

Domestic Transfer Pricing Adjustments: A Zero-Sum-Game of State Tax Revenue? A Tax Supervision Case Study in the Tax Office

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ABSTRACT

According to some experts, domestic transfer pricing correction is believed not to impact the national tax revenue. This is based on the assumption that any increase in tax revenue resulting from the correction at one tax office will be offset by a decrease of the same amount at another tax office (zero-sum-game). This research uses a qualitative method by using a case study approach to describe the impact of domestic transfer pricing correction on national tax revenue. All case studies happened at the Jakarta Gambir Two Tax Office from January to October 2022. This tax office was chosen because the researcher can participate in the tax supervision process. As a consequence, the researcher can gain a better understanding of the case studies. The results show that intra-group service corrections materially impact the national tax revenue, while domestic loan corrections only have a small impact.

Keywords: domestic transfer pricing correction, zero-sum-game, tax revenue

1. INTRODUCTION

Transfer pricing is the price one subunit of a company charges for the services it provides to another subunit of the same company (Horngren et al., 2015). Transfer pricing consists of multinational and domestic transfer pricing. According to Garrison et al. (2003), international and domestic transfer pricing have different objectives. Global transfer pricing tends to minimize taxes, duties, and tariffs, while domestic transfer pricing objectives boost performance evaluation. In addition, Setiawan (2013) agrees that domestic transfer pricing does not impact national

tax revenue. Setiawan's belief (2013) assumes that a tax increase from a domestic transfer pricing adjustment in one tax office will be offset by the same amount in another. For instance, Company A paid an additional one million in tax due to a domestic transfer pricing adjustment. As a consequence of that adjustment, Company B, a counterparty of Company A, will make the negative corresponding adjustment at the same amount as Company A. This related adjustment mechanism finally generates zero impact on national tax revenue.

However, Setiawan's belief (2013) was built on the hypothetical case. This study examines the

impact of domestic transfer pricing adjustment on national tax revenue based on some confirmed cases. Investigating the real impact of domestic transfer pricing adjustment on state tax revenue using confirmed instances is essential for Indonesia's tax purposes. First, it can solve the controversy among tax experts and practitioners about domestic transfer pricing adjustment. In contrast to Setiawan's belief (2013), some experts believe domestic transfer pricing has the same risk as global transfer pricing. For example, Supriyadi (2021) assesses the risk of domestic transfer pricing as risky as multinational transfer pricing, especially when one of the affiliated parties gets tax facilities, is subject to Final Income Tax, or has compensation for fiscal losses. Second, domestic transfer pricing was proven as one fiscal revenue authority risk factor in the case of *India v Glaxo SmithKline Asia (P) Ltd* (2010). In that case, the Indian Supreme Court suggested that the Ministry of Finance of India should broaden the scope of the transfer pricing article to domestic transactions. The third and last reason is that the result of this research encourages Indonesian tax officers to analyze domestic transfer pricing cases.

Furthermore, the risk of domestic transfer pricing in Indonesia has increased since the Indonesian Government released a special 1% tax rate for SMEs (small and medium enterprises) in 2013. The government then revised the SME's tax rate to 0.5% in 2018. This revision widens the domestic transfer pricing risk gap from 24% to 24,5%. DGT (Directorate General of Taxes) must anticipate and mitigate this condition to reduce the risk of domestic transfer pricing.

2. THEORETICAL FRAMEWORK AND HYPOTHESIS DEVELOPMENT

Transfer pricing issues are closely related to special relationships and adjustments. Without a special relationship, tax authorities, including DGT, cannot adjust the price of the transactions.

According to the previous chapter, Setiawan (2013) assumes the corresponding adjustment will offset all primary and secondary adjustments in domestic transfer pricing transactions. However, Setiawan's belief (2013) is

based on a hypothetical case. Primary adjustment, according to the Organization of Economic Co-operation and Development [OECD] (2022), is defined as "an adjustment that a tax administration in a first jurisdiction makes to a company's taxable profits as a result of applying the arm's length principle to transactions involving an associated enterprise in a second tax jurisdiction."

The primary adjustment causes secondary adjustment. It can be treated as constructive dividends, equity contributions, or constructive loans (OECD, 2022). In contrast to primary and secondary adjustment, the second tax jurisdiction makes the corresponding adjustment. The objective of the corresponding adjustment is to eliminate double taxation possibilities. Sigit Sugiharto (personal communication, July 11, 2022), Staff of the Transfer Pricing and Other Special Transaction Section, explained that domestic corresponding adjustment could be made at the taxpayer's request. Sigit's explanation aligns with the Minister of Finance Regulation Number 172 of 2023 concerning the Application of the Arm's Length Principle in Transactions Affected by a Special Relationship.

According to the previous explanations, this research hypothesis is that domestic transfer pricing adjustment impacts the national tax revenue (primary and secondary adjustments, including sanctions, are more or less significant than the corresponding adjustment). The alternative hypothesis is that domestic transfer pricing adjustment does not impact the national tax revenue (primary and secondary adjustments, including sanctions identical to the corresponding adjustment). In this research, the primary adjustment and sanction are based on actual evidence, while secondary and corresponding adjustments are based on hypothetical calculations. Those adjustments are based on estimation for two reasons:

- a. the research objects are the tax supervision process, in which account representatives cannot force the taxpayers to pay for their secondary adjustment corrections; and
- b. the taxpayers and their affiliated parties do not ask for the corresponding adjustment.

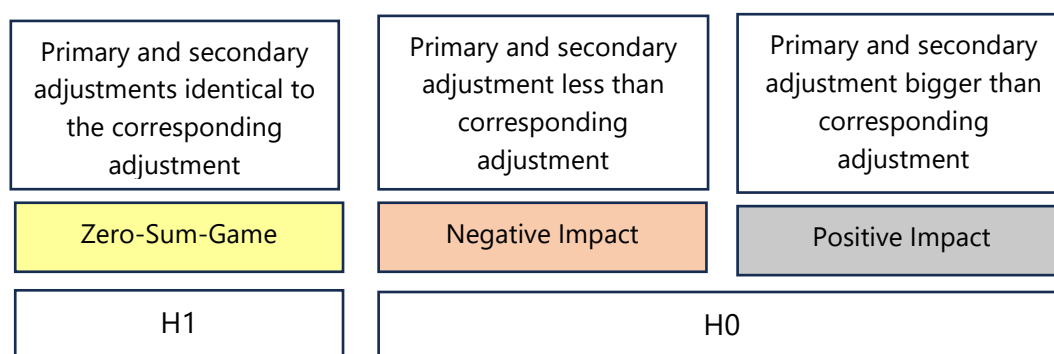


Figure 1 Research Framework
Source: Researchers Processed

2.1 Special Relationship and Affiliated Parties

The term special relationship only exists in the scope of taxation after PSAK 07, the Statement of Accounting Standard 07 (Revised 2015) Disclosures of Related Parties, no longer uses the term. A special tax relationship is regulated in Article 18, paragraph (4) of the Income Tax Law (1983) and Article 2, paragraph (2) of the Value Added Tax Law (1983). A special relationship is considered to exist if:

- taxpayers have direct and indirect equity participation of at least 25% in other taxpayers, a relationship between taxpayers through the involvement of at least 25% in two taxpayers or more, or a relationship between two taxpayers or more, the last mentioned;
- taxpayers control other Taxpayers, or two or more Taxpayers are under the same control either directly or indirectly; or
- there is a family relationship, either blood or marriage, in a straight line and/or one degree sideways.

