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A QUALITATIVE ANALYSIS OF TRANSFER PRICING AUDITS IN LIGHT OF COVID-19 DISRUPTIONS: INDONESIAN CONTEXT

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ABSTRACT

A Qualitative Analysis of Transfer Pricing Audits in Light of COVID-19 Disruptions: Indonesian Context. The global economy and financial markets are now suffering from one of the strongest threats in modern history, an outbreak of Corona Virus Disease 2019 (COVID-19). The main objective of the paper is to contribute to the development of transfer pricing audits due to COVID-19 disruptions in Indonesian context. Furthermore, this paper intends to draw a theoretical framework on tax audits policy from a qualitative perspective. In conducting transfer pricing audits in relation with COVID-19, tax auditors need to assess the comparability analysis used by the taxpayer, the period in which analysis is projected, and intragroup services utilized by Indonesian subsidiaries impacted by the coronavirus crisis to cope with OECD TP Guidelines and Indonesia tax regulations.

Keywords: COVID-19, audit, transfer pricing, Directorate General of Taxes, comparability analysis

ABSTRAK

Analisis Kualitatif atas Pemeriksaan Transfer Pricing Terkait Pandemi COVID-19: Konteks di Indonesia. Pada saat ini, kondisi ekonomi global dan pasar keuangan mengalami gangguan yang disebabkan oleh salah satu ancaman paling berbahaya dalam sejarah modern yaitu pandemi COVID-19. Tujuan utama penelitian ini adalah berkontribusi dalam pengembangan mekanisme pemeriksaan terkait *transfer pricing* sehubungan dengan adanya COVID-19 terutama dikaitkan dengan keadaan di Indonesia. Selanjutnya, penelitian ini akan mencoba untuk membuat kerangka pemeriksaan *transfer pricing* yang dilakukan dengan mekanisme penelitian kualitatif. Dalam melakukan pemeriksaan *transfer pricing* terkait COVID-19

pemeriksa pajak harus melakukan pengujian analisis kesebandingan, pengujian periode data pembanding, dan pengujian atas pemberian jasa intra-group kepada anak perusahaan grup di Indonesia yang terdampak krisis virus corona agar selaras dengan ketentuan OECD dan peraturan perpajakan domestik.

Kata kunci: COVID-19, pemeriksaan, transfer pricing, Direktorat Jenderal Pajak, analisis kesebandingan

1. INTRODUCTION

Currently, the world is at war against an invisible enemy, literally speaking. The global economy and financial markets are now suffering from one of the strongest threats in modern history, an outbreak of Corona Virus Disease 2019 (COVID-19) (Valente et al., 2020a). Economies and markets have been hit severely, and businesses draw contingency plan to ensure their operations keep running (Brennan et al., 2020). The virus outbreak not only affects human lives and economies but also extensively strikes the global supply chain and production. The viruses have knocked-down economic activities across the globe (Sarker, 2020). Thus, a downturn in businesses and markets will lead to a substantial reduction in firms' profits or profits margin due to this unforeseeable event. Some of them might be making a loss and planning to relocate, reduce, and reorganize the entire operations (Brennan et al., 2020). The members of Multinational Enterprises (MNEs) could also need to refinance their working capital using the intra-group financing scheme or other funding arrangements with related parties. As a result, the pandemic has brought in substantial consequences for the transfer pricing policies adopted by the MNEs. In this context, tax authorities need to draw procedures concerning transfer pricing aspects under the shadow of the COVID-19 pandemic, particularly during the audits. The COVID-19 pandemic is jeopardizing the economies of rich and poor countries at a similar spectrum. It has struck and disrupted billions of lives in advanced economies and other parts of the globe and also jeopardizing decades of development progress. The governments face novel problems and cases related to health, unemployment, and poverty. As such, contingency plans and aid packages need to be prepared to protect the economies. Governments around the world also need to maintain monetary and fiscal balance in order to minimize drawbacks and social effects from the pandemic. For developing countries, some of them are fighting the battle on two sides: managing domestic outbreak and its effects while at the same

time addressing macroeconomic spillovers from the deep recessions in advanced economies (World Bank, 2020a).

In addition, COVID-19 pandemic has forced governments to take necessary actions such as travel restrictions and mandatory self-quarantine requirements. These situations are raising many tax-related concerns, especially when cross-border transactions are involved in practice. For example: cross-border workers or employees who are stranded in a country that is not their country of residence. These issues have an impact on the taxing right between those countries, which is currently ruled by the international tax treaty guidelines (OECD, 2020b). Hence, multinationals group need to develop effective business planning to tackle the economic impact of the outbreak to the lowest extent possible, as well as to manage effective tax planning of their group. With these effects, tax authorities are likely to increase scrutiny and monitoring both in the pandemic and post-pandemic period. One of the actions that can be taken into consideration is to develop a contemporaneous procedure for transfer pricing audits.

