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ANALYSIS OF TRANSFER PRICING AS A TAX AVOIDANCE AND PROPOSED SUGGESTION TO PREVENT ITS DISADVANTAGES

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Abstract

It is very obvious that businesses upholding the main economic principal “obtaining maximum profit by minimum capital/investment”. In this paper’s context, the words “capital/investment” in that principal not only defined as a “pre company’s wealth contribution” but also any company’s wealth which required for running the businesses. Therefore, it is not impossible that undertakings always developing in their own ways to increase their profit by avoiding taxes. Eventhough the tax avoiding is not illegal, in some circumstances it disrupts the government’s revenue. Using statutory and case approaches, this paper firstly trying to determine the transfer pricing concept in regards to positive and negative connotations. Secondly, the examination of transfer pricing implementation by undertakings. Then lastly, this paper provides some proposals to prevent the disadvantages of transfer pricing. In regard of that, the government should impose the co-operative relationship between the company and tax administration to ensure that the transfer pricing audit are processed in reasonable time. Another purpose of good co-operative relation is to upheld the proper assessment of business report because lack of co-operation may affect the occurrence of unnecessary cost and uncertainty of the result.

Keywords: Transfer Pricing; Tax Avoidance; Investment.

Abstrak

Sangat jelas bahwa bisnis menjunjung tinggi prinsip ekonomi utama “memperoleh keuntungan maksimal dengan modal minimum / investasi”. Dalam konteks tulisan ini, kata-kata “modal / investasi” pada dasarnya yang tidak hanya didefinisikan sebagai “kontribusi kekayaan pra perusahaan” tetapi juga kekayaan setiap perusahaan yang diperlukan untuk menjalankan bisnis. Oleh karena itu, bukan tidak mungkin bahwa usaha selalu berkembang dengan cara mereka sendiri untuk meningkatkan keuntungan mereka dengan menghindari pajak. Walaupun pajak menghindari tidak ilegal, dalam beberapa keadaan itu mengganggu pendapatan pemerintah itu. Menggunakan pendekatan hukum dan kasus, makalah ini pertama mencoba untuk menentukan konsep transfer pricing dalam hal konotasi positif dan negatif. Kedua, pemeriksaan pelaksanaan transfer pricing oleh usaha. Kemudian terakhir, makalah ini memberikan beberapa usulan untuk mencegah kerugian dari transfer pricing. Sehubungan dengan hal tersebut, pemerintah harus memberlakukan hubungan kerjasama antara perusahaan dan administrasi perpajakan untuk memastikan bahwa audit penetapan harga transfer diproses dalam waktu yang wajar. Tujuan lain dari hubungan kooperatif yang baik adalah untuk menegakkan asesmen laporan bisnis yang tepat karena kurangnya kerjasama dapat mempengaruhi terjadinya biaya yang tidak perlu dan ketidakpastian hasil.

Kata Kunci: Transfer Pricing; Tax Avoidance; Investasi.

Transfer Pricing Concepts

Transfer pricing is kind of a phenomenon in tax areas which is considered as a threat for the tax revenue. Actually, the implementations of transfer pricing can be determined in two connotations; first is for reducing companies' tax liability by such "arrangements" in a trade and secondly, transfer pricing is kind of company's advantages especially for huge company which has lots of networks over the world. The first is a negative connotation because transfer pricing purposes is to take advantages from a country's tax regime. Furthermore, transfer pricing is performed by companies that have intention to do "legal manoeuvres" to improve their profit with less tax. It can be seen that the "legal manoeuvres" is done by constructed such an arrangement in a trade which involving two trading companies with an external company. Basically, the meaning of transfer pricing is explained as the control of a trade between two companies (the seller and the buyer) by other party, it is either the seller or the buyer, or both are controlled by the same person.¹ Otherwise, in taxation context, it can be explained that transfer pricing can lead to a transfer of income or tax base and/or the cost of one taxpayer (company) to another taxpayer (company), which can be manipulated to reduce the overall amount of tax on the taxpayers who have a "special relationship". That the external company that involved in "special relationship" can be the subsidiary company from buyer company or seller company depends on its "power" and it is obviously the bigger company is the one that capable in this context.