Article 8 paragraph 4 of Government Regulation Number 94 of 2010 concerning the Calculation of Taxable Income and Payment of Income Tax in the Current Year explains more detail about special relationship concepts. Direct management control exists if there are similarities between two or more taxpayers, directors, or commissioners. For instance, Mr A is the Director of PT X and the Main Director of PT Y, so PT X and PT Y are considered to have a special relationship. It also exists if the management of different companies has family relations either by blood or

by marriage in a straight line and/or one degree sideways. For example, Mr A served as Director of PT X, and Mrs C, as Mr A's wife, became Director of PT Y. Hence, in that case, PT X and PT Y are considered to have a special relationship.

The government refined the definition of special relationship in PMK-22/PMK.03/2020, Minister of Finance Regulation Number 22/PMK.03/2020 concerning Procedures for Implementing Transfer Price Agreements (Advance Pricing Agreement). These improvements can be seen in the provisions of Article 1 number 13, Article 1 number 15, and Article 4 PMK-22/PMK.03/2020.

Article 1 number 13 PMK-22/PMK.03/2020 defines affiliated parties as parties that have a special relationship with each other. Article 1 number 13 links the concept of a special relationship in tax regulations with affiliated transactions in accounting standards. Article 1 number 15 PMK-22/PMK.03/2020 broadens the scope of related transactions by adding the definition. It expands the related transactions definition to include transactions made between parties who are not related but are affiliated parties of one party or both parties to the transaction, determining the transaction's counterparty and price.

Article 4 PMK-22/PMK.03/2020 expands the element of management control by adding the following two conditions:

- the parties who are commercially or financially known or claim to be in the same business group; or
- one party claims to have a special relationship with the other party.

Even though the government has prepared various regulations relating to related transactions, Ardianto and Dyan (2018) consider that applying PSAK 07 is more appropriate to explain related transactions than tax regulations. Based on that study, the researcher cites the provisions in paragraph 9 of PSAK 07 regarding the definition of affiliated transactions. Based on that paragraph, affiliated transactions are defined as transfers of resources, services, or obligations between the reporting entity and related parties, regardless of whether a price is charged. The associated parties in PSAK 07 consist of people or close family members and other entities. A person or immediate family member is considered to have an affiliate relationship with the reporting entity if they have control or joint control, have significant influence, or are key management personnel of the reporting entity or parent entity of the reporting entity. On the other side, an entity is considered to have a special relationship if it meets the following conditions:

- a. the entity and the reporting entity are members of the same business group;
- b. the entity is an associate or joint venture of a business group in which the reporting entity is a member;
- c. the entity and the reporting entity are joint ventures of the same third party;
- d. the entity is a joint venture of the third-party entity, and the reporting entity is an associate entity of the same third party;
- e. the entity is a post-employment benefit plan for employee benefits from a reporting entity or an entity related to the reporting entity. If the

- reporting entity is the entity administering the program, then the sponsoring entity is also associated with the reporting entity;
- f. an entity that is controlled or jointly controlled by a person or close family member who has a relationship with the reporting entity;
- g. a person or close family member with control or joint control of the entity who has significant influence over the entity or is a member of the entity's key management personnel; and
- h. the entity, or a member of a group of which it is a part, provides critical management personnel services to the reporting entity or the parent of the reporting entity.

Based on the above explanation, the scope of affiliated relationships in PSAK 07 (Revised 2015) is broader than tax regulations. For instance, the affiliate parties in PSAK 07 accommodate sponsoring entities and joint ventures.

2.2 Transfer Pricing

Transactions between affiliated parties are known as transfer pricing. Article 1 number 8 Director General of Taxes Regulation Number PER-32/PJ/2011 concerning Amendment to the Director General of Taxes Regulation Number PER-43/PJ/2010 concerning Application of the Arm's Length Principle in Transactions between Taxpayers and Related Parties defines transfer pricing as determining prices in transactions between parties that have special relationships. Kurniawan (2015) defines transfer pricing as a company policy determining a transaction's

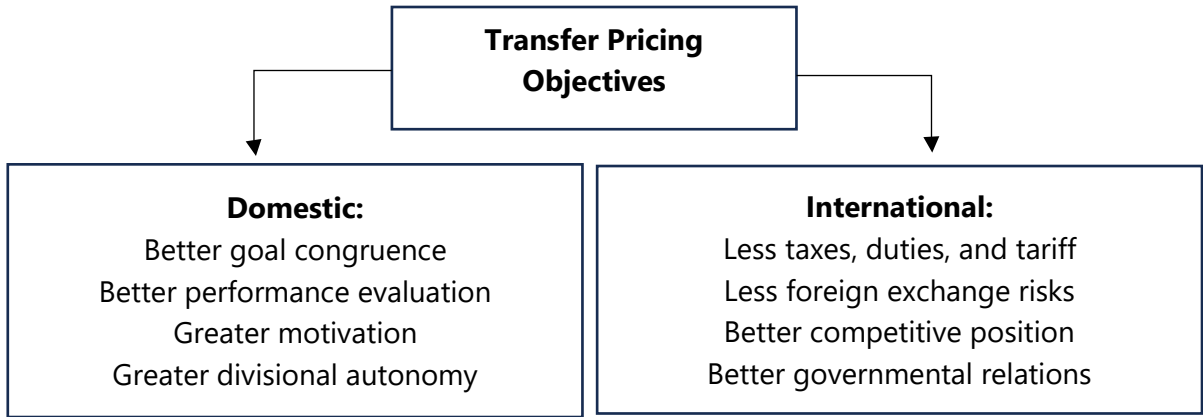


Figure 2 Objective Differences Between Domestic and Global Transfer Pricing Source: Trang, 2016

transfer price with parties affected by special relationships.

There are two kinds of transfer pricing. The first is multinational transfer pricing, and the other is domestic transfer pricing. International transfer pricing's main objective is to reduce taxes by utilizing the different tax rates among countries. On the other hand, the primary aim of domestic transfer pricing tends to make up the performance evaluation. Trang (2016) resumes objective differences between domestic and global transfer pricing in Figure 2.

Taxpayers must apply the arm's length principles for every transaction with related parties. These principles mean the range price or profit between related parties must be similar to the non-related parties. The steps for implementing those principles are based on Article 3 paragraph (2) of the Director General of Taxes Regulation Number PER-32/PJ/2011, include:

a. Comparability analysis.

A transaction is considered comparable if no material or significant difference in conditions could affect the price or profit. If conditions differ, adjustments can be made. Taxpayers must use internal comparison data if internal and external comparison data have the same level of comparability.

b. Transfer pricing methods selection.

PER-32/PJ/2011 permits five transfer pricing methods: the comparable uncontrolled price (CUP) method, the resale price method (RPM), the cost-plus method (CPM), the profit split method (PSM), or the transactional net margin method (TNMM). Each method has specific characteristics and conditions to be implemented.

c. Fairness principal application.

Fair price or fair profit can be in the form of a single price or profit or an acceptable price range or profit.

d. The documentation of steps to determine fair prices or profits should apply to the applicable laws and regulations provisions.

Those steps also apply to particular transactions, such as transactions for the provision of services and transactions for the use of

intangible assets with additional following provisions:

a. Service transactions.

A service transaction between two related parties is considered to exist if services are delivered or acquired, economic benefits can add value, and the value of the service transaction between related parties is equal to the value of the service transaction between independent parties.

b. Transaction utilization and transfer of intangible assets.

Transactions for the utilization and transfer of intangible assets are considered to exist if transactions occur, there are economic or commercial benefits, and the value of transactions for the utilization of intangible assets is the same as transactions with independent parties.