It can clearly be seen that COVID-19 affects global economy and supply chain disruptions. Corporate taxpayers in all sectors and levels – particularly the MNEs – are adversely affected by coronavirus disruptions. Tax authorities are likely to take an audit for transfer pricing transactions taken by the MNEs during the pandemic. Moreover, MNEs must evaluate potential impacts and drawbacks, provide documents, and explain all the rationale for transfer pricing transactions and positions taken during COVID-19 outbreak (Taxand, 2020).

As one of the emerging lower middle-income countries (World Bank, 2020b), Indonesia is suffering economic shock from the pandemic. Various businesses in different sectors such as manufacturing, retail, airlines, hotels, food and beverages, and home industries have been hit intensely, forcing monetary and fiscal authorities adjust their outlook and predictions. From the tax policy perspective, the Indonesian government provides fiscal incentives to overcome the impact of COVID-19 pandemic. Tax stimulus packages are issued to help not only large corporations and small and medium enterprises (SMEs) but also workers and employees to provide economic relieves and secure economic stability. Also, the Ministry of Finance has released regulation concerning the procedure for implementing the Advance Pricing Agreement (APA). It provides greater legal certainty and protection to taxpayers in connection with the Base Erosion and Profit Shifting (BEPS) action.

Multinational groups do businesses in different tax jurisdictions and market

conditions, in which they have nonidentical tax rules and regulations. COVID-19 pandemic allows MNEs to re-think their tax strategies to maintain normal operation and re-allocate resources from one country to another. This kind of arrangement comes with audit consequences from the tax authority.

All in all, this paper tries to contribute to the growing literature by building a conceptual framework and explaining the tax audit mechanism related to transfer pricing transactions taken by corporate taxpayer during and post COVID-19 pandemic in Indonesian context.

2. THEORITICAL FRAMEWORK AND RESEARCH OBJECTIVES

2.1 Theoritical Framework

According to the World Bank Global Economic Prospects (World Bank, 2020a), the COVID-19 pandemic has caused an extreme recession in many countries. Global GDP's baseline could be reduced by 5.2% (Figure 1) and most of Emerging Market and Developing Economies (EMDEs) are expected to have per capita incomes and per capita output shrink in 2020 (Figure 2). EMDEs are vulnerable to a greater recession as they have limited resources – both

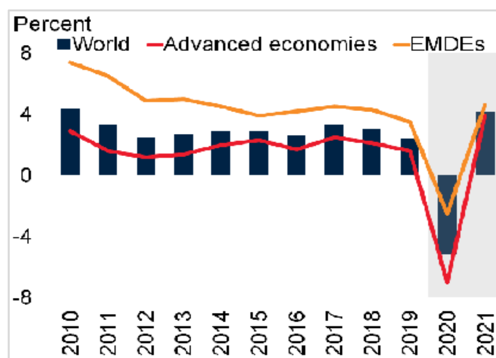

Figure 1 Global Growth
Source: World Bank (Global Economic Prospects, June 2020)

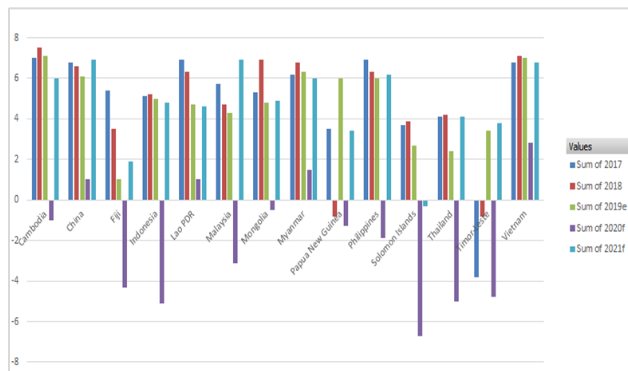

Figure 2 East Asia and Pacific country forecasts
Source: World Bank (Global Economic Prospects, June 2020)

human capital, system, and money – to face formidable challenges related to health, macroeconomic, and social effects of the pandemic. In Asia and the Pacific, policymakers have set up stimulus packages of fiscal and non-fiscal incentives to help industries and people affected by the economic downturn and to support economic activity. The governments also speed up budget allocation and expenditure to focus on the most vulnerable communities.

Tax revenue is likely to fall due to economic downslide. Looking at the magnitude of economic disruption, the pandemic will not only affect the corporate taxes but also individual and household income taxes. Multinational groups need to adjust their transfer pricing policy to capture specific circumstances align with the economic conditions due to coronavirus outbreak. This is because MNEs generate profits from the synergy of combining activities in many jurisdictions. The skills and abilities to do such arrangement; complex corporate structure and shift the profit to low tax jurisdictions; will continue during pandemic time in order to generate more profits to the group.

Transfer pricing refers to the allocation of profits for tax and other purposes between part of a multinational group (OECD, 2002). According to the OECD Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations (OECD, 2017)[1]

> "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".

In addition, Indonesia tax regulations define transfer pricing as a transaction between affiliated parties under the Tax Law Number 36 of 2008 concerning Income Tax (UU PPh) Article 18 (3) which states that Director General of Taxes is authorized to reallocate income and deductions between related parties and to characterize debt as equity for the purposes of the computation of taxable income.

