus as to the proper yardstick or standard of allocation to be applied on the national level, and for an agreement among world tax authorities to resolve problems according to international tax law norms, while tendering simultaneous protection to the needs of national tax administrations and MNE groups.

It is admitted at the outset that the issues in this area are among the most complex in the taxation field, primarily because of the wide range of subjects involved. Of particular difficulty is the issue of transfer pricing—how to determine a fair price, for tax purposes, for transactions between associated (or related) enterprises located in different tax jurisdictions. Analysis of this issue and the development of appropriate solutions call for special economic, tax, and legal expertise. It is necessary, for example, to collect a large body of reliable data, which indeed may not be readily available; to bring to the analysis a deep understanding of the economic factors associated with intercompany transactions; and to possess a similar understanding of MNEs generally and of the particular industry under consideration. Added to these requirements is the need for detailed knowledge of the tax legislation of the various countries in which the particular MNE group operates. The need for a better solution to transfer-pricing disputes between MNEs and national tax authorities is manifest. The significance of MNE intragroup transactions in the world economy today is suggested by the fact that approximately one third of the world trade of goods is within MNE groups, and such trade has been growing at a relatively rapid pace in recent decades. It is clear that substantial tax revenues are at stake in the absence of adequate transfer-pricing controls. It is acknowledged that, at least until recently, many tax authorities have generally failed to cope adequately with MNEs, and particularly with foreign-based MNE groups, which are considered by many tax authorities to have drastically underpaid their fair share of the respective countries' taxes owed.

II. The International Norm

There are two basic approaches for resolving such questions as proper transfer pricing or division of MNE group income among the participating tax jurisdictions. One is the direct or formulaary apportionment approach, which attempts to define and determine the global income of the MNE group and then adopts the proper formula based on economic parameters for the just division of its income among the participating jurisdictions. This approach ignores the distinct economic or legal entities that constitute the MNE group, instead treating the group as one economic entity. The second approach is the indirect or transactional approach. Under this approach, each national MNE is recognized as an independent economic entity, but not necessarily a distinct legal entity, which is a part of the global MNE group. The MNE could therefore be an independent and distinct legal entity under domestic law (for example, a corporate body such as a corporation under US corporation law or a company under UK company law), or it could be a local branch of a foreign corporation, which, for tax purposes, is regarded as a separate entity. A local branch of a foreign corporation with substantial domestic activities is usually considered a permanent establishment (PE) under the bilateral tax treaties and is taxed locally as if it were an independent legal entity. Under the transactional approach, a price must be attached to every transaction between MNEs located in different tax jurisdictions. Therefore, each transaction within the MNE group across national borders is usually subject to domestic taxation. Major progress in the area of international taxation has been made by the OECD and its predecessor, the OECD. Both organizations promoted the concept of bilateral tax treaties, negotiated between

two countries, for the purpose of avoiding international double taxation and preventing inter- national tax avoidance. Many countries now have in place tax treaties that generally follow the OECD model.

With respect to the taxation of MNEs, the OECD has subscribed to the transactional separate-entity approach, respecting the independence of each MNE whether it is incorporated as an independent legal entity or not. This position is reflected in article 9 of the OECD model, which sets out the arm's-length standard, and in article 7, which addresses the taxation of PEs such as branches, although the latter article also permits the use of a formulary apportionment approach in certain circumstances. Under article 7, if an MNE did not establish itself in a host country as a separate legal entity and operated as a PE under the OECD model, it would deal with its foreign-based headquarters, pursuant to article 7(2), as though two independent entities were involved. The PE would then be entitled, under article 7(3), to deduct its business expenses as though it were a separate legal entity.

The OECD model recognizes that many countries treat the foreign branch and its headquarters as a single entity, which they legally are. Accordingly, article 7(4) provides that the income of the PE may be attributed on the basis of a formulary apportionment method where it is customary for the two countries involved to apply such a method. This exception is not allowed when the entities are related, under article 9, which is the general article that applies to most intercorporate transactions of MNE groups. Even in the exception for PEs, the OECD model emphasizes that final results must conform to the separate-entity test and provides that "the results shall be in accordance with the principles contained in the Article." What are the standards or criteria to be applied under the separate- entity approach? It has been well established by international agreements that it is the so-called arm's-length standard that should apply; namely, each transaction between the associated enterprises of the MNE or the MNE group should be priced as it would be if it were carried out by unrelated entities. The arm's-length standard was adopted in the first major study of transfer prices and MNEs by the OECD in 2017 of the OECD models, Article 9 provides:

[Where] conditions are made or imposed between the two [associated] enterprises in their commercial or financial relations which differ from those which would be made between 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 profits of that enterprise and taxed accordingly.

By seeking to adjust profits by reference to the conditions which would have obtained between independent enterprises in comparable transactions and comparable circumstances (i.e., in "comparable uncontrolled transactions"), the arm's length principle follows the approach of treating the members of an MNE group as operating as separate entities rather than as inseparable parts of a single unified business. There are several reasons why OECD member countries and other countries have adopted the arm's length principle. A major reason is that the arm's length principle provides broad parity of tax treatment for members of MNE groups and independent enterprises. Because the arm's length principle puts associated and independent enterprises

on a more equal footing for tax purposes, it avoids the creation of tax advantages or disadvantages that would otherwise distort the relative competitive positions of either type of entity. In so removing these tax considerations from economic decisions, the arm's length principle promotes the growth of international trade and investment.