2.3 Domestic Transfer Pricing

Transfer pricing issues arise from transactions between several affiliated companies in one country (OECD, 2022). However, this issue is not included in the OECD Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations. The issue of domestic transfer pricing appears in Article 2, paragraph (2) of the Director General of Taxes Regulation number PER-32/PJ/2011. According to the article, transfer pricing regulation in domestic affiliated transactions only applies to related transactions that take advantage of tariff differences. Among others, due to the imposition of final or non-final tax, the treatment of the imposition of sales tax on luxury goods, or transactions conducted with Taxpayers of Oil and Gas Cooperation Contract Contractors.

The term "among others" in Article 2 paragraph (2) of the Director General of Tax Regulation number PER-32/PJ/2011 is dynamic because it only illustrates transactions with the possibility of a tariff difference between domestic affiliated parties.

Several countries, such as India and Zimbabwe, also apply domestic transfer pricing

regulations. India adopted them in 2012, while Zimbabwe adopted them in 2016.

Unlike Indonesia, small and medium enterprises (SME companies) must apply Zimbabwe's domestic transfer pricing regulation. The regulation is good for preventing profit shifting and transfer pricing abuse but also burdens SME companies more (Wealth et al., 2022).

In India, domestic transfer pricing is regulated by the Finance Act 2012 (PricewaterhouseCoopers, 2013). It includes sales and purchase transactions between taxpayers and tax holiday facilities with closely connected entities and expenses based on section 40A (2) of the Finance Act 2012. This regulation is an amendment version of the Income Tax Act 1961. It was changed due to India's Supreme Court recommendation in the case of Commissioner of Income Tax IV versus Glaxo SmithKline Asia P Ltd. The judge recommended to India's Ministry of Finance to widen the scope of transfer pricing rules to the domestic transaction to reduce complex litigation cases in the future. Before the amendment, India's Supreme Court assumed that the tax officer could not adjust the transaction value between Glaxo SmithKline Asia P Ltd and GSKCH as its supplier because the Income Tax Act 1961 does not regulate domestic transfer pricing cases (India v Glaxo SmithKline Asia (P) Ltd, 2010).

Section 40A (2) of the Finance Act 2012 is almost identical to Indonesia's domestic transfer pricing regulations. One of the differences between section 40A (2) and Indonesian regulation is the difference in terminology and the percentage of ownership, which is considered to have a substantial effect. At first glance, section 40A (2) of the Finance Act 2012 seems to adopt commercial accounting provisions directly; it uses terms such as sister company, investor company, and investee company, as well as in terms of ownership, which sets a lower limit for control at 20% shareholding.

PricewaterhouseCoopers (2013) illustrates the scope of the Finance Act 2012 with company B as an example. Company B must apply domestic transfer pricing provisions when conducting transactions with company owners with substantial interests, entities, and individuals. Substantial

interest is in line with the provisions of commercial accounting, characterized by shared ownership of 20%. Other domestic transfer pricing transactions are between Company B and its sister companies and Company B and associated entities/subsidiaries/joint ventures owned by Company B.

In addition, transactions between Company B and companies that the Directors of Company B substantially own include transactions with members of the director's family, Company B's dealings with the Directors of Company B, the Directors of the company it owns, and shareholders with substantial interests, including their family members. Payments to Directors are also included in one of the scopes of domestic transfer pricing.

3. RESEARCH METHODOLOGY

This paper uses the qualitative case study method. According to Creswell in Raco (2015), the case study is one of five qualitative methods. He divides the qualitative methods into five kinds: biography, phenomenology, ethnography, grounded theory, and case study. According to Creswell in Raco (2015), a case study is a method that tries to comprehensively understand one specific case by collecting information from diverse sources.

Raco (2015) divides the case study method into descriptive, explorative, and explanatory categories. The descriptive method tries to describe one symptom or fact. In contrast, the explorative method tries to develop a hypothesis by gaining a deep understanding of one issue. The explanatory method seeks information about causality aspects and arguments. According to Raco's (2015) classification, this research is an explorative case study method because it tries to gain a deep understanding of domestic transfer pricing.

This research uses a case study approach because domestic transfer pricing is unique. It does not happen in all tax offices and has minimal literature, especially in Indonesia's cases.

This research combines primary and secondary data to understand the cases better. Interview competent persons to collect primary

data. There are some professionals as source persons, including the head of supervision section I and the Account Representative at the Jakarta Gambir Two Tax Office (KPP Pratama Jakarta Gambir Dua), the Account Representative at the Central Jakarta Medium Tax Office Two (KPP Madya Dua Jakarta Pusat), and Staff at the Special Transaction Examination Sub-Directorate, DGT Head Office. Source persons were elected due to their involvement in the cases and knowledge.

This research also uses primary documentation as a research source. This primary documentation includes SP2DK (Letter of Request for Explanation of Data and/or Information), BAPK (Minutes of Providing Information), BAP4DK (Minutes of Request for Explanation of Data and/or Information), and LHP2DK (Report on the Results of a Request for an Explanation of Data and/or Information). Even though this research uses actual data, it cannot reveal the true identity of the taxpayers due to Article 34 paragraph (1) of KUP Law (the General Provisions and Tax Procedures Act). Hence, this research uses the code for the taxpayers and affiliated parties.

This research was conducted from January to October 2022 in the Jakarta Gambir Two Tax Office. However, there are four cases of domestic transfer pricing. Three cases were solved at the supervision stage, while another was proposed for the next audit phase. This research uses three completed tax supervision cases to better understand domestic transfer pricing corrections and their impact on national tax revenues.

Besides tries to get answers about our hypothesis, which includes these four steps:

- a. describing the factual correction of domestic transfer pricing;
- b. counting hypothetical secondary adjustments;
- c. counting hypothetical corresponding adjustments; and
- d. comparing the primary and secondary adjustments sanction to the corresponding adjustment.

This research also describes the following aspects as well:

- a. disclosure of related transactions on corporate income tax returns;

- b. sample position on CRM TP (compliance risk management of transfer pricing); and
- c. taxpayer transfer pricing scheme.

4. RESULTS AND DISCUSSION

4.1 Overview

This research uses three completed tax supervision cases, as stated in the previous section. The first case is PT N, which has service transactions with its sister companies. Initially, the AR (Account Representative) for PT N did not know that PT N and its service providers were related parties. AR asked PT N about marketing, supervising, and administration costs because they reduced 65% of PT N's gross profit. AR realized that PT N and its service providers were related parties when analyzing contracts and other supporting documents during counseling.

The second case is the PT M Case. PT M Case is remuneration to owner-affiliated parties. Unlike the case of PT N, AR for PT M suspected the most significant portion of the honorarium was paid to the shareholders and their family members due to the similarity of specific names among the honorarium recipients. AR then tried to investigate his suspiciousness by checking the Indonesia Citizenship Portal (Portal Dukcapil), which was proven.

The last case is the PT V case. It was a loan and interest-related transaction. The interest rate between PT V and its affiliated is bigger than 38% per annum. This amount is more significant than Indonesia's average interest rate bank (Anggraeni, 2022). AR for PT V then sends SP2DK relating to charging interest on PT V's affiliated loans. AR uses JIBOR (Jakarta Interbank Offered Rate) data as a reasonable interest rate because AR for PT V does not know PT V's credit risk as a factor of adjustment to the data JIBOR rate. Resumes of the cases are shown in Table 1.

4.2 N Corporation for the 2019 Fiscal Year

Trigger from PT N's case is based on differences in the number of purchases between the Corporate Income Tax Return and Value Added Tax Return.