In conclusion, based on the definition above, transfer pricing transactions between related taxpayers have strict guidelines (under the OECD guidelines for international context) and domestic tax regulations (under the Indonesian tax law). These transactions and arrangements are closely monitored by the Directorate General of Taxes (the DGT) both at consultation and audit stages. If the transfer

[1] Many tax jurisdictions and taxpayers refer to TPG as a key reference in the application of the arm's length principle

prices or values do not meet the arm's length principle, tax returns might be restated and heavy penalties could be applied.

According to the Director General of Taxes Regulation Number PER-32/PJ/2011 Concerning the Amendment of the Director General of Taxes Regulation Number PER-43/PJ/2010 Concerning the Application of the Arm's Length Principles in Transactions Conducted by Taxpayers with the Related Parties (PER-32) stipulates that:

> "Arm's Length Principle/ALP is a principle that regulates if the condition in transactions between related parties are similar or comparable to the transactions between independent parties, then the price or profit in related parties' transactions must be the same as to or be in the range of prices or profits in independent parties' transactions".

As a result, there should be no difference in price or profit for transactions between related parties under same families, groups, ownerships, and the ones with independent parties under similar circumstances.

On May 30th 2013, the DGT released Director General of Taxes Regulation Number PER-22/PJ/2013 Concerning Tax Audit Procedures for Taxpayers with Related Party Transactions (PER-22), in which revokes KEP-01/PJ.07/1993 regarding the same subject. Under PER-22, definition of transfer pricing tax audit is an audit performed by the DGT to test the application of arm's length principle in relation with related party transactions.

There are some examples of affiliated transactions subject to an audit under PER-22 such as: sale, purchase, transfer, and utilization of tangible assets, intra-group services, transfer and utilization of intangible assets, interest payment, and sale or purchase of stock.

2.2 Related Literature

Given the span of the pandemic is less than 1 year (as per this paper is written), research on tax impact of COVID-19, specifically in relation with transfer pricing practice in developing countries, is limited and still emerging. Many scholars and policymakers have written an extensive set of papers on policy consequences and macroeconomic issues due to coronavirus pandemic. However, little is known from the transfer pricing perspectives. As the documentation of economic shocks keeps expanding, researchers and government think tanks are in a race to publish writings, commentaries, articles, journals, and analytical pieces.

Li (2005) presents that transfer pricing audits was an important concern in international transfer pricing policy for New Zealand and Australian companies. This is

due to the aggressiveness from the tax authorities in both countries in administering and enforcing transfer pricing rules. Furthermore, Cools et al. (2008) explain that OECD Transfer Pricing Guidelines is adopted as main reference to deal with transfer pricing cases. MNEs are exposed to the threat of transfer pricing tax audits. A heavy penalty can be applied not only to the tax adjustments but also for insufficient or untimely transfer pricing documentations. However, the tax authorities would accept transfer prices between interrelated parties if the parties (MNEs) could prove that independent parties would have chosen similar prices under similar circumstances.

Mulyani (2010) examines factors influencing MNE's decisions to comply with transfer pricing regulations in Indonesia. The research finds that the lack of training and tax auditors' preference not to take transfer pricing audits lead to a relatively low probability of an MNEs being subject to a transfer pricing audit. Similarly, Muhammadi et al. (2016) explore tax auditors' perspective on MNEs transfer pricing of intangible assets and reports that tax auditors have difficulties dealing with intangible property arrangements on transfer pricing.

In addition, Chan et al. (2015) state that many tax authorities find transfer pricing as the most common act of tax avoidance by MNEs. In China, action of tax avoidance comes with a price. It costs China an annual US$4.7 billion loss in tax revenue. Therefore, Chinese tax authority is very likely to impose heavy penalties on transfer pricing audit adjustments.

Wardhana (2019) argues that the arm's length standard fails to address the problems of aggressive transfer pricing practices by MNEs in developing countries. The research also finds that the current Indonesian transfer pricing regime fails to address aggressive transfer pricing practices by MNEs because the current transfer pricing provision covers a broad definition leading to inaccurate interpretations by taxpayers and the tax authority.

Moreover, in 2020 OECD released a guidance on tax issue and the impact of COVID-19 crisis on the cross-border workers, permanent establishment (PE), residency status, and place of effective management (OECD, 2020c).

Research papers and articles related to COVID-19 impact on transfer pricing are also released by some of prominent consultant offices. The Bureau of National Affairs, Inc. releases a paper on global developments due to COVID-19 and how to apply an arm's length principle during an economic crisis (Brennan et al., 2020). In addition, Deloitte also publishes an article about transfer pricing considerations as a response of COVID-19 pandemic (Meyer et al., 2020). According to Deloitte, some key areas in transfer prices that should be managed and monitored by MNEs are transfer pricing models, travel restrictions, temporary relocation of business functions,

funding arrangements, intra-group goods and services, and Advanced Pricing Agreements (APA) negotiations. Finally, KPMG posts an article on what tax directors might consider when determining current target profit margins during COVID-19 disruptions (Clair et al., 2020). KPMG suggests, for practical reasons, to consider reducing the target margin now with potential true ups at the end of the year. Moreover, it is reasonable to consider making adjustments to either the tested party data or the comparable data and revising contractual arrangements.

