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FACTORS AFFECTING TRANSFER PRICING AGGRESSIVENESS IN INDONESIAN MULTINATIONAL COMPANY

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ABSTRACT

Transfer pricing has been cited as the most crucial tax avoidance issue in multinational companies. Transfer pricing transactions may be conducted by a person or an entity that has special relationship with the company which might against the arm's length principle. As many issues have been arisen regarding tax avoidance through transfer pricing practices, this study wants to examine the factors affecting transfer pricing aggressiveness in multinational companies listed on Indonesia Stock Exchange for year 2013-2017. Sampling method used in this study is purposive sampling. Differ from the previous research, this research will use panel data regression model with Stata software. The sample is hand-collected sample of 120 publicly-listed Indonesian multinational companies. Applying random effect model, this model use leverage and firm size as control variables. The result showed that tax expense, exchange rate and share ownership affect transfer pricing aggressiveness in multinational companies in Indonesia.

INTRODUCTION

Multinational companies play an important role in country's economic growth. Along with the growth of country's economic, the growth of multinational companies are also increasing rapidly. In the increasing of multinational companies, transactions often occur between members of companies with the same group which include the sale of goods or service, license right and other intangible assets. It is difficult to determine the price of the transactions that occur between companies. The pricing between companies with the same group is often referred to as transfer pricing. Transfer pricing itself is defined as the price in transaction between affiliated companies – parent company and foreign subsidiary companies (Eden, 2009).

The relationship that are intertwined between affiliated companies often cause the transactions of goods and services between them to be unfair by raising or lowering prices at existing market price (Chan et al., 2004). These different prices are often misused to avoid tax or minimize tax burden.

Tax expense becomes the main factor in applying practice of transfer pricing. Transfer pricing is used by multinational companies as a tool to reduce their taxes and maximize their profit. Transfer pricing practice that often occurs is through sales either goods or services by minimizing the selling price between companies under the same group and transferring the profits obtained to company that is domiciled in the tax heaven country or country that does not collect the tax (Alino & Lane, 2015; Huda, 2017). The relation between transfer pricing and taxation have been ruled in Indonesian Tax Regulation no. 36 (2008), which stated that General Directorate of Taxation have a right to determine the taxable income for any taxpayer whom has a special relation with other taxpayer in accordance with the fairness and business customs which are not influenced by special relation (arm's length principle) by using price comparison method between independent parties, resale price method, cost-plus method, or other methods (Petrus, 2013).

Other factors that can influence the practice of transfer pricing is exchange rate (Marfuah et al., 2019; Chan et al, 2004 ; Tjandrakirana & Ermadiani, 2020). Generally, multinational company denominates their cash flow into dollar currency. Since the value of dollar will keep changing overtime, this might lead the company to do a transfer pricing. Besides tax expense and exchange rate, share ownership is also affecting company's aggressiveness in doing transfer pricing. Zhou (2011) and Lo et al., (2010) stated that controlling shareholder prioritizes their interests rather than another investors' interest. Controlling shareholder also has a power to affect management's decision which maximize their satisfaction but harm the non-controlling shareholder's interest.

Arham et al., (2020) have already done literature study on the publications in journals indexed by SINTA (Science and Technology Index - Ministry of Research and Technology /National Agency for Research and Innovation in 2000-early 2020. The result revealed that there are 29 out of 41 publications regarding transfer pricing aggressiveness determinants, especially tax, tunneling incentives and bonus mechanism. Other determinant, such as exchange rate and share ownership are relatively rare. Also there are 31 out of 41 publications used quantitative data method. However, differ from the previous research, this research will seek the best model for panel data first and then test the hypothesis.

The objective of this research is to find new model on factors affecting the transfer pricing aggressiveness, which includes the exchange rate and share ownership. Research on this topic is very important since it might support on controlling the opportunistic behavior of the managers. On a macro level, the model on factors affecting transfer pricing aggressiveness might provide contribution for policy maker on how to increase the government's income from taxes. As shown in Table 1, the tax ratio trends for the last ten years (2010 - 2020) in Indonesia is decreasing. These data are released by Directorate General of Taxes – Ministry of Finance of the Republic of Indonesia.