Table 1 Summary of the General Description of the Research Sample

Source: Researchers Data

| No. | Taxpayer | SP2DK Number | Tax year | LHP2DK | Types of Affiliate Transactions |
|-----|----------|--------------|----------|---------|---|
| 1 | PT N | SP2DK-296 | 2019 | Already | Intra-group service fees in the form of office administration, sales, and supervision services between PT N and affiliated parties who are taxpayers are subject to a Final Income Tax of 0.5%. |
| 2 | PT M | SP2DK-595 | 2018 | Already | Compensation for family members who own shares as well as management. |
| 3 | PT V | SP2DK-592 | 2020 | Already | The interest rate charged for the loan exceeds the fair interest rate. There is no difference in tax rates between PT V and affiliated parties. |

Table 2 PT N's Financial for the Year Ended December 31, 2019 (Expressed in Rupiah)

Source: Researchers Processed

| | |
|---------------------------------------|-------------------------------|
| Sales | 33,346,792,280 |
| Cost of Goods Sold | <u>26,414,716,359 -</u> |
| Gross Profit | 6,932,075,921 |
| Insurance costs | 36,785,318 |
| Marketing costs | 2,250,000,000 |
| Analysis costs | 6,050,000 |
| Sandstone costs | 900,000,000 |
| Operational costs | 1,125,000,000 |
| Supervision costs | 1,125,000,000 |
| Salary and benefits costs | 41,106,720 |
| Medical costs | 777,734 |
| Rental costs | 5,005,000 |
| Miscellaneous expense | 78,201,850 |
| Total operational expense | <u>5,570,426,622 -</u> |
| EBIT | 1,361,649,299 |
| Interest income | 6,152,759 |
| Interest tax | (1,230,552) |
| Bank administration fee | (893,500) |
| Net income outside of business | <u>4,028,707 +</u> |
| Earning before tax | 1,365,678,006 |
| Income tax | <u>315,709,562 -</u> |
| Net income | <u>1,049,968,444</u> |

AR analyzed financial statements and found additional indications that taxpayers had not fulfilled their tax obligations as follows:

a. PT N has not made Article 21 withholding income tax for supervision services for Rp1,125,000,000.

b. PT N has not made Article 23 withholding income tax for marketing services for Rp2,250,000,000.

c. PT N must explain the sandstone cost of Rp900,000,000 and the operational cost of Rp1,125,000,000.

There were no domestic transfer pricing indications at the beginning of the analysis because there was no indication on the CRM TP Engine, and the taxpayer did not disclose its affiliated transactions in its corporate tax income return. Researchers show PT N's income statement for the year ended 31 December 2019 in Table 2.

The lack of electronic tax documents is one possible factor in undetected special relationship transactions among PT N and its affiliated parties in CRM TP. PT N affiliated parties are not PKP, an abbreviation for *Pengusaha Kena Pajak* (Taxable Entrepreneur), so they do not issue tax invoices. PT N does not withhold Article 23 Income Tax because its related parties are taxpayers subject to Final Income Tax according to PP 23 of 2018 (Government Regulation Number 23 of 2018 concerning Income Tax on Operating Income Received or Acquired by Taxpayers Having Certain Gross Revenue).

All of the initial findings were sent to the taxpayer through SP2DK number 296, dated February 21, 2022, and the taxpayer provided a written response as follows:

- the difference in purchase data originates from the purchase of non-taxable goods and completes the response with supporting documents in the form of purchase documents, delivery documents, and proof of payment to suppliers;
- taxpayers do not withhold Article 21 Tax Income because corporate taxpayers carry out

supervision services, namely PT N1; taxpayers also do not withhold Article 23 Tax Income because PT N1 has a Certificate of Fulfilling Criteria as a Taxpayer Based on PP 23 of 2018;

- taxpayers do not deduct Article 23 Tax Income for marketing services from PT N2 and PT N3 because the two companies have a Certificate of Fulfilling the Criteria as Taxpayer Based on PP 23 of 2018; and

- the sandstone cost account represents marketing costs to PT X, and the operational cost represents the cost of office administration services performed by PT N4.

AR conducted research on data from PT N1, PT N2, PT N3, PT N4, PT X, PT N's suppliers, and PT N's customers in 2019 with the following research results:

- the taxpayer has one main customer (73.5% of sales was made to this customer), but it has three marketing services providers: PT X, PT N2, and PT N3;
- the taxpayer has two suppliers; and
- the taxpayer does not have fixed assets in an office or mining storage site, but it has office administration services with a tremendous value; PT N records office rental fees of Rp5,005,000 and office administrative service fees paid to PT N4 of Rp1,125,000,000.

Transaction schemes from suppliers, vendors, and customers of PT N are displayed in Figure 3.

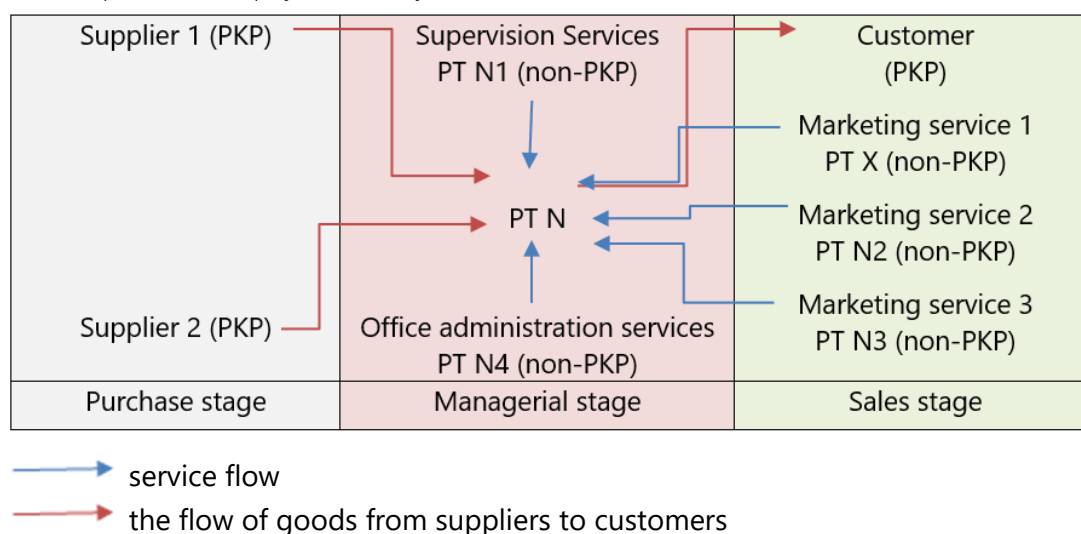


Figure 3 PT N's Transaction Schemes
Source: Researchers Processed

During the analysis of contract documents among PT N and PT N1, PT N2, PT N3, and PT N4, AR finds that all of the contracts' formats are the same. It consists of 4 articles with contract details in Article 1, commissions/remuneration and banking data in Article 2, dispute resolution in Article 3, and contract closing provisions in Article 4. The basis for distributing remuneration/commission between PT N and PT N1 to PT N4 is the same, based on the number of shipping barges of Rp75,000,000/barge shipping of mining goods.

Because of the research results above, AR for PT N seeks a relationship between PT N and PT N1 to PT N4 with the following results:

- Supplier 1, Supplier 2, Customer, and PT X are independent parties.
- A holding company became the parent company of PT N, PT N1, and PT N4.
- This holding company has two related companies not involved in the PT N transaction scheme, PT N5 and PT N6. In addition, PT N5 has 90% of PT N's shares.
- PT N with PT N1 and PT N2 have a special relationship based on the similarity in management among the three companies. The Director of PT N (from now on referred to as Dir. N) serves as Commissioner of PT N1 (PT N1

has a Director, namely Dir. N1) and Director of PT N2, in addition to managing PT N2, Dir. N also has a 40% share ownership in PT N2 (PT N2 has one more Director besides Dir. N, namely Dir. N2).