2.3 Research Objectives

The main objective of the paper is to contribute to the development of transfer pricing audits due to COVID-19 disruptions in Indonesian context. This paper intends to draw a theoretical framework on tax audits policy and defends an understanding of transfer pricing audits. The analysis in this paper might be necessary as a first step to delineate the assessment of transfer pricing audits policy in relation with COVID-19 crisis in Indonesia, particularly for Indonesian Tax Authority – Directorate General of Taxes (DGT).

This research also tries to filing the gap by developing framework for transfer pricing audits in DGT due to unprecedented event of coronavirus. This study fills the gap by extending the implementation of audit rules and regulations in more practical ways.

3. RESEARCH METHODOLOGY

This research is that of qualitative. In this case, the researcher develops concepts and collects facts, but not conduct a hypothetical test. In qualitative research, hypotheses are not tested. It is rather theory building not theory testing. To answer research questions or concerns, this study uses sources of case laws, Indonesian tax regulations, and international guidelines as source of analysis. The outcome of this research would be a proposition to DGT related to transfer pricing audits.

4. RESULTS AND DISCUSSIONS

4.1 Transfer Pricing Regime in Indonesia – Current State

In Indonesian tax system, there are three stages of the development of transfer pricing regime: the application of the substance over form principle (1983-2010), implementation of OECD's arm's length principle (from 2010), and the adoption of G20/OECD BEPS Action Plans (from 2015) (Wardhana, 2019). G20/OECD developed 15 actions to equip governments with domestic and internationals regulations and instruments to mark tax avoidance and ensuring fair taxing rights (OECD, 2020a). The action plans endorsed by the G20/OECD are: Action 1 – Tax Challanges on

Digital Economy, Action 2 – Hybrid Mismatch Arrangements, Action 3 – CFC Rules, Action 4 – Interest Deductions Limitation, Action 5 – Harmful Tax Practices, Action 6 – Prevention of Treaty Abuse, Action 7 – Permanent Establishment Status, Action 8 – Transfer Pricing (Intangibles), Action 9 – Transfer Pricing (Risks and Capital), Action 10 – Transfer Pricing (Other High-Risk Transactions), Action 11 – BEPS Data Analysis, Action 12 – Mandatory Disclosure Rules, Action 13 – Country-by-Country Reporting, Action 14 – Mutual Agreement Procedure, and Action 15 – Multilateral Instrument.

As a key partner of OECD since 2007, Indonesia has actively participated on an equal footing in new BEPS Inclusive Framework. In June 2017, Indonesia was among the countries that signed the Multilateral Convention to Implement Tax Treaty Related Measure to Prevent BEPS. Moreover, Indonesian government has adopted BEPS action plans into domestic tax regulations to address and prevent double non-taxation, as well as anti-abuse provisions. In regards to BEPS Actions 1, which raised a broader tax challenges, Indonesian government has issued a series of regulations to address tax consequences on electronic trading and digital economy. For example, Government Regulation Number 80 of 2019 concerning Electronic Trading (PP 80), Government Regulation in-Lieu-of Law Number 1 of 2020 concerning State Financial Policy and Financial System Stability in Response to Coronavirus Disease 2019 (PERPPU 1), and Minister of Finance Regulation Number 48 of 2020 concerning Procedures for Collection and Reporting of Value Added Tax on Utilization of Intangible Taxable Goods and/or Taxable Services Through Electronic System (PMK-48). Digitalization of the economy and other technological advances have enabled business enterprises to be heavily involved in the economic life of a jurisdiction without a significant physical presence). Indonesia has adopted the significant economic presence regime under PERPPU-1 Article 6 which requires certain amount of consolidated gross sales, certain amount of sales in Indonesia, and number of active users of digital media in Indonesia.

To response BEPS Action 4, DGT releases the Minister of Finance Regulation Number PMK-169/PMK.010/2015 concerning Determination of Corporate Taxpayers' Debt to Equity Ratio for Income Tax Calculation Purposes (PMK-169). According to the PMK-169 Article 2, the maximum debt-to-equity ratio (DER) is four to one (4:1). On November 2017, DGT issued the Director General of Taxes Regulation Number PER-25/PJ/2017 (PER-25) which stipulates an implementation rule for the debt-to-equity ratio. PER-25 also provides a detailed information in relation to the implementation of PMK-169. Moreover, PER-25 provides the standard documents

required by the taxpayers to comply with DER regulations: overall DER calculations and summary of offshore loans. Both documents should be attached to the relevant taxpayers' annual tax return (Azis et al., 2017b).