III. Arm's length principle

The international standard that OECD member countries have agreed should be used for determining transfer prices for tax purposes. It is set forth in Article 9 of the OECD Model Tax Convention as follows: where "conditions are made or imposed between the two enterprises in their commercial or financial relations which differ from those which would be made between 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 profits of that enterprise and taxed accordingly".

When independent enterprises transact with each other, the conditions of their commercial and financial relations (e.g. the price of goods transferred or services provided and the conditions of the transfer or provision) ordinarily are determined by market forces. When associated enterprises transact with each other, their commercial and financial relations may not be directly affected by external market forces in the same way, although associated enterprises often seek to replicate the dynamics of market forces in their transactions with each other.

The arm's-length standard (A L S) has also been endorsed by the UN model treaty between developed and developing countries. The arm's length principle is the pricing principle needed to be applied within intragroup transactions. The arm's length principle means that the same pricing and conditions should be applied as if the transaction would be between independent non-associated parties. The tax authorities' viewpoint on the arm's length principle is that the taxable income is accumulated and accounted within the country where the taxable income is generated. For taxation purposes the pricing methods applied needs to be internationally approved where the pricing and terms and conditions are equivalent to non-related companies. What is the ALS, and why did the Treasury seek to defend it in these terms? The problem for which the ALS attempts to provide the solution may be illustrated by a simple example. Suppose that a product (e.g., computers) is manufactured by a corporation in country A, and then sold to a wholly-owned subsidiary of the manufacturer in country B, which proceeds to resell it to unrelated customers. In this common situation, the taxable profit of the subsidiary is determined by three factors: (i) the price at which it resells the computers to the unrelated customers, (ii) its expenses other than cost of goods sold, and (iii) the price which it pays its parent corporation for the computers. The first two of these factors are governed by market forces outside the control of the parent or the subsidiary. However, because the parent controls the subsidiary, the third factor (the price for which the manufacturer sells the computers to the reseller, or the 'transfer price') is wholly within the control of the related parties. Accordingly, the potential for abuse arises because the related parties will seek to increase after-tax profits by manipulating the transfer price. If the effective tax rate in the manufacturer's country is higher, the price will be set as low as possible so as to channel all taxable profit to the reseller.

Conversely, if the effective tax rate in the reseller's jurisdiction is higher, the transfer price will be as high as possible, so as to eliminate any taxable profit of the reseller and concentrate the entire profit in the hands of the manufacturer. But for tax considerations, the affiliated parties do not care what the transfer price is, since it merely reallocates profits within the affiliated group. Given these facts, it is understandable that transfer pricing manipulation is one of the most common techniques of tax avoidance. This is especially true in the international sphere, as there are great differences in effective tax rates among jurisdictions. Indeed, some economists have argued that the ability to manipulate transfer prices is a major reason for the existence of multinational enterprises (MNEs), which are groups of affiliated corporations operating in more than one country. It is estimated that trading among such affiliates encompasses about one-third of world manufacturing trade, and that percentage is constantly increasing. The transfer pricing problem is, therefore, one of the major international tax policy challenges for the coming century. The ALS, as traditionally conceived, responds to the transfer pricing problem by seeking to determine whether transactions between related taxpayers reflect their 'true' tax liability by comparing them to similar transactions between unrelated taxpayers dealing at arm's length. The ALS, as traditionally conceived, responds to the transfer pricing problem by seeking to determine whether transactions between related taxpayers reflect their 'true' tax liability by comparing them to similar transactions between unrelated taxpayers dealing at arm's length.

The arm's length principle has also been found to work effectively in the vast majority of cases. For example, there are many cases involving the purchase and sale of commodities and the lending of money where an arm's length price may readily be found in a comparable transaction undertaken by comparable independent enterprises under comparable circumstances. There are also many cases where a relevant comparison of transactions can be made at the level of financial indicators such as mark-up on costs, gross margin, or net profit indicators. Nevertheless, there are some significant cases in which the arm's length principle is difficult and complicated to apply, for example, in MNE groups dealing in the integrated production of highly specialized goods, in unique intangibles, and/or in the provision of specialized services. The pricing and terms and conditions within an intragroup is usually made centrally within the corporation. Transactions within an intragroup need to apply to similar market conditions that would be applied for transactions between independent parties. OECD member countries continue to endorse the arm's length principle as embodied in the OECD Model Tax Convention (and in the bilateral conventions that legally bind treaty partners in this respect) and in the 1979 Report. These Guidelines focus on the application of the arm's length principle to evaluate the transfer pricing of associated enterprises. The Guidelines are intended to help tax administrations (of both OECD member countries and non-member countries) and MNEs by indicating ways to find mutually satisfactory solutions to transfer pricing cases, thereby minimizing conflict among tax administrations and between tax administrations and MNEs and avoiding costly litigation. The Guidelines analyze the methods for evaluating whether the conditions of commercial and financial relations within an MNE satisfy the arm's length principle and discuss the practical application of those methods. They also include a discussion of global formulary apportionment.