- Dir. N2 becomes the Director of PT N3, which means PT N2 and PT N3 have unique relationships.
- Dir. N1 becomes commissioner of PT N4, which means PT N1 and PT N4 have special relationships.
- According to Article 4 PMK-22/PMK.03/2020, AR concludes that PT N has a special relationship with PT N1, PT N2, PT N3, and PT N4.

The relationship among all the companies in N holding is visualized in Figure 4. After the pattern of the special relationship can be identified and proven by AR for PT N, he tests the existence of service delivery, aspects of economic or commercial benefits, and the aspect of fair value for service delivery. All the tests were conducted according to Article 14 paragraph (2) PER-32/PJ/2011. Testing these aspects is done by requesting taxpayer information using a question guide based on Appendix I Director General of Taxes Circular Letter Number SE-50/PJ/2013 concerning Technical Guidelines for Audit of

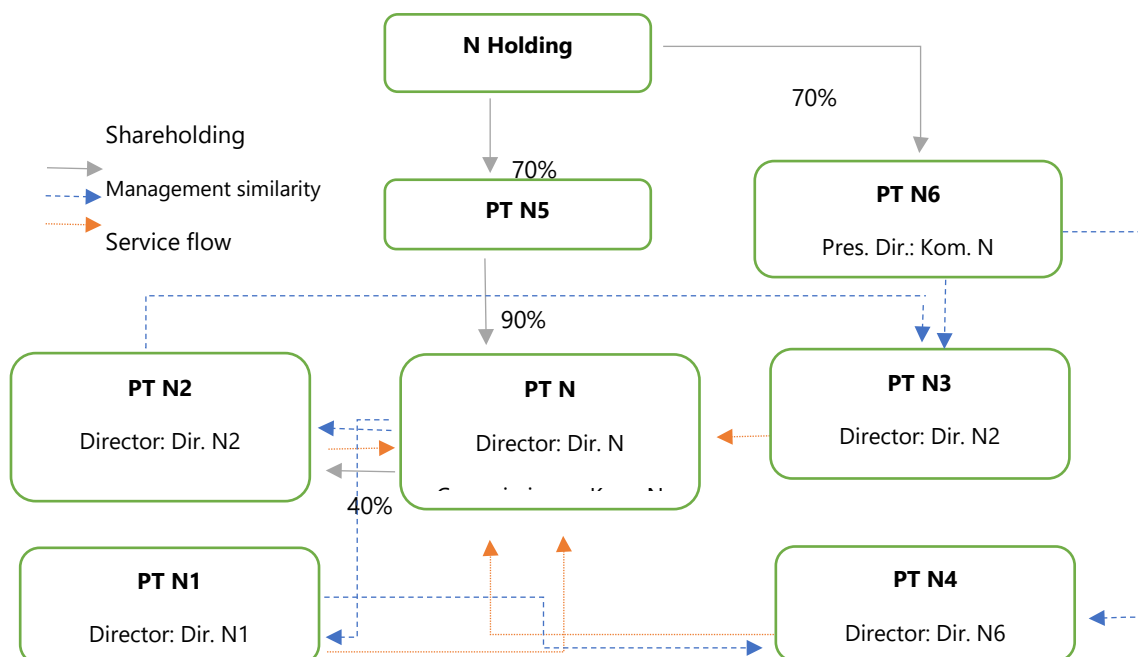


Figure 4 The Relationship Among All the Companies in N Holding
Source: Researchers Processed

Taxpayers with Special Relationships. Based on the data at the BAPK between AR and PT N's attorney, it is known that PT N did not prepare transfer pricing documentation (TP Doc). Moreover, marketing services are provided by three different companies, namely PT X (an independent party), PT N2, and PT N3, even though PT N only has one customer.

The first sales transaction was carried out on July 8, 2019. The marketing services work contract between PT N, PT N2, and PT N3 was signed on January 7, 2019. Transactions between PT N and PT X (independent parties) were carried out without a contractual agreement.

AR tests taxpayers' reasons about the needs and qualifications of marketing service providers. It explains that it needs a marketing service provider because it is a new company. It also explained that selecting service providers is entirely the decision of the director of PT N (Dir. N), and the appointment process is carried out directly without any tender process for service providers.

The next question related to the existence aspect of the service (service has been rendered) is the qualification aspect of the marketing service providers. AR asked questions related to the company's qualifications, segregation of duties on marketing services, and the basis of remuneration/compensation. In addition, AR also confirmed the number of dedicated persons from PT N2 and PT N3.

The taxpayer's attorney explained that PT N2 and PT N3 do not have special qualifications related to marketing services, and there is no separation of duties between PT N2, PT N3, and PT X. The basis of remuneration/compensation for PT N2 and PT N3 is Rp75,000,000/barge shipment, both large-capacity and small-capacity barges. Regarding the availability of a dedicated person, he explained that PT N2 and PT N3 did not provide any dedicated person for PT N. The taxpayer also explained that the basis for the invoice was only a sales invoice without any evidence/other documents related to the delivery of marketing services by PT N2 and PT N3.

Based on the BAPK results, AR compared the taxpayer's statement with the data on the SIDJP (DGT information system application). Based on

data from SIDJP, PT N2 is classified as a transportation management service business field. The number of employees on the Periodic Income Tax Return 21 of 2019 is nil, and the total assets in Appendix 1A of the 2019 Corporate Income Tax Return are nil. PT N2 was registered as a taxpayer on July 18, 2019. PT N3 has a business field classification as a business consulting service and business brokerage with assets in Appendix 1A of the Corporate Income Tax Return only in the form of air conditioners and printing machines and has a workforce of 16 people.

The taxpayer's attorney did not understand the process of providing supervision services by PT N1 in detail. He only knows that the supervision services are related to loading and unloading goods. Questions relating to the existence aspects were answered similarly in the cases of marketing services by PT N2 and PT N3. Based on the SIDJP, it is known that the PT N1 has a business field classification as a rental service and civil construction machinery and lease. PT N1 does not have the assets in Appendix 1A of the Corporate Income Tax Return and only has three employees.

The last intra-group service transaction is an office administration service provided by PT N4. In addition to the same questions asked to PT N2 and PT N3, AR also asked about the background needs for office administration services and the qualifications of PT N4. AR thinks PT N does not need an office administration service provider because PT N only rents a virtual office and does not have many employees. The taxpayer's attorney did not answer why PT N needs an office administration service provider. He only explained that PT N4 only carried out activities in administration and filing company documents. PT N4 is not responsible for preparing financial statements and tax reports because the taxpayer's attorney conducts all those processes. According to the SIDJP, AR for PT N also identified that PT N4 does not have assets based on Appendix 1A of the Corporate Income Tax Return and does not have a workforce based on Periodic Income Tax Return Article 21.

The summary of BAPK and existence analysis conducted by AR for PT N is shown in Table 3.