In the event that the Taxpayers' debt to equity ratio exceeds the maximum debt to equity ratio (4:1), the amount of borrowing cost that is allowed to be deductible in calculating taxable income is calculated in accordance with the maximum debt to equity ratio. The limitation on interest deduction is designed to prevent base erosion through the use of interest expense, particularly the use of related party debt to get an exorbitant interest deductions. In addition, arrangements of third party debt could also lead to an excessive interest deductions through an excessive proportion of group's total net third party interest expense, or bears the burden of interest deductions on debt used to earn non-taxable income (OECD, 2020b). OECD defines banking sector and insurance are not subject to DER regulations. However, Indonesia's DER regulations added four types of taxpayers who are not subject to DER regulations including financial institutions, mining and oil and gas, infrastructures, and businesses subject to final income tax. Furthermore, according to the OECD, interest limitation rules have different forms. The most common type is thin capitalization rules (43 tax jurisdictions including Indonesia), followed by earning stripping rules (33), rules of a general nature or not specified (9), rules of another type (4), and lastly, safe harbor rules (1) as can be seen on Figure 3.

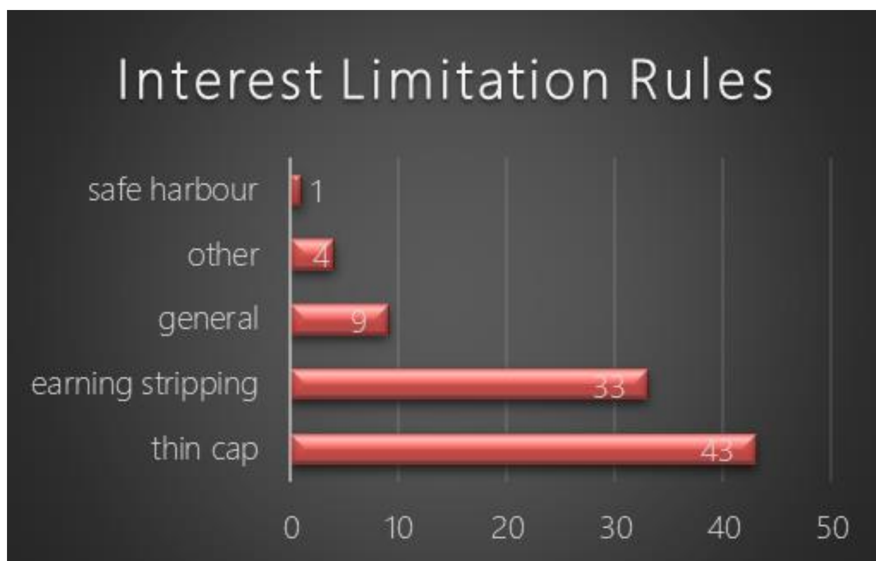

Figure 3 Interest limitation rules across the OECD/G20 Inclusive Framework
Source: OECD Progress Report July 2019 – July 2020

In accordance with the BEPS Actions 8, 9, 10 and 13 DGT has released several regulations to ensure that the profits of MNEs better align with economic activity and value creation. According to the Government Regulation Number 74 of 2011 concerning Regulation on Procedure for Implementation of Rights and Fulfillment of Obligations of Taxation (PP-74) Article 10 Paragraph (2) "...*in the event that a taxpayer conducts a transaction with related parties, the taxpayer should retain documents to support the facts and circumstances that transaction with related parties has been in accordance with the arm's length principle*".

The implementation of PP-74 stipulated in the Minister of Finance Regulation Number PMK-213/PMK.03/2016 concerning Types of Additional Documents and/or Information Must Be Retained by a Taxpayer Conducting a Transaction with Parties Having Special Relationship (PMK-213). According to the PMK-213, taxpayers must provide documents as part of their Transfer Pricing Documentation, such as Master File, Local File, and/or Country-by-Country Report (CbCR). The required documents are consistent with the BEPS Actions 13 and could be used by MNEs as an instrument to comply, support and manage the Indonesian transfer pricing needs.

PMK-213 also clearly describes that for taxpayers excluded with the obligation to provide Transfer Pricing Documentation (TPD), they are still required to apply the arm's length principle in relation with transaction with related parties. Therefore, for Indonesian taxpayers, the obligation to prepare TPD should not be planned as merely an administrative action. It should also be viewed as their act of support to the transfer pricing regulations and as a defense strategy during the transfer pricing audits process (Azis et al., 2017a). In addition to the PMK-213, DGT releases the implementation regulation on CbCR through Director General of Taxes Regulation Number PER-29/PJ/2017 regarding Procedures for the Management of CbCR (PER-29). PER-29 provides detailed guidance on which groups required to file CbCR, what is required to file CbCR, and when is the time to file CbCR in Indonesia. The issuance of PER-29 can be seen as commitments and continuous efforts of DGT to bring clarity and guidance for the taxpayers in connection with transfer pricing rules set forth by the OECD through BEPS Actions 13 (Meyer et al., 2020).