Table 1
Tax Ratio in Indonesia (2010-2020)

year	tax ratio	difference
2010	12,90%	
2011	13,80%	0,90%
2012	14,00%	0,20%
2013	13,60%	-0,40%
2014	13,10%	-0,50%
2015	11,60%	-1,50%
2016	10,80%	-0,80%
2017	10,70%	-0,10%
2018	11,40%	0,70%
2019	10,73%	-0,67%
2020	7,90%	-2,83%

LITERATURE REVIEW AND HYPOTHESIS DEVELOPMENT

Transfer Pricing Aggressiveness

Transfer pricing aggressiveness is a tendency of a company to do transfer pricing (Richardson et al., 2013). Transfer pricing aggressiveness shows how aggressive a company to do a practice of transfer pricing in their business activities (Alviyani, 2016) to reduce tax liability (Santos, 2016). There are two kinds of transfer pricing, which are intra-company and inter-company transfer pricing. Intra-company transfer pricing is a practice of transfer pricing between divisions under the same company, while inter-company transfer pricing is a practice of transfer pricing between affiliated companies.

Under PSAK 7 (2009), affiliated party is a party that has a right to manage other parties, or has a significant influence on other parties in making decision. Transaction between affiliated parties are a transfer of resources or obligations between parties that have special relationship, regardless of whether the price is calculated. Meanwhile, according to Indonesian Tax Regulation number 36 (2008), a special relationship conditions is when a company owns directly or indirectly at least 25% of equity capital in other firms. As stated in International Accounting Standard (2006), affiliated party is a person or entity having relation with the person or entity that prepares and reports their financial statement. These persons could be family member who is related with reporting company in terms of power and authority against the company, key management personnel of entity or parent of reporting entity.

Based on PSAK 7 (2009), about related party disclosures, related party is a party that has the right to contribute and affect the activities in making financial decisions made by other parties (Tanoto, 2013).

Tax Expense

In multinational company, it is common to have tax rates differences in several countries or jurisdictions of its subsidiaries. It means that global or multinational corporate tax strategy might not be fit to be implemented by the subsidiary in certain local jurisdiction. Through this practice, the multinational company which located in country with higher tax rate mostly will transfer their tax expense to their subsidiaries which located in country with lower tax rate (Noviastika et al, 2016).

Total tax expense paid will always be the management's concern because higher tax expense means reducing the company's profit (Eden, 2009). Management motivations to reduce tax expense can be explained by the agency theory. Reducing tax expense means increasing the profit. By increasing the profit, management will get more bonus, if the company implement bonus scheme using profit as the basis for measuring management's performance. The manager will have more tendency to put his effort to maximize the profit of the company by using the transfer pricing transactions (Lo at el., 2010).

Another company's motivation to minimize the tax expense is the need of the company to get positive attention from the stakeholders. The company will put its effort on reducing the tax expense through transfer pricing. Marfuah & Azizah (2014) as well as Hidayat et al., (2019) did research on this issue and found that there were significant and negative effect of tax to the transfer pricing decision. The more efforts on reducing the tax expense the more aggressive the company in doing the transfer pricing. Hence, the amount of tax expense will determine the transfer price aggressiveness (Ronan et al., 2019 and Zhou, 2011). Thus, the first hypothesis of this research is:

H1: Tax expense affects company's transfer pricing aggressiveness

Exchange Rate

The fluctuation of exchange rate is reported as the gain or loss on currency translation on the financial statement and it give an impact to the company's profit. There are three effects of exchange rates fluctuation which are foreign currency transactions, foreign currency translation (conversion) and the effect of economic risk (Chan et al., 2004). This risk is happened when there is unexpected changes on the exchange rates.

Chan et al., (2004) stated that multinational companies might try to reduce their foreign exchange rate risk to increase the global profit. It can be done by transfer or convert it to the strongest exchange rate. It means, they utilize transfer pricing in order to increase the profit as a whole. Another way that they might do when the exchange rate fluctuates is shifting their wealth to places with more stable currency exchange (Alino & Lane, 2015).

There are several research on the effect of exchange rate toward transfer pricing (Chan et al., 2004; Marfuah & Azizah, 2014; Alino & Lane, 2015; Santos, 2016; Marfuah et al., 2019; Tjandrakirana & Ermadiani, 2020). Chan et al., (2004) stated that managers, especially those who were influenced by the bonus incentive were concern with the company's profit. Therefore they tend to consider the effect of exchange rate and implement transfer pricing to increase the company profit, and in turn to get the bonus. This result was inline with the one done by Tjandrakirana and Ermadiani (2020). They found that exchange rate give a negative significant influence on transfer pricing decision. It means that exchange rate will drive the implementation transfer pricing or the aggressiveness of transfer pricing transaction done by the company. The Reseach done by Santos (2016) proved that foreign exchange volatility will have impacts to the transfer pricing aggressiveness. Thus, the second hypothesis will be:

H2: Exchange rate affects company's transfer pricing aggressiveness

Share Ownership

Lo et al., (2010) did research on the important of corporate governance, expecially the existance of independence director and corporate ownership toward managers manipulation of transfer pricing. One year after, Zhou (2011) also did the same research using data from China companies as sample since most of them have high ownership concentration High ownership concentration means high influence through its shareholding cash flow right or control right (Zhou, 2011).