Table 3 Summary of Existence Aspect Testing Analysis in PT N's BAPK
Source: Researchers Processed

| No. | Question Aspect | Marketing Services | Supervision Services | Office Administration Services |
|-----|--|--|--|--|
| 1. | Service needs background | The company is still new and requires marketing services | The company is still newly established and requires supervision services | Taxpayers do not explain the background of the need for services |
| 2. | Tasks Distributions | There is not any | There is only one provider | There is only one provider |
| 3. | Service providers qualifications | Transportation management service and business and brokerage service | Rental service and civil construction machinery | - |
| 4. | Basis of remuneration/ Compensation | Per barge delivery of goods | Per barge delivery of goods | Per barge delivery of goods |
| 5. | Availability of exceptional employees for PT N | - | - | - |
| 6. | Proof of service has been provided | Sales invoice only | Sales invoice only | Sales invoice only |
| 7. | Ownership of assets | AC and printer | - | - |
| 8. | The number of workers in labour supply companies | 16 employee | Three employees | - |

The result of PT N's intra-group service transactions is similar to Simamora and Hermawan's (2017) research. She found that the existing aspects caused most corrections of intra-group service transactions. This condition indicates that the tax officers must notice. They must strengthen the existence aspects analysis before doing the fair value test.

Based on the test results above, AR PT N and his supervisor asked the taxpayer to make a positive fiscal correction entirely for intra-group service costs because the taxpayer failed to fulfill existence aspects. The taxpayer's attorney only wants to make a positive fiscal correction on office administration and supervision costs. He argues that PT N2 and PT N3 have carried out marketing services and asks AR to adjust to the next stage, namely the fair value tests among taxpayers with PT N2 and PT N3. AR uses PT N's internal data

as comparison data. AR uses transactions between PT N and PT X and the CPM method to determine the fair price of transactions.

AR uses PT X's Gross Profit Margin data, which is 56.03%, to calculate the fair price of the transaction between PT N, PT N2, and PT N3. Based on data from SIDJP, it is known that PT N2 and PT N3 have a total cost of Rp56,744,192 and Rp480,895,037 so the fair price of the transaction is Rp88,538,026 for PT N2 and Rp588,177,781. Consequently, the taxpayer must make a positive fiscal correction of Rp1,573,284,194 for marketing services transactions with PT N2 and PT N3. PT N subsequently corrected the 2019 Corporate Income Tax Return for Rp850,001,428. For the 2019 Corporate Income Tax Return correction transaction, AR subsequently issued a 2019 Corporate Income Tax STP (Tax Collection Letter) number 00039/106/19/XXX/22 for Rp196,787,561.

Table 4 Domestic Transfer Pricing Correction of PT N (Expressed in Rupiah)

Source: Researchers processed

| No. | Type of Correction | Nature of Correction | Amount of Tax Correction |
|-----|--|----------------------|--------------------------|
| 1 | Primary Correction | Real | 850,001,428 |
| 2 | Secondary Correction | Hypothetical | 573,492,629 |
| 3 | Corresponding Adjustment | Hypothetical | (19,116,421) |
| 4 | Sanction | Real | 196,787,561 |
| 5 | Total Revenue (Real and Hypothetical [1 to 4]) | | 1,601,165,197 |
| 6 | Total Real Revenue (1+ 4) | | 1,046,788,989 |

The actual total revenue for the state treasury was Rp1,046,788,989.

The next researcher simulated if PT N1, PT N2, PT N3, and PT N4 made a corresponding adjustment. The four companies are taxpayers subject to Final Income Tax based on PP 23 of 2018. For supervision service and office administration service transactions with PT N1 and PT N4, all positive fiscal corrections were carried out so that the corresponding adjustment value for the transaction was Rp2,250,000,000 and the tax refunded by the state was $Rp2,250,000,000 \times 0.5\%$ or Rp11,250,000. The taxpayers of PT N2 and PT N3 are partially corrected for Rp1,573,284,194 so that the tax value that the state must return in the event of a corresponding adjustment is $Rp1,573,284,194 \times 0.5\%$ or Rp7,866,421. Hence, the total corresponding adjustment from PT N1 to PT N4 is Rp19,116,421.

The hypothetical secondary adjustment is treated as a dividend to the owner of the group of N-holding corporations. A total secondary adjustment would be $15\% \times Rp3,823,284,194$ (total positive fiscal correction) or Rp573,492,629 (DGT, 2023). So, the net revenue addition from domestic transfer pricing correction is Rp1,601,165,197. Researchers summarize the correction in Table 4.

4.3 M Corporation for the 2018 Fiscal Year

PT M is the holding company of the M Group. The most significant income for taxpayers comes from divestment and dividends from its subsidiaries. Dividends from subsidiaries include deemed dividends from equity participation jointly with PT R, a member company of the M Group. The

beneficial owner of M Group is Pres. Dir. M. He is the major shareholder in almost all M Group companies and the President Director of PT M. He also appoints his children, Dir. M (second child and Director PT M), Dir. M1 (first child, President Director of PT M1), and his wife manage some M Group companies.

The issue of PT M is the existence of honorarium payment transactions to management's family members. The taxpayer divested shares in an associated entity, PT M1, in 2018. It records a gain on the transfer of Rp94,307,637,763. PT M also received dividend income from its subsidiary for Rp39,730,782,539, a gain on foreign exchange of Rp6,773,515,605, and a gain on equity participation in the company P2P Lending and deposit interest of Rp1,841,970,338. PT M does not declare any related transactions in Appendix VI and Appendix 3A of the Corporate Income Tax Return. The financial statements of PT M researchers are presented in Table 5.

PT M, Dir. M1 and PT M0 are the shareholders of PT M1. Each has 18.7%, 1.8%, and 31.5% of PT M1 shares. They agreed to sell their shares to a third party in 2018. Researchers put the M Group relationship and schemes in Figure 5 to better understand.

PT M paid the Dir. M1 and Pres. Dir M's wife has an honorarium fee of Rp7,000,000,000. AR then indicated that the honorarium payment was a fee for the personal needs of the taxpayer or his dependents, as required by Article 9 paragraph (1) letter I of the Income Tax Law.

The taxpayer's attorney then provides evidence and supporting documents in the form of a director's circular decision regarding honorees related to the transfer of PT M1 shares. PT M

Table 5 PT M's Financial Statement (Expressed in Rupiah)

Source: Researchers Processed

| | | |
|---------------------------------------|----------------|------------------------|
| Profits from the divestment of shares | | 94,307,637,763 |
| Dividend | | 39,730,782,539 |
| Bank interest income and P2Plending | | 1,841,970,338 |
| Other income | | 50,743 |
| Gain on foreign exchange. | | 6,773,515,605 |
| Total Revenue | | 142,653,956,988 |
| Salary expense | 287,553,619 | |
| Insurance fee | 45,000,000 | |
| Miscellaneous expense | 26,685,648 | |
| Legal and professional fees | 8,980,000 | |
| Honorarium fees | 31,021,428,571 | |
| Health costs | 2,143,500 | |
| Total cost | | 31,391,791,338 |
| Profit before tax | | 111,262,165,550 |
| Negative Fiscal Correction | 43,379,722,607 | |
| Positive Fiscal Correction | - | |
| Taxable income | | 67,882,443,043 |
| Income tax | | 16,970,610,761 |