In relation with the application of arm's length principle, DGT released Director General of Taxes Regulation Number PER-43/PJ/2010 (PER-43) as last amended by PER-32/PJ/2011 (PER-32) dated 11 November 2011 concerning Regulation on Application of Arm's Length Principle in Transaction Between Taxpayer and the Party Having Special Relations. PER-43 and PER-32 are issued by DGT as commitment to endorse the OECD TP Guidelines. Although Indonesia is not a member of the OECD, the

OECD TP Guidelines are generally accepted in practice, albeit not in their entirety (Setiawati, 2017). PER-43 stipulates direction to apply the arm's length principle in regards with related parties' transactions. It includes a comparability analysis to determine comparable enterprises, selection on appropriate transfer pricing methods, application of arm's length principle, and documentation on transfer prices based on domestic tax regulations. Moreover, PER-32 provides additional guidance on comparability analysis which specifies a preference of internal comparable over external comparable. The external comparable can be obtained from commercial databases or other resources. In terms of selecting transfer pricing methods, PER-32 revises a strict hierarchy method on PER-43. PER-32 has adopted the most appropriate method which requires some considerations, such as the strengths and weaknesses of each method, functional analysis based on the nature of related party transactions, availability of valid information, and comparability level and appropriate adjustments. In addition, domestic related-party transactions are exempt from the transfer pricing regulation of PER-32, except for the use of different tax rates due to final income tax in certain sectors, sales tax on luxury goods, and transaction with oil and gas contractors. The most current regulation in regards with arm's length principle is PMK-22/PMK.03/2020 concerning Procedure for Implementation of Advance Pricing Agreement, which also regulates the application of the arm's length transaction between related parties.

4.2 COVID-19 and Transfer Pricing Audits – Indonesian Practice

COVID-19 affects MNEs around the globe within every aspect of their value chain, effecting and imposing challenges on the MNE's current transfer pricing framework. Thus, sharp increase in costs and steep decline in demand and profits are inevitable. MNEs' extraordinary losses due to pandemic can be seen from the transfer pricing assessment perspective as a tool to spread and allocate those losses within MNEs' groups and value chain participants. Moreover, other than value chain of multinational groups, the coronavirus disruptions also lead to detrimental effect on sales generated, value of tangible and intangible assets, earnings before interest and tax (EBIT), and cash flow of the MNEs affected by the outbreak (Valente et al., 2020b). Further descriptions on the impacts of COVID-19 for the majority of MNEs can be seen in Table 1. In connection with transfer pricing audits (TP audits), DGT has issued PER-22 as a guideline for the tax auditors to conduct TP audits. They need to look at the taxpayers' TP Document (TPD) as a basis in applying the arm's length principle (ALP) within their transactions. However,

Table 1 COVID-19: Impacts for Majority of MNEs
Source: Adopted from WTS Global (with author's adjustments)

Supply Chain	Financial	People	Structure and Regulation
manufacturing shut down	reduced cash-flow	potential layoffs	new business models
price volatility and obsolence	termination payment	remote workforces	changed transfer pricing models
reduced capacity and downtimes	increased liquidity needs	changed roles and responsibilities	enterprise and shareholder values
reduced demand	lease breakage fees	crisis management	IP/brand impacts
re-routing of supply chain	asset impairments	dual residency changes via temporary dislocation place of management	place of effective management
temporary relocation of business functions	short and long-term financing	engagement with tax authorities	safe harbor rules

TPD is not the only document used by taxpayers to maintain the ALP procedure. There are some other documents such as inter-company agreements related to sales, purchase, service fees, export/import documents, and invoices.

To conducting transfer pricing audits under the shadow of COVID-19 pandemic, tax auditors in Indonesia need to consider several possibilities that may arise during the audits. According to PER-22 tax auditors shall determine characteristic of taxpayer's businesses and do the functional analysis. There are some parameters to consider, such as industry analysis, affiliated transaction analysis, characteristics of taxpayers as part of the group, and financial ratio. In the event of coronavirus, conducting comparability analysis is likely to be more challenging due to lack of suitable comparable entities. Economic downturns affect profitability of most companies, and thus applying multi-year data based on previous year and three years average may be bias because it may not reflect the pandemic's economic condition. A pandemic adjustment to the comparability analysis is essential to capture a more reliable arm's length analysis to taxpayers affiliated transaction in order to make the analysis captures current economic condition. In conducting comparability analysis due to coronavirus, tax auditors may rely on single year 2019 only as *pre-pandemic period* (*ex-ante basis*) instead of using a multi-year approach.

An ex-ante basis is pointed out by the OECD TP Guidelines paragraph 3.69 which states:

> "In some cases, taxpayers establish transfer pricing documentation to demonstrate that they have made reasonable efforts to comply with the arm's length principle at the time their intra-group transactions were undertaken, i.e. on an *ex ante* basis" (OECD, 2017).