Shareholders who have a large proportion of share ownership usually play more active role in company's activities compare to the minority shareholders (Lo et al., 2010). Control right owned by the majority shareholder will influence management decision and strategy. Both might have the same interest in doing the aggressive strategy to increase the company profit. Shareholders do investment with the expectation to generate good return. Shareholder prefers tax aggressiveness (Chen et al., 2008). While the managers with performance-linked incentive will also have the same motivation and interest toward company's profit. Research done by Zhou (2011) and Dinca and Fitriana (2019) found that share ownership has significant influence toward transfer pricing aggressiveness. Thus, the third hypothesis is:

H3: Share ownership affects company's transfer pricing aggressiveness

Leverage and Firm Size as Control Variables

This research will use two control variables, which are leverage and firm size. Several research on transfer pricing or transfer pricing aggressiveness has already been done and prove that leverage have significant influence (Waworuntu and Hadisaputra, 2016; Anh et al., 2018; Ronan, et al., 2019 and Tjandrakirana and Ermadiani, 2020).

Leverage is ratio used to measure the usage of debt in financing company's operation or a ratio used to measure the ability of a company to pay all of its obligations, both in short-term and long-term liabilities if the company is dissolved or liquidated. The research by Ozkan (2001) gives an evidence that companies that have a high tax obligation will choose to be in debt in order to reduce the tax burden. By doing this, it can be said that the company has aggressive initiative towards taxes. Research by Mills and Newberry (2004) shows that companies with high leverage report lower Effective Tax Rates (ETR). They also state that companies with higher debt than equity are more aggressive in planning their tax system.

A company can be said to be a big company if its assets are large. Vice versa, if the assets owned are small, the company is said to be a small company A company which has big total assets shows that this company has reached its maturity where the company's cash flow has been positive and is considered to have a good prospect in a relatively long period of time (Kiswanto & Ardyaksa, 2014).

Big companies are more aggressive in organizing tax planning strategies than small companies. Transfer pricing is usually done by a company which has special relationship with other parties. Special relationship is usually owned by

large companies, where large companies have more branches or associations, so that a big company has a bigger possibility to do transfer pricing than a small company which is only a single company. A company with big profits tends to be involved in tax avoidance due to large profits which increase their tax burden.
Research that revealed the impact of firm size on the transfer pricing aggressiveness are Waworuntu and Hadisaputra (2016), Anh et al., (2018), Dinca and Fitriana (2019), Ronan et al., (2019) as well as Tjandrakirana and Ermadiani (2020).

RESEARCH METHODOLOGY

In order to find the relationship, this study involves numerical figures that can be taken from companies' financial reports obtained from Indonesia Stock Exchange (IDX) official website. The population on this study is all multinational companies listed in Indonesia Stock Exchange for period of 2013-2017, since starting 2013 until 2017 the tax ratio in Indonesia tends to decreasing constantly or it never increased on that period as revealed in Table 1. In 2018 it was increasing and this year is excluded from the research. Although it was decreasing again in 2019 and even getting worse in 2020, but it was due to the Covid-19 abnormal or pandemic situation.

As this study applies non-probability purposive sampling technique, judgment of the author is used to select the sample. Sample initially consists of 614 publicly-listed Indonesian companies. However, the sample is reduced to 120 companies, due to exclusion of 93 financial companies types, 372 companies without overseas subsidiaries as well as exclusion of 29 companies that did not report their financial statement in the research period.

Therefore, 600 observation data used from 120 companies over 5 years period. This research will use panel regression data model. There are approaches that might be used, which are fixed effect model and random effect model. To select the models, Hausman test will be carry on. Hausman test define H0 is the used of REM. Thus, whenever the p-value is less than 0.05 then the hypothesis will be rejected or fixed effect model is chosen (Firdaus, 2020). This research will use Stata as a statistical tools.