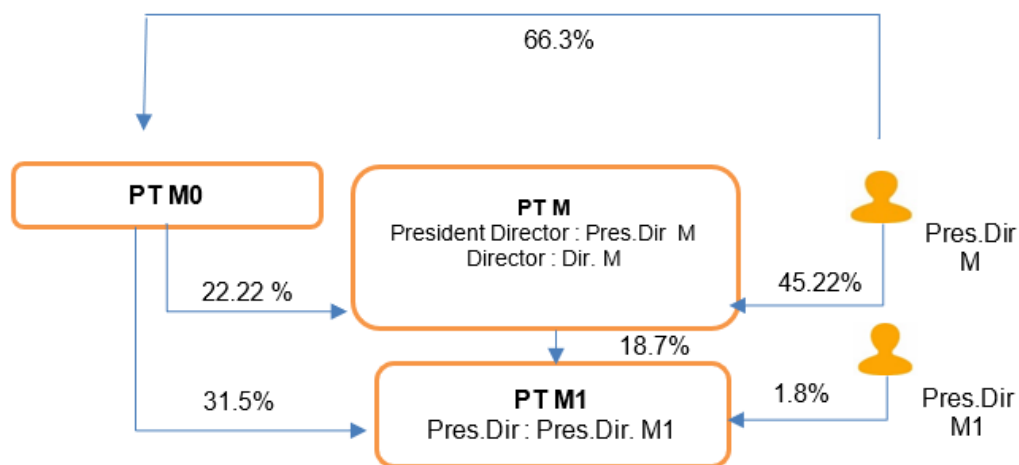


Figure 5 Company Affiliation Relationship of M Group

Source: Researchers Processed

Directors' Circular Decree does not explain the basis of remuneration and performance indicators of honorarium recipients. AR for PT M then diverted suspicion from Article 9 paragraph (1) letter I of the Income Tax Law to an alleged particular transaction. AR for PT M asked for evidence that the honorees rendered his services and expertise to PT M in the context of divesting PT M1 shares.

PT M's attorney did not provide data to AR regarding the aspect of providing services that the

Dir.M1 and Pres. Dir M's wife had carried out. However, he is willing to make adjustments in the form of a price fairness correction of 50% of the honorarium. He assumes that the Dir has done the services. However, PT M did not make transfer pricing documentation for the transaction. PT M subsequently made a positive fiscal correction of Rp3,500,000,000 for the honorarium expenses. As a result, PT M's Corporate Income Tax from the domestic transfer pricing correction increased by Rp875,000,000. In addition, the sanction based on

Table 6 Comparison Between Honorarium and Dividends to PT M (Expressed in Rupiah)

Source: Researchers Processed

| No. | Tax Type | Taxes Payable |
|--|-----------------------|---|
| a. Initial conditions | | |
| 1 | Corporate Income Tax | 16,970,610,761 (See Table 5) |
| 2 | Article 21 Income Tax | 2,100,000,000 (30% x 7,000,000,000) |
| 3 | Final Income Tax | 0 |
| Total Income Tax Payable | | 19,070,610,761 |
| b. condition after correction of domestic TP | | |
| 1 | Corporate Income Tax | Initial taxable income: 67,882,443,043 Correction honor fee: 3,500,000,000 Final taxable income: 71,382,443,043 Corporate Income Tax: 17,845,610,761 |
| 2 | Article 21 Income Tax | 1,050,000,000 (30% x 3,500,000,000) |
| 3 | Final Income Tax | 350,000,000 (10% x 3,500,000,000) |
| Total Income Tax Payable | | 19,245,610,761 |
| Difference post-correction conditions | | 175,000,000 |

Table 7 Domestic Transfer Pricing Correction of PT M (Expressed in Rupiah)

Source: Researchers Processed

| No. | Type of Correction | Nature of Correction | Amount of Tax Correction |
|-----|--|----------------------|--------------------------|
| 1 | Primary Correction | Real | 875,000,000 |
| 2 | Secondary Correction | Hypothetical | 350,000,000 |
| 3 | Corresponding Adjustment | Hypothetical | (1,050,000,000) |
| 4 | Sanction | Real | 207,900,000 |
| 5 | Total Revenue (Real and Hypothetical [1 to 4]) | | 382,900,000 |
| 6 | Total Real Revenue (1+ 4) | | 1,082,900,000 |

Article 8 paragraph (2) increased to Rp207,900,000. Consequently, state revenue from PT M's domestic transfer pricing correction became Rp1,082,900,000.

In the case of PT M, the issue of domestic transfer pricing seems to be not material because we think that the Article 21 Income Tax rate for individuals (30%) is much higher than the Corporate Income Tax rate (25%). That is partially true because the components of the distribution of money to the Dir. M1 and the wife of the President Director M is the distribution of dividends from PT M to shareholders (in this case, his family members). So, PT M is still obliged to withhold the Final Income Tax of the individual dividend by 10%. Therefore, there is a 5% difference in tariffs in the case of PT M as a tax motive.

The next researcher simulated if Dir. M1 and Pres. Dir M's wife made a corresponding

adjustment, and Jakarta Gambir Two Tax Office made the secondary adjustment. The total corresponding adjustment is $\text{Rp}3,500,000,000 \times 30\% = \text{Rp}1,050,000,000$. This amount must be subtracted from the Article 21 Income Tax. Otherwise, the secondary adjustment will bring $10\% \times \text{Rp}3,500,000,000 = \text{Rp}350,000,000$ as an additional correction to the state (DGT, 2023). According to the calculation above, the state will receive Rp382,900,000 net if all corrections apply. Researchers summarize the correction in Table 7.

4.4 V Corporation for the 2020 Fiscal Year

PT V is the holding company of group V. PT V's primary revenue comes from dividend income and the transfer of shares of subsidiaries, associates, or joint ventures controlled by PT V. PT V, as the

Table 8 PT V Financial Statement (Expressed in Rupiah)
Source: Researchers Processed

| | | |
|----------------------------|----------------|-----------------------|
| Share divestment income | | 45,676,929,773 |
| Dividend | | 10,328,551,974 |
| Deposit Interest Income | | 15,676,164 |
| Total income | | 56,021,157,911 |
| Salary expense | 134,377,036 | |
| Bank Administration fee | 490,000 | |
| Permit cost | 800,000 | |
| Investment costs | 35,187,000,000 | |
| Loan interest costs | 2,820,600,000 | |
| Consultant fee | 400,000,000 | |
| Total cost | | 38,543,367,036 |
| Profit before tax | | 17,477,790,875 |
| Negative Fiscal Correction | 10,344,228,138 | |
| Positive Fiscal Correction | - | |
| Taxable income | | 7,133,562,737 |
| income tax | | 1,569,383,802 |
| Net profit | | 5,564,178,935 |

holding company of group V, does not prepare consolidated financial statements and only makes financial statements for itself as a reporting entity. PT V's tax attorney explained that there were no consolidated financial statements because one family controlled PT V's majority shares, and the family did not need consolidated financial statements.

PT V 2020 sold its 33.3% share ownership in PT V1 to PT Z for Rp45,676,929,773. PT V also recorded dividend income from one of the associated entities owned by PT V of Rp10,328,551,974. Taxpayers recorded an interest expense component of Rp2,820,600,000 and investment costs for PT V1 shares of Rp35,187,000,000. The financial statements of PT V researchers are shown in Table 8.

Based on the data in Table 8, the most significant cost structure for taxpayers comes from investment and interest costs. The investment cost is the cost of acquiring PT V1's share ownership. The value matched with changes in PT V1's company deed related to the amount of authorized capital and the amount of paid-up capital of PT V1 so that AR does not make any corrections to PT V1's investment costs. The interest expense of Rp2,820,600,000 came from PT V's loan to PT V2. The interest expense is related

to PT V's loan transaction to PT V2 in 2018, amounting to Rp8,945,000,000. PT V paid off part of the loan in 2019, so the balance owed to PT V2 as of December 31, 2019, amounted to Rp6,395,000,000. PT V does not recognize interest expense on an accrual basis in 2018 and 2019 and does not disclose debt transactions to PT V2 in Attachment VI and Special Attachment 3A of the Corporate Income Tax Return.