DGT has applied the ex-ante basis in PMK-213 which mentions that Transfer Pricing Documentation (master file, local file, and/or country-by-county report) must be prepared based on data and information available at the time of the related party transaction

Consequently, in a case of audit for tax year 2020, the use of comparable data related to the time period using multiple year 2017 – 2019 as basis for comparability analysis might not be relevant because such years were not affected by coronavirus. By averaging out the comparable data over a number of years, the true impact of the current's economic conditions may not be duly reflected in the results (Davis et al., 2020). Although the use of multiple year has been stated in PER-22 to increase the level of comparability analysis, but in the event of coronavirus, this might not be a proper approach due to unfavorable economic conditions.

Analysis of the period of economic downturn is essential and requires attention from the DGT. Alternatively, tax auditors can use the comparable data related to previous economic downturn period such as 2008 (Clair et al., 2020; Valente et al., 2020b). However, this might not be proper due to different spectrum of area affected by the economic challenges. In 2008 downturn, only some countries were suffered because of the crisis. Furthermore, for transfer pricing audits in the event of post COVID-19 pandemic, the use of single year 2020 as comparable data is also essential to conducting benchmarking analysis. In addition, tax auditors should also carefully assess the choice of reference markets/countries by the taxpayers for comparability analysis because COVID-19 pandemic may have significant effect to some countries and being limited to other countries, in which comparable data might be impacted.

In addition to time period, special consideration must be placed to the comparability analysis, such as issues related to companies with operating losses. Taxpayer sometimes consider the loss-making companies as comparable entities when assessing the arm's length principle. This may rise to a tax audit dispute because tax auditors are likely to take out companies with consecutive operating losses for comparability analysis purposes since they do not reflect the normal course of

profitable business. According to the OECD TP Guidelines Paragraph 3.65 as follows:

> "Generally speaking, a loss-making uncontrolled transaction should trigger further investigation in order to establish whether or not it can be a comparable. Loss-making comparables that satisfy the comparability analysis should not however be rejected on the sole basis that they suffer losses" (OECD, 2017).

According to the paragraphs 3.65, tax auditors should conduct a comprehensive analysis to consider all relevant information from taxpayers not solely from the basis of losses. From the Indonesian tax court perspective, in the tax court decision number PUT-80433/PP/M.XIIA/16/2017 (PT.XYZ vs. DGT) concerning dispute for the tax year 2011 in regards with loss-making companies as comparable data, tax court judges' opinion could be used by the tax auditor as reference during the audits in normal condition. In PT. XYZ vs. DGT, tax auditor argues that loss-making company in which incurred losses for three consecutive years cannot be used as benchmark in analyzing arm's length principle. Thus, the tax auditor rejects and takes out the company from the benchmarking lists. From perspective of the taxpayer, loss-making company can be taken into account if the level of business and industrial group is similar to taxpayer in Indonesia. Tax court judges confirm/upheld the decision from the tax auditor and state that loss-making company is not relevant as reference and benchmarking for the arm's length principle analysis. As consequence, the judges conclude that adjustment made by the tax auditor regarding loss-making company rejection is affirmed.

However, in the event of the pandemic, including loss-making companies in the list of comparable to determine the arm's length transaction is a common-sense to do and tax auditors should consider this fact when conducting an audit. According to OECD TP guidelines, a further analysis of losses during the pandemic is a part of investigation as stated in paragraph 3.65. Moreover, according to the OECD TP Guidelines paragraph 1.129, the unfavorable economic conditions and inefficiencies are legitimate as a basis for comparability analysis. It is likely that COVID-19 pandemic falls within the termination in the paragraph 1.129 and as a result, loss-making comparables can be justified in assessing comparability analysis. Tax auditor shall conduct further examination whether the pandemic alone is sufficient to justify the losses subjected to a company. To support the analysis, tax auditor might look at the decision from supreme court judges concerning the issue. According supreme court decision number PUT-48156/PP/M.XIII/15/2013 (PT. ABC vs. DGT) for the tax year 2009, loss-making

company due to 2008 global crisis is relevant as comparable data for the tax year 2009 (ex-ante). The supreme court judges argue the decision from the tax auditor and affirm taxpayer's position. In conclusion, the economic condition analysis in an ex-ante approach is important to pinpoint the range of arm's length principle.

Another pandemic adjustment is using allocation of overall risks and losses. Coronavirus crisis comes with economic risks and market risks for the MNEs. Understanding how MNEs allocate and spread the risks is crucial to the tax authority because this arrangement affects the choice of transfer pricing method and analysis. The key point is to learn how related entities having less complex functional profile, bearing limited risk and remunerated on target margin basis, are impacted by the crisis (Jacchia, 2020). The OECD TP Guidelines conclude that remuneration of an entity should reflect functions performed, assets utilized, and risks assumed. In such perspective, the use of Transactional Net Margin Method (TNMM)[2] seems to be the most common method used by the taxpayer in regards with the pandemic. In a crisis phase, entities within the group may perform greater functions and assume higher risks. As such, the use of profit/loss split approach might be more suitable than the traditional TNMM method. The limitations on comparable entities could be the trigger to shift the appropriate transfer pricing method due to economic downturns (Davis et al., 2020). In the context of transfer pricing audits, Indonesian tax auditor might use profit split method to test the arm's length pricing with reference to the contribution of each entity to the profits arising at the group level. The method applies equally to the losses as it does to profits. The profit split (or loss split) method captures economic risks due to pandemic in inter-related or correlated transaction in the group. The tax auditor needs to conduct a thorough review on agreements and policies whether or not the agreements allow the application of a profit/loss split and reflect current economic conditions. Another consideration is because in transactional profit split, transaction involving significant economic risks by all parties is acceptable. For these considerations, the Comparable Uncontrolled Price (CUP)[3] (method is likely *unacceptable* in times of coronavirus crisis because there are some factors that would impact product pricing during and post