The second is a positive connotation because the involved companies manage to do a "spent efficiency" in their business, and they take advantages of their power and wealth. Explicitly, it is almost the same with the negative connotation because the keyword for both is "profit improvement", however the positive connotation in the transfer pricing implementations can be achieved if only the companies apply the "arm's length" principle. That principle is mentioned in the "Article Of The Oecd Model Tax Convention On Income And Capital 2010" (hereinafter; the OECD Model) article 9 (1) that: "...in either case conditions are made or imposed

¹ Saunders. G and Antczak. G, *Tolley's Corporation Tax* (Tolley Publisher 2001).[25].

between two enterprises in their commercial or financial relation which differ from those which would be made between independent enterprises, then any profit 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”.

It is implicitly explains that the independent companies will be treated similarly in the same or similar transaction with the companies that have special relationship otherwise, in taxation context, the profit will be recalculated accordingly² to upheld the balance of tax liability. However, in positive connotation, the transfer pricing has to be done with strict provisions and also allowed methods. And both of them are mentioned in the “Transfer Pricing Legislation – A Suggested Approach” which was prepared in June 2011 by the Organisation for Economic Co-operation and Development (Hereinafter; OECD) and provided the basic structure and contents for global regulation. Moreover, the allowed methods which are mentioned in section 4³ for implementing “positive” transfer pricing are: (i) Comparable Uncontrolled Price Method, (ii) Resale Price Method, (iii) Cost Plus Method, (iv) Transactional Net Margin Method, (v) Transactional Profit Split Method.

Transfer Pricing as Undertakings Tax Avoidance

It is mentioned above, in “negative connotation”, transfer pricing is about to disturb the tax revenue in a country. However, it does not apply to tax haven country which is a country that has low rate taxes not at all⁴ and that circumstances obviously attract various companies to establish their business activity there. The existence of tax haven countries might be the cause of the transfer pricing development itself, because it is obviously that the main purposes of any business activity is to

² HM Revenue & Custom, ‘Transfer Pricing: Legislation: Rules: The Arm’s Length Principle’ (2016) <<http://www.hmrc.gov.uk/manuals/intmanual/intm412040.htm>> accessed 10 January 2013.

³ Organisation For Economic Co-Operation And Development, ‘OECD Transfer Pricing Legislation – A Suggested Approach’ (2011) <<http://www.oecd.org/tax/transfer-pricing/45765682.pdf>> accessed 10 January 2013.

⁴ Dharmapala D. and James r. Hiner Jr., ‘Which Countries Become Tax Havens?’ (2009) 93 Journal of Public Economics.

achieve profit as many as possible and to take opportunities as much as possible. Therefore, lots of companies take the opportunities from tax haven countries in addition not only to expand their business but also to avoid their “loss” otherwise their tax liability upon a country. For instance “A is an automotive company that manufactures cars. A produced car which costs £1000 and sell it to B (an affiliated company in tax haven country) for £1100. After that, the cars are sold to C (non-affiliated company) at £1500” .

In that example, what actually happening was a transaction between A and C because it is clear that B has “special relation” with A, and in this transaction A is taking advantages from tax haven country and he supposed to pay tax on profit $£1500 - £1000 = £500$, however because of the condition that B is in tax haven countries, therefore deductible profit instead of £500 is $£1100 - £1000 = £100$ and the tax only imposed on the £100 amount than £500. This circumstance not only could reducing the tax revenue but also kind of disadvantages for minority shareholders because the company sales and the profit becoming low. Specifically, the transfer pricing process regulation in international transaction based on English Law was adjusted by the Revenue in *Waterloo plc v CIR* as follows:⁵ First, If the price below market price, the latter is substituted in computing the seller’s profit unless, the buyer is a UK resident, is entitled to deduct the price paid in his own profits. Second, If the price is above market price, the latter substituted in computing the buyer’s profit unless, the seller is a UK resident, would have to bring in, as a trade receipt, the price received.