For guidance and interpretation of the arm's length principle, OECD transfer pricing guidelines is recommended to be used as reference. The OECD transfer pricing guidelines are internationally accepted and an important interpretation source for the application of the arm's length principle. In addition to the OECD transfer pricing guidelines the intragroup need to take into account the national legislation for the different countries where the intragroup companies are registered. Tax authorities can reassess income tax and make income tax adjustments for companies where there is a deviation in applying the arm's length principle. Income tax adjustments will be made as if the arm's length principle would have been applied. OECD have instructions of how the transfer pricing documentation should be outlined. The OECD transfer pricing instructions include different methods available of pricing the intragroup transactions and comparing that the transfer price is according to arm's length principle.

In seeking to achieve the balance between the interests of taxpayers and tax administrators in a way that is fair to all parties, it is necessary to consider all aspects of the system that are relevant in a transfer pricing case. One such aspect is the allocation of the burden of proof. In most jurisdictions, the tax administration bears the burden of proof, which may require the tax administration to make a prima facie showing that the taxpayer's pricing is inconsistent with the arm's length principle. It should be noted, however, that even in such a case a tax administration might still reasonably oblige the taxpayer to produce its records to enable the tax administration to undertake its examination of the controlled transactions. In other jurisdictions the taxpayer may bear the burden of proof in some respects. Some OECD member countries are of the view that Article 9 of the OECD Model Tax Convention establishes burden of proof rules in transfer pricing cases which override any contrary domestic provisions. Other countries, however, consider that Article 9 does not establish burden of proof rules (cf. paragraph 4 of the Commentary on Article 9 of the OECD Model Tax Convention). Regardless of which party bears the burden of proof, an assessment of the fairness of the allocation of the burden of proof would have to be made in view of the other features of the jurisdiction's tax system that have a bearing on the overall administration of transfer pricing rules, including the resolution of disputes.

OECD guidelines is an attempt to provide worldwide consensus of pricing of intragroup transactions internationally. OECD guidelines wants to ensure that the intragroup companies are not using transfer prices for the purpose of manipulating taxation. Multinational companies act aggressively to minimize global taxes and aggressive tax planning needs to be replaced with firmer rules. OECD has defined five pricing methods that can be used to apply the arm's length principle. The transfer pricing methods are comparable uncontrolled price method (CUP), resale price method, cost plus method, transactional net margin method (TNMM) and transactional profit split method. The transfer pricing methods by OECD are divided into traditional transaction methods and transactional profits methods. The traditional transaction methods are comparable uncontrolled price method, resale price method and cost plus method. Transactional profits methods are transactional net margin method and transactional profit split method. When choosing the transfer pricing method for the intragroup transaction the best suitable method for the situation should be chosen. The prioritized method is the comparable uncontrolled price method and recommendations are to choose a traditional transaction method instead of a transactional profit method. The transfer

pricing method chosen is affected by the companies within the intragroup transaction and the functions and risks related to the transaction. When choosing the transfer pricing method, the intragroup need to analyze the strengths and weaknesses of the different transfer pricing methods and what information is available for comparability and how reliable the information is. The five transfer pricing methods given in the OECD transfer pricing guidelines are not required to be used as long as the intragroup is applying a pricing method that is according to the arm's length principle and the method selected is justified in the transfer pricing documentation.

While recognizing the foregoing considerations, the view of OECD member countries continues to be that the arm's length principle should govern the evaluation of transfer prices among associated enterprises. The arm's length principle is sound in theory since it provides the closest approximation of the workings of the open market in cases where property (such as goods, other types of tangible assets, or intangible assets) is transferred or services are rendered between associated enterprises. While it may not always be straightforward to apply in practice, it does generally produce appropriate levels of income between members of MNE groups, acceptable to tax administrations. This reflects the economic realities of the controlled taxpayer's particular facts and circumstances and adopts as a benchmark the normal operation of the market.

A practical difficulty in applying the arm's length principle is that associated enterprises may engage in transactions that independent enterprises would not undertake. Such transactions may not necessarily be motivated by tax avoidance but may occur because in transacting business with each other, members of an MNE group face different commercial circumstances than would independent enterprises. Where independent enterprises seldom undertake transactions of the type entered into by associated enterprises, the arm's length principle is difficult to apply because there is little or no direct evidence of what conditions would have been established by independent enterprises. The mere fact that a transaction may not be found between independent parties does not of itself mean that it is not arm's length.

While recognizing the foregoing considerations, the view of OECD member countries continues to be that the arm's length principle should govern the evaluation of transfer prices among associated enterprises. The arm's length principle is sound in theory since it provides the closest approximation of the workings of the open market in cases where property (such as goods, other types of tangible assets, or intangible assets) is transferred or services are rendered between associated enterprises. While it may not always be straightforward to apply in practice, it does generally produce appropriate levels of income between members of MNE groups, acceptable to tax administrations. This reflects the economic realities of the controlled taxpayer's particular facts and circumstances and adopts as a benchmark the normal operation of the market.