Dependent Variable

Transfer Pricing Aggressiveness

Transfer pricing aggressiveness is measured by using TPRICE (Richardson et al., 2013). It employed eight items using binary number. All the information for measuring the transfer pricing aggressiveness can be found in notes to financial statement, particularly in the receivables, loans and related party transactions sections. Those accounts aim to measure the occurrences of non-arm's length transactions which lead to the percentage of transfer pricing aggressiveness. The eight items to measure transfer pricing aggressiveness are:

1. The existance of interest free bearing loan between related entities
2. The existance of debt forgiveness or written-off loan between related entities
3. The existance of loss of impairment loan between related entities
4. The provision of non-monetary consideration without commercial justification
5. The absence of formal documentation to support the selection of appropriate arm's length methodologies or the formal documentation regarding related parties transactions
6. The removal or transfer of capital assets to related entities without commercial justification
7. The absence of arm's length justification for transaction between related entities
8. The transfer of losses between related entities without commercial justification

The eight items abovementioned are summed up and then divided by 8 to get each company's index. The higher the percentage of overall result, the higher is the level of transfer pricing aggressiveness.

Independent Variable

Tax Expense

The ratio used to measure the tax expense of a company is Effective Tax Rate (ETR) which shows a percentage of the tax rate borne by the company. ETR is assessed from financial information reported by the company. Effective tax rate is the ratio of tax expenses minus deferred tax expense divided by taxable income (Noviastika et al., 2016).

$$Tax\ Expense = \frac{tax\ expense - deferred\ tax\ expense}{profit\ before\ tax}$$

Exchange Rate

The variable exchange rate is calculated from profit or loss on foreign exchange divided by profit or loss on sales Marfuah & Azizah (2014)

$$Exchange\ Rate = \frac{Foreign\ exchange\ gain\ or\ loss}{profit\ before\ tax}$$

Share Ownership

Share ownership can be measured by dividing the highest shares issuance with outstanding shares (Marfuah & Azizah, 2014). This measurement shows the company ownership percentage of controlling shareholder.

$$Share\ Ownership = \frac{highest\ shares\ issuance}{outstanding\ shares}$$

Leverage

The leverage ratio chosen in this study is Debt to Equity Ratio (DER) which compares the amount of company's liabilities to company's equities (Richardson et al., 2013). The measurement of DER is total liabilities divided by total equities.

$$Leverage = \frac{total\ liabilities}{total\ assets - total\ liabilities}$$

Firm Size

The size of the company can be determined from the total value of the company's assets in the balance sheet at the end of period.The firm size can be assessed from the logarithm of company's assets. Total assets are seen as relatively more stable than total sales (Anh et al., 2018).

$$Firm\ size = Ln(total\ assets)$$

In this study, the relationship between variables will be presented by multiple regression model. It is modified from regression model created by Richardson G. (2013).

$$Y_{i,t} = \alpha + \beta_1 X_{1i,t} + \beta_2 X_{2i,t} + \beta_3 X_{3i,t} + \beta_4 X_{4i,t} + \beta_5 X_{5i,t} + \varepsilon_{i,t}$$

$Y_{i,t}$: Transfer pricing aggressiveness
α : Regression constants
β : Regression coefficient
$X_{1i,t}$: Tax expense
$X_{2i,t}$: Exchange rate
$X_{3i,t}$: Share ownership
$X_{4i,t}$: Leverage
$X_{5i,t}$: Firm Size
$\varepsilon_{i,t}$: Error

RESULT AND DISCUSSION

As revealed in Table 2, among 600 data, there are 60 data from 12 companies which need to be eliminated because they are outliers. Hence, total observations that will be used are 540 observations. Table 2 shows the statistic descriptive for the data in this research.

Table 2. Descriptive Statistics

Variable	Obs	Mean	Std. Dev.	Min	Max
tpa	540	0.307	0.192	0.000	0.860
etr	540	0.168	0.293	-1.560	1.780
exchrate	540	-0.006	0.658	-8.140	4.830
shrown	540	0.492	0.213	0.030	2.330
lev	540	1.256	3.152	-30.640	39.490
lsize	540	29.650	1.523	25.313	33.320

Source: Output Software Stata

Hausman test was carried on after creating panel regression using fixed effect model and random effect model before the hypothesis testing. The result of Hausman test showed p-value as shown on Table 3.

Table 3. Hausman Test

chi2(5)	= (b-B)'[(V_b-V_B)^(-1)](b-B)
	= 9.09
Prob>chi2	= 0.1056
(V_b-V_B is not positive definite)	

Source: Output Software Stata

Based on the result of Hausman test, random effect model will be chosen in this research.