Actually, the main reason companies perform transfer pricing because basically, tax avoidance is done to upheld the taxpayer’s right to reduce, minimise their tax liability.⁶ That argument was explicitly explained by Lord Tomlin in *IRC v Duke of Westminster* that “every man is entitled if he can to order his affair so as that the tax attaching under the appropriate Acts less than it would otherwise be”. In the transfer pricing context, the companies try to reduce their tax liability

⁵ Saunders. G and Antczak. G.Loc.Cit

⁶ A.J. Easson,[*et.al.*], *Cases and Materials on Revenue Law* (2nd ed, Sweet&Maxwell 1990).[45].

through complicated methods and it is obviously has to be considered by involved jurisdictions (especially non tax haven countries) to upheld their revenue because it will not become a problem if involved jurisdictions in a transaction are developed countries. In the contrary, the problems will occur if the transaction involving developing countries which obviously require huge amount of income to run their government and usually the biggest income for them is from tax revenue.

However, the modern transfer pricing regulation does not consider “small and medium businesses”⁷ which in the United Kingdom both of them are determined as;⁸ the small enterprise is a company which has maximum fifty staffs and the annual turnover limit is approximately €10 million with €10 million balance sheet total; the medium enterprise is a company which has maximum 250 staffs and the annual turnover is approximately €50 million with €43 million balance sheet total. Generally, the “small and medium enterprises” get the exemption of transfer pricing rules because it might be considered that those enterprises do not have significant capability upon a tax regime. Otherwise, their tax liability does not have huge impact on a country’s revenue therefore the international provisions relieve them from transfer pricing restriction. The transfer pricing implementations cannot be underestimated because, as mentioned above, for developing countries it is kind of disadvantages because obviously they will get less income from tax revenue and therefore, those developing countries has to enact a regulation to prevent transfer pricing become a tool for companies to relieve their tax liability.

Proposed Suggestions to Prevent Transfer Pricing Disadvantages

The first step to prevent transfer pricing disadvantages, especially for tax revenue, is upheld the OECD Model for regulating the transfer pricing practice. Moreover, the regulation has to be upheld strictly because if the regulation has little “gap”, it is not impossible be used up by the companies to perform transfer pricing.

⁷ Tiley J., ‘UK Tax Guidance 2009-2010 Last Accessed’ (LexisNexis, 2009) 1186 <www.bakertilly.com/uploads/International-tax-update-0213.pdf> accessed 11 January 2013.

⁸ HM Revenue & Custom, ‘The Definition of Small and Medium Enterprises’ <<http://www.hmrc.gov.uk/manuals/intmanual/INTM412080.htm>> accessed 12 January 2013.

For instance; in Indonesia, that the legal system is civil law, the new problem in relation with transfer pricing is the implementation of OECD does not supported by the Taxation Act⁹ because the act does not regulate the transfer pricing clearly. Moreover, it can be used by the company for hiding behind those “loose” regulations because obviously in civil law system, Acts or Codes is the strongest law basic. Argentina also has the new Income Tax Act which govern that if a foreign company; involved in, has control upon local company whether directly or indirectly, the local company has to assess its income for being taxed and allowed to deduct the price as if that price were whose of independent parties.¹⁰ It was mentioned to uphold the tax liability especially in corporation tax and Argentina’s government try to anticipate the loss of tax revenue. Therefore, the future provision in a country has to support the OECD Model to achieve maximum regulation upon transfer pricing practice.