[2] According to the OECD, TNMM is a method in transfer pricing that compares the net profit margin of a taxpayer (ratio of net profit relative to an appropriate base, e.g. costs, sales, or assets) that a taxpayer realizes from a controlled transaction.

[3] A CUP method compares the price charged in a controlled transaction to the price charged in a comparable uncontrolled transaction in comparable circumstances.

pandemic. For example: extension of payment term, re-arrangement of interrelated financing, foreign exchange fluctuations that might affect pricing policy, and different government policies amongst countries for commodity prices.

From the interrelated financing scheme perspective, tax auditor should be aware of interest rate used by the taxpayer. Many central banks are cutting down interest rates to tackle the impact of the coronavirus. Company may decide to re-arrange the loan/financing agreement to adjust the rates. During the audits process, it is important for tax auditor to appropriately analyze that the taxpayer would be able to apply interest rate at arm's length. There is a chance that the taxpayer is charged at higher rates by the groups for related loan compared to independent company that utilizes external source of funds for group funding. Thus, an audit adjustment/correction is likely to be imposed by the tax auditor for this arrangement because there is no similar level of consistency between related party transaction and third-party arrangement. In addition, deferment of payment for trade transactions may give rise to a transfer pricing consequence such as whether or not the interest should be imposed for the deferment. The tax auditor needs to be more aware and analyze such business decisions and look at the documentation or agreement for the revised term of settlements.

In terms of intercompany charges (management fees, support fees, technical service fees, IT service charges, etc.) tax auditor might review existing arrangements for payment of intercompany charges. This concern arises because during and post COVID-19 pandemic there might be a reduction in utilization of intercompany services and thus there is minimum obligation for Indonesian company to pay the management or service fees because such benefits are no longer accruing to the Indonesian taxpayers acting as subsidiaries. However, in the event of such services needed by Indonesian subsidiaries, tax auditor shall assess the application of arm's length principle into intra-group service transactions. It is because dispute between the taxpayer and DGT on intra-group services is often caused by non-adoption of minimum standard of TP Guidelines on intra-group services particularly in the issues regarding the benefit test, existence test, no related to business activity and the arm's length price issue (Setiawati, 2017). From the tax judges' perspective, in case number PUT-58181/PP/M.IIB/13/2014 (PT. N/A vs DGT) for tax year 2009 concerning correction of management fee (in the form of technical assistance fee) as a constructive dividend, the judges upheld the correction from the tax auditors. According to the case, in determining whether intra-group services

have been rendered (the existence test), tax court judges assess the economic or commercial benefits of such activities, the arm's length fee of the transactions, no duplication activities, no incidental benefits, and no shareholder activities. The assessment conforms with the OECD TP guidelines, and thus the tax auditor shall maintain the same standard of assessment when conducting a transfer pricing audit of intra-group services in relation with the COVID-19 pandemic. Adjustment/ correction might be imposed to the taxpayer if there is no sufficient substantiation related to the intra-group management or service fees, particularly during the coronavirus crisis. In general, categories of intragroup services can be seen in Figure 4.

5. CONCLUSIONS

Around the globe, many countries are affected by the COVID-19 pandemic and MNEs should work effectively to overcome the effect of the outbreak. During the crisis, MNEs are faced with a number of challenges, including transfer pricing policies. As a consequence, tax authorities are likely to impose a transfer pricing audit to MNEs during and post pandemic. In DGT, the roles of tax auditor are essential to ensure that companies are adapting proper transfer pricing guidelines and regulations into their policies regarding COVID-19. In

Figure 4 Author's Perspective: Categories of Intragroup Services

conducting transfer pricing audits, tax auditors need to assess the comparability analysis used by the taxpayer, the period in which analysis is projected, and intragroup services utilized by Indonesian subsidiaries to cope with OECD TP Guidelines and Indonesia tax regulations.

6. IMPLICATIONS AND LIMITATIONS

Researches and papers concerning transfer pricing audits during COVID-19 pandemic are relatively scarce. The subsequent research is expected to bring other aspects of transfer pricing including royalty and dividend payment to get more comprehensive approach of the COVID-19 issues. Furthermore, a legal and case law approach should be expanded to current tax court and supreme court decision regarding transfer pricing to capture the coronavirus effect on transfer pricing audits.

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