IV. The OECD Model Tax Convention

The authoritative statement of the arm's length principle is found in paragraph 1 of Article 9 of the OECD Model Tax Convention, which forms the basis of bilateral tax treaties involving OECD member countries and an increasing number of non-member countries. Article 9 provides:[Where] conditions are made or imposed between the two [associated] enterprises in their commercial or financial relations which differ from

those which would be made between 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 profits of that enterprise and taxed accordingly.

Traditional transaction methods are regarded as the most direct means of establishing whether conditions in the commercial and financial relations between associated enterprises are arm's length. This is because any difference in the price of a controlled transaction from the price in a comparable uncontrolled transaction can normally be traced directly to the commercial and financial relations made or imposed between the enterprises, and the arm's length conditions can be established by directly substituting the price in the comparable uncontrolled transaction for the price of the controlled transaction. As a result, where, taking account of the criteria, a traditional transaction method and a transactional profit method can be applied in an equally reliable manner, the traditional transaction method is preferable to the transactional profit method. Moreover, where, taking account of the criteria, the comparable uncontrolled price method (CUP) and another transfer pricing method can be applied in an equally reliable manner, the CUP method is to be preferred. A range of figures that are acceptable for establishing whether the conditions of a controlled transaction are arm's length and that are derived either from applying the same transfer pricing method to multiple comparable data or from applying different transfer pricing methods, known arm's length range.

The CUP method is a particularly reliable method where an independent enterprise sells the same product as is sold between two associated enterprises. For example, an independent enterprise sells unbranded Colombian coffee beans of a similar type, quality, and quantity as those sold between two associated enterprises, assuming that the controlled and uncontrolled transactions occur at about the same time, at the same stage in the production/distribution chain, and under similar conditions. Such information may be obtainable from commodity markets or may be deduced from dealer prices. If this difference does have a material effect on price, some adjustments would be appropriate. If a reasonably accurate adjustment cannot be made, the reliability of the CUP method would be reduced, and it might be necessary to select another less direct method instead.

All OECD countries with territorial tax systems have designed provisions that seek to prevent base erosion and profit shifting by multinational corporations. Designing a territorial tax system requires balancing competing goals: exempting foreign business activity from domestic taxation, protecting the domestic corporate tax base, and creating a simple system. A system can generally only have up to two of these. Many countries including the Indonesia have either reformed or adopted new rules to protect their tax bases in recent years. More than 130 countries are discussing a global minimum tax as an additional measure of tax base protection, although it is unclear whether this policy will amend current rules or create a complex new layer of tax rules for multinationals. Most OECD countries operate what is known as a territorial corporate tax system where foreign earnings of multinational corporations are generally exempt from domestic taxation. Such systems allow for multinational businesses to make investments and generate earnings in multiple jurisdictions and remit those earnings to domestic shareholders with little or no extra taxation at the entity level. In most cases, territorial tax systems provide a full or partial exemption for

foreign profits through a “participation exemption.” The goal of a territorial tax system is to tax companies based on the location of their production, which can be difficult in today’s highly globalized and increasingly digitalized world. This is because production processes can stretch across several jurisdictions and can include transactions that are difficult to price. Companies with multinational production processes take deductions and report revenues throughout the world to allocate their profits. As such, it is often difficult to determine exactly how much profit should be taxed in each country. The difficulty in determining the location of profits also means that territorial tax systems are vulnerable to base erosion. The fact that production processes span multiple tax jurisdictions leaves room for companies to take advantage of country-level differences in tax policy to allocate revenues and costs across tax jurisdictions in a way that can minimize their worldwide tax liability. Because territorial systems mean companies do not face an additional tax on foreign profits that are repatriated to the parent company, multinational corporations have a greater incentive to avoid domestic tax liability through various forms of tax planning.

Due to these challenges, countries with territorial corporate tax systems set up rules to define if and how foreign profits are taxed, as well as rules that prevent base erosion and profit shifting. These rules include Controlled Foreign Corporation (CFC) rules, limitations on interest deductibility (thin capitalization rules), and other similar measures. The rise of territorial tax systems and concerns about profit shifting by multinational corporations led the G20 in 2013 to propose that the OECD pursue an agenda focused on designing policies to minimize base erosion and profit shifting (the BEPS Project). Following the BEPS recommendations in 2015, many countries have adopted reforms to their territorial systems to limit some of the opportunities for tax planning by multinational corporations. In the EU, this has taken the form of the Anti-Tax Avoidance Directive (ATAD). Anti-base erosion rules and the extent to which countries exempt foreign profits from domestic taxation vary significantly from country to country. It is not clear that a “perfect” or pure territorial tax system exists. Rather, countries need to trade off among three key goals: eliminating domestic taxes on foreign profits, protecting their domestic tax bases, and making their tax rules as simple as possible. Countries are now debating whether further measures are necessary to protect territorial tax systems from abuse. The ongoing debate over a global minimum tax is directly related to limiting opportunities for multinationals to reduce their tax liabilities through utilization of low-tax jurisdictions. Whether a global minimum tax will result in changes to existing rules meant to address the same problem (such as CFC rules) is unclear.