Table 4. Random Effect Model

Random-effects GLS regression

Number of obs = 540
Number of groups = 108

tpa	Coef	Std. Err	z	P>|t|
etr	0.02037	0.01150	1.77	0.076*
exchrate	0.01176	0.00466	2.52	0.012
shrown	-0.04970	0.02796	-1.78	0.076*
lev	-0.00006	0.00105	-0.05	0.958
lsize	-0.01848	0.00739	-2.50	0.012
_cons	0.87626	0.21917	4.00	0.000

Prob > chi2 = 0.0036

*significant at α=10%

Source: Output from Stata

As shown on Table 3, the p-value is 0.1056 which is higher than 0.05. p-value higher than 0.05 means H0 cannot be rejected, thus random effect model is chosen for the panel data in this research

Panel regression for random effect model for the data used in this research is shown on Table 4. From Table 4, it can be seen that F-test is significant, because the result shows p-value as much as 0.0036, less than 0.005. It means that tax expense, exchange rate, share ownership, leverage and size simultaneously effect the transfer pricing aggressiveness. R squared is 45,2%, meaning that 45,2% variation in tax aggressiveness can be explained by the variables used in this research.

Table 4 also shows the result of the t-test from the data used. From this table, it can be seen that tax expense, exchange rate, share ownership have partially significant influence to transfer pricing aggressiveness.

Random effect model has already used GLS or generalized least square. So, it contain no autocorrelation and it is homocedastic already as shown on Table 5.

Table 5

Coefficients	: generalized least squares			
Panels	: homoskedastic			
Correlation	: no autocorrelation		Number of obs =	540
Estimated covariances =		1	Number of groups=	108
Estimated autocorrelations=		0	Time periods=	5
Estimated coefficients=		6	Wald chi2(5)=	37.48
			Prob > chi2=	0.00
Log likelihood=		142.6879		

Source: Output from Stata

Tax expense affects company's transfer pricing aggressiveness

According to Table 4, tax expense has p-value of 0.076, which is significant at α = 10%. It means H1 cannot be rejected. It means there is significant relationship between tax expense and transfer pricing aggressiveness. It implies that tax expense is relevant in affecting transfer pricing aggressiveness of multinational companies in Indonesia. The finding is aligned with the studies of Noviastika et al.,2016; Ronan et al., 2019; and Zhou, 2011. The higher the tax expense is, management might be more aggressive in using transfer pricing to reduce the tax expense either for higher bonus expectation or getting higher attention from the stakeholder in producing more profit.

Exchange rate affects company's transfer pricing aggressiveness

According to the p-value result from Table 4, the exchange rate has a significant effect to transfer pricing aggressiveness. The p-value is 0.012 and it is smaller than 0.10, even smaller than 0.05. It means hypothesis 2 (H2) is supported. It implies that exchange rate is relevant in affecting transfer pricing aggressiveness of multinational companies in Indonesia. The result is consistent with the study done by Chan et al. (2004) and Tjandrakirana and Ermadianti (2020). However, the coefficient proves a positive relationship, different with the result form Tjandrakirana and Ermadianti (2020). It might be caused by the amount of foreign exchange gain did not high enough to drive the company to do transfer pricing aggressiveness in increasing the profit. It is aligned with the statistic descriptive in Table 2 that the mean of exchange rate is negative or – 0.006. However, from Table 4 it is still proven that exchange rate affects transfer pricing aggressiveness.

This result inline with Chan et al., (2004) stated that those who concern with company's profit tend to consider the effect of exchange rate and implement transfer pricing to increase the company profit, and in turn to get the bonus

Share ownership affects company's transfer pricing aggressiveness

Referring to the p-value of the share ownership variable from Table 3, it can be said that there is a significant relationship between share ownership to transfer pricing aggressiveness. It means that the hypothesis 3 (H3) is supported. It implies that share ownership is relevant in affecting transfer pricing aggressiveness of multinational companies in Indonesia. The result is consistent with the study done by Zhou (2011) as well as Dince and Fitriana (2015). It means that controlling shareholders of a multinational company mostly gain benefit by taking the profit of non-controlling shareholders by doing transaction with affiliated parties.

CONCLUSIONS

The purpose of this study is to find out the factors affecting the transfer pricing aggressiveness in Indonesian companies especially in multinational companies using panel regression data model. It proved that random effect model is model that fit with data gathered. It can be concluded that tax expense, exchange rate and share ownership have influence to transfer pricing aggressiveness using leverage and size as control variables.

This research has limitations such as it did not differentiate the sectors of each company. This research also need to be expanded by employing other variables such as corporate governance, since this research only use one factor of corporate governance, which is share ownership.

The result of this research imply that control over tax expense, exchange rate and share ownership are very important to reduce the opportunistic behavior of the manager. In macro level, government needs to stabilize the exchange rate since it might bring impact to transfer pricing aggressiveness that in turn, will affect the government's income from tax sector and / or tax ratio of the country.

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