In relation to regulations, the transfer pricing rules should have “wide range application”. Because the “small and medium enterprises” get exemptions in the international regulation and it means that those enterprises gain some advantages to do transfer pricing in their business activity. It can be imagined that those companies will grow bigger with lots of experiences in transfer pricing and in simple explanation, another additional threat for a tax regime. The wide range application has to be upheld because it is not impossible that those “small and medium” companies have relationship with a huge multinational company (MNC), and that MNC is “playing” with the exemptions. Furthermore, in the United Kingdom, the taxpayers (company) who have no relation to other company or there are no transaction with related company, the transfer pricing rules cannot be applied,¹¹ nevertheless in the OECD Guidelines for Multinational Enterprises, it was mentioned in the taxation commentary that “a member of an MNE group in one country may have extensive economic relationships with member of the same MNE group in other countries,

⁹ In Indonesia, anything that has relation with tax are governed by DirektoratJendralPerpajakan(Tax Ministry).

¹⁰ Arguello M.F., ‘Argentina: Taxation – Transfer Pricing’ (2000) IELTR N1.

¹¹ Tiley J.*Loc. Cit.*

and such relationships may affect tax liability of each of the parties”. Therefore the tax liability of each party has to be maximum imposed. Another thing, the expansion of application should consider the transactions not only with related companies but also with non-related companies, which indicated below fair market price.

Secondly, the involvement of public accountants has to be considered. It is because in the practice, the lack of public access to get the details of the company transaction, causing that company free to modify its financial reports. Otherwise the company will be free to manipulate its transaction and it is not impossible that if that company perform transfer pricing not with other company which has special relationship. Moreover, that circumstance will not upheld the arm’s length principle because the sales turnover might be reduced by performing under invoice. Furthermore, to prevent the financial reports manipulation of a company, the government should undertake an analysis of the financial reports not only by the internal accountants but also external accountant to double check whether the reports was made properly or not. And the public accountants involvement have to be regulated as well because the main requirement of this analysis is the availability of comparable internal and external data. Specifically, the required data for analysing the transfer pricing practice are:¹² (a) Databases: information from a variety of publicly available sources and provide a way of finding companies that are carrying out broadly similar activities to the company under review. (b) Custom data: collected for assessing custom duties to get details of cross border transaction, including the companies connection. (c) Patent office: working relationship with patent office is necessary to identify the cross border transfer of intellectual property. (d) Tax treaty intelligence: information which can be obtained from another tax administration, furthermore the exchanges of information under double taxations agreement is required to get opportunity that the transfer pricing audit is not missed. (e) Press report, trade magazine and other information from the public domain: those sources provide the particular companies trade sector which is very useful to

¹² OECD, ‘Dealing Effectively with the Challenges of Transfer Pricing’ (2006) 23 <http://www.oecd-ilibrary.org/taxation/dealing-effectively-with-the-challenges-of-transfer-pricing_9789264169463-en> accessed 11 February 2013.

get information about the business activities in particular area. (f) Internet searches.

It is difficult for those public accountants to achieve that, except the public information, if there are no such regulations which can be a legal basic to support them, because it is not impossible that those companies refused to give their financial report by reason their reports are made properly by their own accountant. Moreover, that circumstance can be compounded by the delay in obtaining business records. Fortunately, the disclosure of the companies' information was mentioned in the Chapter III of the OECD Guidelines for Multinational Enterprises that enterprises should disclosed any information regarding their business activity, however the problem will emerge if there is a transaction which involving a company from country that has not ratified the OECD Model and it will become worst if that party has "special relationship" or an affiliation company. It is possible that a company will take an opportunities upon that "gap" and argued that the company confidentiality such as; companies documents, activities, etc, has to be upheld.

In regard of that, the government should impose the co-operative relationship between the company and tax administration to ensure that the transfer pricing audit are processed in reasonable time. Another purpose of good co-operative relation is to upheld the proper assessment of business report because lack of co-operation may affect the occurrence of unnecessary cost and uncertainty of the result. The co-operation can also be enforced with other countries because the cross-border transactions obviously involving various countries and the co-operation agreement is required to achieve effectiveness in correlative adjustment upon transfer pricing. Therefore in Article 9 OECD stated that it is not necessary in the event of fraud, negligence or intentional misconduct. Thus, it is clear that the agreement purposes to avoid double taxation. However, in Indonesia, this correlative adjustment is often overlooked because it does not include any notification to the tax authorities of other countries. Therefore, the agreement with other countries has to be considered as a government method because in international taxation perspective, the transfer pricing adjustment made by the tax authorities in the country should be followed by correlative adjustment in the opposed country where the transaction has been made