Over the last three decades, most OECD countries have shifted towards territorial tax systems and away from residence-based or “worldwide” systems. The goal of many countries has been to reduce barriers to international capital flows and to increase the competitiveness of domestically headquartered multinational firms. As part of designing these territorial tax systems, countries also constructed rules that determined when and if foreign profits would be exempt from taxation. They also put in place and strengthened rules that attempt to limit profit shifting. There are basically three major aspects that define the scope of a country’s international corporate tax system. First are so-called “participation exemptions.” Participation exemptions are what create a territorial tax system. They allow companies to exclude or deduct foreign profits that they receive from foreign subsidiaries from domestic taxable income. This exempts those foreign profits from domestic tax, and thus they are only taxed abroad. In contrast, a worldwide system has no or few participation exemptions, and subjects most or all foreign profits to domestic taxation. Second are controlled foreign corporation (CFC) rules. The aim of these rules is to discourage or prevent domestic

multinationals from using highly mobile income (interest, dividends, royalties, etc.) and certain business arrangements to avoid tax liability on their domestic earnings. They work by defining what constitutes a “controlled” foreign company and when to attribute foreign income of these controlled companies to a domestic parent’s taxable income. Third are limitations on deductible payments. These rules are used to prevent domestic and foreign companies from using deductible payments such as interest or royalties to shift profits from high-tax into low-tax jurisdictions. While limitations on participation exemptions and CFC rules only apply to headquartered firms, these limits also address base erosion by foreign-based multinational corporations. The United Kingdom’s shift from a worldwide tax system to a territorial system provides a good example. In 2009, the UK adopted a participation exemption that exempted foreign-earned dividends from taxation. Since then, the UK has adopted limits on deductibility of debt and additional anti-base erosion rules including a diverted profits tax (DPT) and a tax targeted at offshore intangible assets. Other countries have gone through similar transitions in recent years by moving to territorial treatment of foreign earnings while adopting a variety of anti-base erosion rules. Looking at rules throughout the developed world, it is not clear that there exists a “perfect” or pure territorial tax system. This isn’t because a territorial tax system is a bad idea. Rather, it is because the taxation of corporate profits is fundamentally challenging. Thus, countries need to make several trade-offs in designing their systems.

A territorial tax system basically must balance three competing goals: (a) exempting foreign business activity from domestic taxation; (b) protecting the domestic tax base, and (c) creating simple rules. It is only possible to accomplish two of these goals at the same time. Simplification is at odds with a policy that exempts foreign business activity from domestic tax while trying to protect the domestic tax base. Protecting the domestic tax base is at odds with a policy that exempts foreign business activity alongside simple rules. Finally, a policy that protects the domestic tax base with simple rules does not fit with exempting foreign business activity from domestic taxation. A country may opt to enact a “pure” territorial tax system that completely exempts foreign profits from domestic taxation. This would be relatively straightforward and would eliminate the incentive for multinational corporations to invert or locate in other jurisdictions. However, the lack of domestic tax on foreign profits would make profit shifting into low-tax jurisdictions much more attractive.

A country could instead enact a territorial tax system with a system of targeted anti-base erosion provisions. These provisions may reduce the incentive to shift profits and, through exemptions, maintain some competitiveness for their headquartered corporations in foreign jurisdiction. The trade-off, however, is the rules may be complex to implement. In contrast, lawmakers could opt for a blunt solution to tax avoidance as part of their territorial tax system, such as a minimum tax on foreign profits. This may be simple and protect the tax base. However, this moves away from territoriality and would maintain an incentive for companies to invert and become a company based in a jurisdiction that does not operate a minimum tax on foreign profits.

No country in the OECD has a pure territorial tax system with no limits or restrictions. However, there are systems with fewer rules than others. Switzerland, for example, is the only OECD country that has not enacted CFC rules. Governments around the world are incorporating supplemental measures to address the problem of base erosion and profit shifting. These additional measures add layers of complexity to the application of taxation rules. And even if it is a worthy policy goal to address base erosion and profit shifting, creating complex rules is not a good policy. Countries enact territorial tax systems through what are called “participation exemptions” or dividend deductions. Participation exemptions

eliminate the additional domestic tax on foreign income by allowing domestic companies to either ignore foreign income in the calculation of their taxable income or to deduct foreign income when it is paid back to the domestic parent company. Participation exemptions can also apply to capital gains. Companies that sell their shares in a CFC and realize a gain may face no domestic tax on those gains.