PT V's special relationship transactions were also not detected in the DGT's CRM TP, even though there was proof of withholding Article 23 Income Tax. Hence, AR for PT V suspects that the PT V case and its affiliated parties did not appear in CRM TP risk because PT V and PT V2 are at the same tax rate. PT V reduced the share of ownership in PT V2 to 24.12% in attachment VI corporate income tax return from the value that should have been recorded, 99%. The affiliation scheme of researchers is shown in Figure 6.

Based on the indication of a special relationship above, AR PT V made SP2DK-592 and asked about the fairness of charging PT V's loan interest costs to PT V2. AR uses JIBOR data as the fair interest rate. AR uses the JIBOR interest rate because AR does not know the level of financing risk owned by PT V. The JIBOR interest rate in 2020 is 4.57%/year.

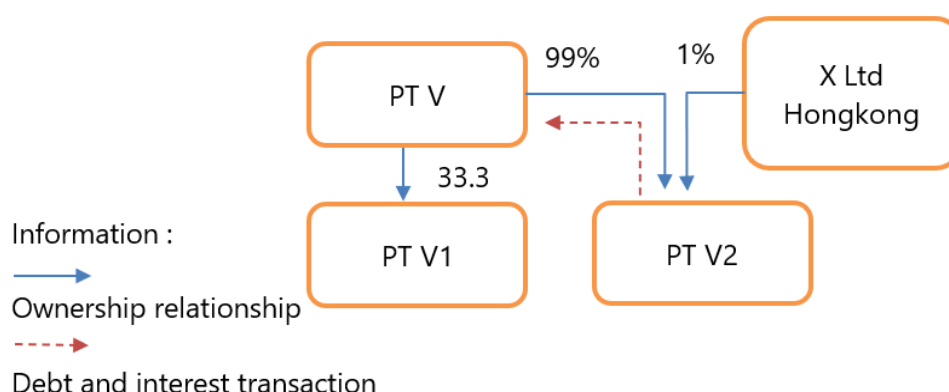


Figure 6 Group Interest and Special Relationship Transaction Scheme
Source: Researchers Processed

Table 9 Domestic Transfer Pricing of PT V (Expressed in Rupiah)
Source: Researchers Processed

| No. | Type of Correction | Nature of Correction | Amount of Tax Correction |
|-----|--|----------------------|--------------------------|
| 1 | Primary Correction | Real | 102,182,000 |
| 2 | Secondary Correction | Hypothetical | 70,215,000 |
| 3 | Corresponding Adjustment | Hypothetical | (102,182,000) |
| 4 | Sanction | Real | 19,105,162 |
| 5 | Total Revenue (Real and Hypothetical [1 to 4]) | | 89,320,162 |
| 6 | Total Real Revenue (1+ 4) | | 122,187,162 |

PT V's proxy agreed to a correction based on the fairness of interest rates but did not agree on whether the reasonableness of interest rates was measured using JIBOR interest rate data. The proxy of PT V expressed willingness to correct the interest rate if using the interest rate of one of the private banks in Indonesia, which was 10.75% in 2018, 11.25% in 2019, and 10.5% in 2020. With this reasonable interest rate, the taxpayer, on a self-assessment basis, corrects the 2020 Corporate Income Tax Return. The taxpayer makes a positive fiscal correction of interest expense of Rp468,100,000, and the tax payable from the correction is Rp102,182,000. The correction came from calculating interest expense using the interest rate at one of the private banks amounting to Rp2,352,500,000 compared to the previous interest expense of Rp2,820,600,000.

Regarding the corresponding adjustment, the amount of negative fiscal correction made by PT V will be the same as that of positive fiscal correction. However, in the case of PT V, it also

does not result in a zero-sum game because there is a potential for secondary adjustment and corporate income tax bills Article 8 paragraph (2) of KUP Law to PT V for Rp19,105,162. The secondary adjustment will be treated as a dividend of $15\% \times \text{Rp}468,100,000 = \text{Rp}70,215,000$ (DGT, 2023). The domestic transfer pricing of PT V is shown in Table 9.

In addition, the corresponding adjustment by PT V2 will be one of the checkpoints because PT V2 will be overpaid. AR PT V has suspicions that the location of the transfer pricing transaction is actually in PT V2 because X Ltd, as the holder of 1% shares in PT V2, has a legal domicile in Hong Kong, which has a corporate income tax rate of only 16.5% (Deloitte, 2021). That is in line with one of the three basic interest cost transfer pricing schemes, according to DGT (2016), where the group places high interest in countries with high tax rates. Even though it only controls 1% of PT V2's shares, X Ltd has a special relationship with PT V2 and PT V because X Ltd controls PT V2

technologically. Based on data from the World Intellectual Property Organization (WIPO), X Ltd is the trademark owner for products produced by PT V2. The loan extension from X Ltd by PT V2 to PT V1 can also be used in PT V2's transfer pricing document as material for analyzing the substance and loan requirements of PT V2 to X Ltd.

5. CONCLUSION

This research aims to prove domestic transfer pricing correction and its relation to the national tax revenue. This research is essential because some tax practitioners assume that domestic transfer pricing does not give any additional tax revenue to the government (Setiawan, 2013). However, no research in Indonesia has tried to bring up the real case of domestic transfer pricing corrections. Most of Indonesia's transfer pricing research tends to multinational transfer pricing cases or uses hypothetical numbers for domestic transfer pricing correction. Researchers face many difficulties in obtaining the whole population of domestic transfer pricing in Indonesia because of the secrecy principle of Article 34 of KUP Law. So, we use three cases to describe the actual condition of domestic transfer pricing. Even though it can be generalized as a general conclusion, researchers believe that this research can bring one brick to the development of domestic transfer pricing knowledge because one of the researchers is directly involved in the supervision process and gains a better understanding of the research object.

According to the research result, researchers can prove the tax motive of domestic transfer pricing in the case of PT M and PT N. PT M and PT N want to take benefit of tax tariff, and PT M gain benefit from the individual dividend and corporate income tax tariff difference, while PT N gain benefit from SME's tax and corporate income tax. In the case of PT V, researchers cannot prove that PT V has a tax motive for doing a domestic transfer pricing scheme. However, PT V and its affiliated parties have a relationship with the multinational company, which can be the real reason for the domestic transfer pricing scheme. Besides tax motives, this research also shows that

domestic transfer pricing correction brings additional income to state revenue in a confirmed case of state tax revenue. It also explains that even if taxpayers ask for the corresponding adjustments, there is no zero-sum game to the state tax revenues because the primary, secondary, and sanction implied to taxpayers are bigger than reducing revenue from corresponding adjustments.

6. IMPLICATIONS AND LIMITATIONS

This research gives practical insight into Indonesia's DGT as a tax-regulated party. Firstly, DGT must improve its CRM TP Engine because, in the case of PT N, it cannot detect transfer pricing risk. One of the possibilities is the absence of electronic tax documents, such as electronic tax invoices and withholding documents. Secondly, if domestic transfer pricing happens, and it seems does not have any tax motives, the tax officer has to analyze it because, in the case of PT M, we see that PT M almost does not have any tax motive because this company has withheld tax article 21 with the highest tax rate of 30%. However, PT M can obtain a 5% tax benefit from its scheme. Lastly, DGT should have a sharing mechanism between tax offices in all of Indonesia when domestic transfer pricing happens; it is crucial because companies from one group usually spread around some tax offices.

This study has some limitations. For example, we cannot include the whole population of domestic transfer pricing in Indonesia, and our case study only explains intra-group service and loan cases. Researchers suggest future research can obtain whole domestic transfer pricing in Indonesia. So, the following research can make a general conclusion using quantitative or mixed-approach methods.

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