and this principle was mentioned in the Article 9(2) OECD that when a country to adjust the profit of a company for the tax purposes, however that profit had already taxed in another country and the position of the profit should be obtained by that company, then the other country shall do correlative adjustment. Furthermore, in regards with the “wide range” application, the transaction of a company with the “special relation” parties has to be upheld. Otherwise, that particular transaction has to use fair market value in dealing the special parties. The “special parties” in English Law determined, based on the circumstance that the company’s affairs are conducted according to a person’s intention, as:¹³ (1) Nominees, (2) Spouse, (3) The brother, sister, ancestor or lineal descendant of himself or his spouse, (4) The spouse of a person in number 3, (5) Any person with whom he is in partnership, (6) The spouse, brother, sister, ancestor or lineal descendant of any person within number 5, (7) The nominees of any person within number 2 and 6.

Thirdly, the taxpayers (in this context; the companies) who perform transfer pricing should be published as a “moral pressure”. It is because performing transfer pricing in a country, means that avoid the tax liability. Unfortunately, tax avoidance is not illegal as long as it is done in a proper way. However, either tax evasion or tax avoidance are threats for a tax regime revenue because basically the differences of both of them are slightly different and had not determined properly. The “moral pressure” is the only way to deal with tax avoidance because in lots of jurisdictions tax evasion is obviously committed as a crime, and on the other hand the tax avoidance has been being committed as a taxpayer’s right although it is considered as a revenue disruption. In Indonesia for instance; in Article 50(1) Tax Court Act , stated that the tax court is open to the public. With the government announced tax proceedings, will open the eyes of the public that maybe the well-known companies turned out to commit fraud to avoid taxes. This suggestion also kind of public involvement which is wider because lots of experts will get information and it is not impossible that their criticism might be useful to develop better regulations.

Fourthly, the government should provide a data centre— in order to update the

¹³ Saunders. G and Antczak. G.*Op.Cit.*[26].

latest price of commodities which is required for the companies' financial report assessment. It is necessary to check the fairness in annual turnover of a company in regard to arm's length principle. Basically, the transfer pricing is performed by manipulating the price and the existence of data centre is useful to determine whether the particular transactions are made in reasonable price or not. Because the essential thing which is important to determine the bad thing in transfer pricing practice, especially in trading companies, is the reasonable price which can be observed from particular data centre for instance; in Indonesia there is Indonesian Coal Index which updating the latest price of mineral commodities for the sales turnover assessment of a mining companies.

Fifthly, it is required to construct single document window (SDW)¹⁴ method among countries that have implemented tax treaties, and multilateral forums, such as APEC. The single document method will control the shipping price between the seller and buyer's countries effectively because with that method, the invoice issuance by the "dummy" company in the tax haven country will be taxable thus the transfer pricing will be not efficient for those companies' business activity. Furthermore, it is not impossible that huge company will create an affiliation company or a branch in the tax haven countries for supporting their transfer pricing. The transfer pricing practice not only applied by arranging the price but also by the royalty payment to the main company, for instance; "A is a subsidiary company of X company which achieved a licence to sell the product of X company. A is located in a tax haven country. On the other hand, X also established a non-affiliated company in non-tax haven country called Z. Upon the annual turnover, A pay royalties to X for £ 90 billion, furthermore with the same amount of turnover, Z only pay royalties to A for £ 10 billion". In that example, there should be a further examination because there is a possibility of the payment to X is a disguised dividend payment from A. If the government does not impose the "deep monitoring" to such circumstances, the transfer pricing becoming more difficult to be prevented regarding to the fact