Some countries, such as Luxembourg, grant full exemptions for both foreign capital gains and foreign dividend income earned by domestic corporations. Other countries offer exemptions for one type of income, but not the other. Estonia, for instance, offers a full exemption for dividend income received from foreign subsidiaries (when certain requirements are met). Capital gains are only taxed when a distribution is made. Of the 37 OECD member states, 34 countries offer some exemption or deduction for dividend income, 30 countries offer an exemption for capital gains, and 29 countries offer an exemption or deduction for both. Chile, Korea, and Mexico provide neither an exemption for capital gains nor dividends. Participation exemptions also range from full to partial deductibility or excludability. For example, France exempts 95 percent of foreign dividend income and 88 percent of foreign capital gains. Countries providing partial exemptions often do so because it is less complex than accounting for business expenses that don't directly correlate to physical production. Usually, companies are required to allocate overhead costs of their headquarters, such as office supplies, to foreign subsidiaries. Allocating these costs can be complex. So instead of writing rules requiring companies to allocate expenses, countries allow companies to deduct those costs domestically but tax a small portion of their foreign profits instead.

V. Five Transfer Pricing Methods

Traditional Transaction Methods

Traditional transaction methods measure terms and conditions of actual transactions between independent enterprises and compares these with those of a controlled transaction. This comparison can be made on the basis of direct measures such as the price of a transaction but also on the basis of indirect measures such as gross margins realized on a particular transaction.

Transactional Profit Methods.

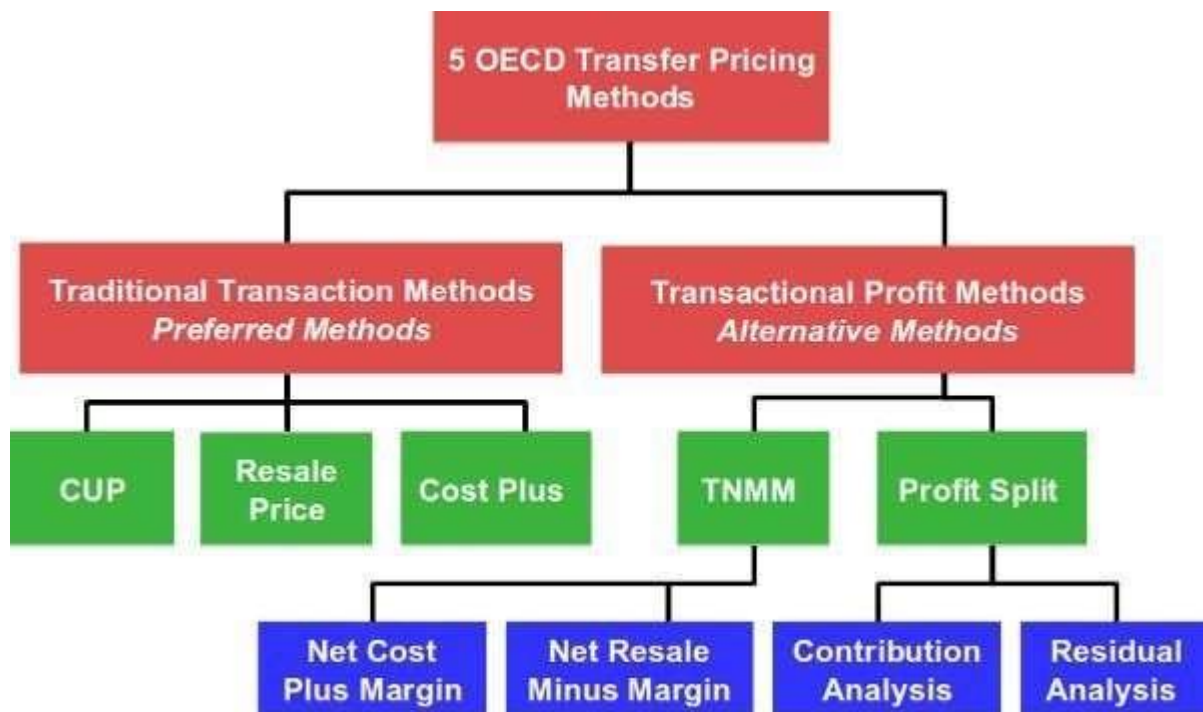
The transactional profit methods don't measure the terms and conditions of actual transactions. In fact, these methods measure the net operating profits realized from controlled transactions and compare that profit level to the profit level realized by independent enterprises that are engaged in comparable transactions. The transactional profit methods are less precise than the traditional transaction methods, but much more often applied. The reason is that application of the traditional transaction methods, which is preferred, requires detailed information and in practice this information is not easy to find. The OECD Guidelines discuss five transfer pricing methods that may be used to examine the arm's-length nature of controlled transactions. Three of these methods are traditional transaction methods, while the remaining two are transactional profit methods.

Traditional transaction methods:

- 1) CUP method
- 2) Resale price method
- 3) Cost plus method

Transactional profit methods:

- 4) Transactional net margin method (TNMM)
- 5) Transactional profit split method.



Source: Transfer Pricing Asia, 2021.

The OECD Guidelines provide that taxpayer should select the most appropriate transfer pricing method. However, if a traditional transaction method and a transactional profit method are equally reliable, the traditional transaction method is preferred. In addition, if the CUP method and any other transfer pricing method can be applied in an equally reliable manner, the CUP method is to be preferred.

VI. Limitations to Participation Exemptions

While most countries have enacted participation exemptions to eliminate the domestic tax on foreign profits, these exemptions are not unlimited. Countries have a range of rules that determines whether foreign profits are subject to tax when repatriated or paid back to their domestic parent. Many European Union (EU) member states offer exemptions only when the resident company holds at least 10 percent of the subsidiary's share capital or voting rights for some specified period. France and Germany are notable exceptions, with

France requiring only a 5 percent holding, and Germany unconditionally exempting 95 percent of foreign dividends and capital gains. In the case of the United States, the participation exemption adopted in 2017 is limited to dividends received by corporations that are 10 percent owners of foreign corporations (U.S. shareholders) according to the tax code. The foreign portion of the dividend is allowed as a deduction. However, the exemption does not apply to “hybrid dividends,” payments that are treated as tax-exempt dividends in the United States but deductible payments (such as interest) in another jurisdiction. Some countries also limit participation exemptions and dividend deductions based on a foreign subsidiary’s location. EU member states typically limit exemptions to subsidiaries located in other EU member states or within the European Economic Area (EEA). Some countries publish a “blacklist” of jurisdictions where the tax regime is considered abusive and will not provide exemptions to profits earned in those jurisdictions. Others, such as Norway, impose a standard where a company needs to conduct real business activities abroad to qualify for a participation exemption. This directly excludes holding companies and other kinds of passive operations from receiving an exemption. Some countries have restrictions based on the line of business a foreign subsidiary is in. For example, several countries that exempt most dividend income will not exempt profits derived from certain service-based subsidiaries such as law offices.

VII. Controlled Foreign Corporation Rules

A common concern with moving to a territorial tax system is base erosion. Under a territorial tax system, companies no longer face an additional tax on foreign profits that are repatriated to the parent company. Because of this, multinational corporations have incentives to avoid domestic tax liability by using transactions to shift income to foreign subsidiaries in jurisdictions with lower tax rates. Countries address this issue with anti-base erosion rules called “CFC rules.” These rules aim to discourage or prevent domestic multinationals from using highly mobile income (interest, dividends, royalties, etc.) and certain business arrangements to avoid domestic tax liability. CFC rules are designed to prevent profit shifting without penalizing foreign subsidiaries engaged in legitimate business practices. CFC rules are not unique to countries with territorial tax systems. CFC rules generally outline policies for taxing the undistributed income of a domestic corporation’s foreign subsidiaries. This means that if a foreign subsidiary of a domestic parent corporation is deemed a CFC and subject to a country’s CFC rules, all or a portion of its profits are immediately subject to domestic tax. The income can either be taxed separately from domestic income or incorporated into the taxable base of the domestic parent corporation. CFC rules are very common throughout the OECD. Only Switzerland does not have any formal CFC rules. Though some OECD countries enacted CFC rules in the 1970s, most enacted or modified their rules following the recommendations from the OECD BEPS project in 2015. In the post BEPS world, a MNE will be required to disclose more quantitative and qualitative information to the tax authorities in, potentially, all the jurisdictions in which it has affiliates. In some countries, there will also be local transfer pricing information returns to be filed.

Some countries often have other more qualitative base erosion provisions that attempt to accomplish the same goal as CFC rules. For example, Belgium’s CFC rules only apply to companies that are non-genuine arrangements. This requires the tax authority to determine whether the activities of a foreign subsidiary are connected to real business operations or if the entity exists simply for avoiding taxes. CFC rules, while complicated and highly variable, all follow a common outline. First, an ownership threshold or test is used to

determine whether an entity is considered a CFC. Next, a second tier of standards is used to determine if the CFC is taxable in the parent company's country. Finally, the rules determine what types of income are taxable.

VIII. Interest Deduction Limitations

Under most tax systems throughout the world, the interest corporations pay on loans and bonds is deductible against taxable income, while interest income is taxable. It is common practice for a multinational corporation to lend itself money, by providing loans to and from subsidiaries located in foreign countries. These cross-border loans are helpful for companies to expand and make new investments in foreign markets. However, as with other deductible expenses, interest deductions can be used to exploit cross-country differences in corporate tax systems to reduce corporate tax liabilities. Multinational corporations have an incentive to take out loans in high-tax countries, where they can take deductions, and lend from low-tax countries, where they can realize interest income, resulting in a lower worldwide tax burden. Interest deduction rules can be seen as supplemental to CFC rules. CFC rules apply only to resident corporations whereas interest deduction limitations apply to all corporations—foreign and domestic. To combat potential abuse of interest deductions, countries place limitations on these expenses. Thirty-five of the 37 OECD nations place some sort of formal limitation on interest expense deductions. Ireland currently has informal limitations on interest deductions but is set to implement formal rules starting January 1, 2022. Most of the EU members modified their regimes and included an interest expense limitation rule due to the application of ATAD. Interest deduction limitations are often implemented through rules specifically targeted at multinational corporations, called thin capitalization rules. Thin capitalization rules target companies whose debt levels far exceed equity. Most of these rules are designed to apply when a company has a debt-to-equity ratio beyond a predetermined threshold. Of the 35 OECD nations which currently operate interest deduction limitation rules, 16 employ this method. In some cases, tax authorities also use the debt-to-equity ratio on assessments to evaluate whether interest deductions can be restricted.