¹⁴ Suryana B.A., 'Menangkal Kecurangan Transfer Pricing (Preventing the Transfer Pricing Fraud)' (2012) <<http://www.pajak.go.id/content/article/menangkal-kecurangan-transfer-pricing>> accessed 13 January 2013.

that nowadays the transfer pricing is about to be more complicated. Therefore, by this method all of the transaction can be monitored by the government in the involved countries. The determination of the transfer pricing methods is also very essential thing in respect with arm's length principle. It was mentioned in the second suggestion above that the disclosure of a company's information has to be enforced. Because transfer pricing involving more than two companies, therefore it is necessary to impose the comparability analysis concept¹⁵ which can be applied to the transfer pricing methods.¹⁶ However, in "Commentary on Article 9 Concerning The Taxation of Associated Enterprises" it was mentioned that the OECD Model (especially in Article 9) does not provide a specific methods to be adjusted, thus countries that has ratified OECD Model use different methods to face this circumstance and the other option is the bilateral agreement for synchronising the provisions in both countries. Actually, this option does not have advantages because the bilateral arrangement will be arranged more than one, considering that a tax regime will be dealing with another tax regime from different jurisdiction and there is possibility of the emergence of confusion in a tax regime because the suitable methods for each other tax regime will be different.

Furthermore, in determining the fair price upon a transaction between companies that have "special relationship" can be applied to transaction with non-related company as well if the transaction is similar.¹⁷ That "similar" term does not have to be identical, but comparable. Therefore the comparability analysis is required for determining the appropriate method that is about to be applied in a country. It is because, each method of transfer pricing has its own disadvantages. For instance; "transactional profit split" is one of transfer pricing methods which is done by identifying the combined income on affiliate transactions¹⁸ that will be shared by those who have a special relationship is the basis of an acceptable economically provide a proper estimate of profit distribution will occur and be reflected in the

¹⁵ Organisation For Economic Co-Operation And Development.*Op.Cit.*[18].

¹⁶ *ibid.*

¹⁷ Indonesian Tax Forum, 'Comparability Analysis Concept' (2012) <<http://www.forum-pajak.org/konsep-kesebandingan-comparable-t60.html>>.

¹⁸ Organisation For Economic Co-Operation And Development.*Loc. Cit.*

agreement between the parties who does not have a special relationship.

That method can only be applied in the transaction which involving affiliated company or special relationship parties therefore the disadvantages is, it has no possibility for the tax authorities to examine that transaction separately. Another thing is, this method also applied in the transaction involving intangible property as the effect of caused by the development of global supply chains.¹⁹ That development has close relationship of the role of Multi National Enterprise (MNE) or Multi National Company (MNC) in the business area globally because it is possible that a member of an MNE or MNC group in one country's tax regime may have extensive economic relationship with the same group in another countries thus it may affect the tax liability of each party. On the other hand, that circumstance is burdensome for the tax authorities to obtain the proper comparable data because there are some countries that upholding the limitations with respect to public information availability such as; there is no requirement for companies to report the documentation with the tax administrative, or the domestic market is not quite big therefore it is difficult to obtain comparable independent parties.

Conclusion

In conclusion, it was already explained above that the transfer pricing is only advantageous for the company because it can be used for improving their income by reducing their extra cost. On the other hand, the transfer pricing practice is a disturbance for the tax revenue of a tax regime and based on the "negative connotation" concept, the transfer pricing can be considered as global tax avoidance. Because transfer pricing involving various countries and also different jurisdictions by the establishment of Multi National Company (MNC) or Multi National Enterprise (MNE) that have important role in the development of transfer pricing itself.

Therefore, for confronting against the transfer pricing in the "negative connotation" the suggestions for the government are: (1) Make the OECD Model

¹⁹ *ibid.*[20].

as a basic international regulation for regulating the transfer pricing practice domestically and make that domestic regulation has a wide range of application. (2) The consideration of public involvement. (3) The publication of transfer pricing practice inside the country as a “moral pressure”. (4) The establishment of data centre in regard to the properties price. (5) The determinations of the proper transfer pricing method to be applied in the country.

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