Indonesia has been formulating provisions related to transfer pricing since 1984 when tax reform began. However, the technical guidelines for assessing compliance with the arm's length principle that would be implemented by tax auditors were formulated in 2010 and put into effect in 2011. There are various challenges in implementing the current transfer pricing provisions are the following: regarding the payment of intangible use, regarding the limitation of interest payments, Indonesia has issued a regulation regarding the debt-to-equity ratio, the provisions related to intragroup services payments have basically been regulated in the technical provisions of transfer pricing, the examination related to the selling price and the buying price for intra-group trading has basically been regulated in Indonesian domestic regulations. In addition, in the transfer pricing test, there were quite large disputes caused by technical problems such as (i) choosing the transfer pricing test method (ii) selecting comparative data (iii) improper audit process. Indonesia has formulated provisions related to transfer pricing since 1984 when the first tax reform was introduced. However, the technical guidelines for assessing the fulfillment of the arm's length principle to be implemented by the tax examiner were only formulated in 2010 and effectively implemented in 2011 and the last following period through Law No. 11/2020 and the 2021 KUP Bill. There are various challenges in implementing transfer pricing provisions. that exist today, especially related to payments for the use of intangibles, payment restrictions (debt-to-equity ratio), payments for intragroup services which are basically regulated in the technical provisions of transfer pricing and

inspections related to selling prices and buying prices on intra-group trading. basically it has been regulated in Indonesian domestic regulations. In addition, in the transfer pricing test, there are quite large disputes caused by technical problems such as (i) selection of transfer pricing testing method (ii) selection of comparative data (iii) inappropriate audit process. As cross-border financial institutions develop, concerns about transfer pricing and BEPS are expected to increase. It is therefore very important that the Indonesian tax authorities prioritize the recruitment of skilled personnel to address the complexities posed by the global trading of financial instruments by MNE groups.

IX. Concluding Remarks

- 1) The role of multinational enterprises (MNEs) in world trade has continued to increase dramatically over time. This in part reflects the increased pace of integration of national economies and technological progress, particularly in the area of communications. The growth of MNEs presents increasingly complex taxation issues for both tax administrations and the MNEs themselves since separate country rules for the taxation of MNEs cannot be viewed in isolation but must be addressed in a broad international context.
- 2) Transfer-pricing disputes between tax authorities and multinational enterprises (MNEs) are the most important issue in international taxation today. Their resolution requires a balancing of the respective interests of both parties. On the one hand, tax authorities seek to subject MNEs to an appropriate level of taxation on their global income and to achieve an appropriate allocation of that income among the jurisdictions involved.
- 3) The evolving regulatory landscape shaped by the OECD's BEPS project will put significant additional pressure on a widely used class of intercompany arrangements. In particular, taxpayers' successful defense of "principal-service provider" arrangements where the service providers earn stable and (relatively) low returns will depend crucially on two factors, the ability to demonstrate that the principal possess the requisite control/substance over the specific risk it contractually bears and a methodology that can quantify such risk under a reliable and defensible application of the arm's length principle.
- 4) Under Action 14, countries have committed to implement a minimum standard to strengthen the effectiveness and efficiency of the mutual agreement procedure (MAP). The MAP is included in Article 25 of the OECD Model Tax Convention and commits countries to endeavor to resolve disputes related to the interpretation and application of tax treaties. The Action 14 Minimum Standard has been translated into specific terms of reference and a methodology for the peer review and monitoring process. The minimum standard is complemented by a set of best practices.
- 5) The OECD model recognizes that many countries treat the foreign branch and its headquarters as a single entity, which they legally are. Accordingly, article 7(4) provides that the income of the PE may be attributed on the basis of a formulary apportionment method where it is customary for the two countries involved to apply such a method.
- 6) Tax authorities need to focus greater attention on the global trading of financial instruments by multinational financial institutions groups. As Indonesia's financial institutions expand across borders, the concerns over transfer pricing and BEPS are likely to intensify. It is therefore imperative that the Indonesia revenue authorities

prioritize the recruitment of skilled personnel in order to address the complexities posed by the global trading of financial instruments by multinational financial institution group

References

Bakker, Anuschka and Marc M. Levey, 2011. Transfer Pricing and Dispute Resolution, IBFD Print books'

OECD (2016), BEPS Action 14 on More Effective Dispute Resolution Mechanisms, Peer Review Documents, www.oecd.org/tax/beps/beps-action-14-on-more-effective-dispute-resolution-peer-review-documents.pdf (accessed on 22 August 2017).

OECD (2015), Model Tax Convention on Income and on Capital 2014 (Full Version), OECD Publishing, Paris, <http://dx.doi.org/10.1787/9789264239081-en>.

Transfer Pricing Asia, 2021. Five Transfer Pricing Methods With Examples, <https://transferpricingasia.com/2017/03/17/five-transfer-pricing-methodsexamples/>