

**Determinants Of Transfer Pricing Decisions – Case Of Indonesia And Malaysia**

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**Abstract**

*The purpose of this study is to investigate the impact of effective tax rates, tunneling incentives, and debt provisions on firms' decisions to use transfer pricing. The study uses quantitative methods and utilizes secondary data from annual reports of companies operating in the food and beverage sector listed on Malaysian and Indonesian stock exchanges from 2020 to 2022. This study uses a purposive sample, selecting 12 companies that meet certain criteria, resulting in a total sample of 36 company years. A panel regression analysis of the collected data is then performed. This result shows that tunnel incentives have a positive impact on the decision to implement transfer pricing. However, the effective tax rate and debt arrangements do not have impact on the company's transfer pricing decisions.*

**Keywords:** Transfer Pricing, Effective Tax Rate, Tunnelling Incentive, Debt Covenant

**INTRODUCTION**

Transfer pricing presents a notable obstacle to the expansion of multinational corporations in Indonesia, often perceived as a method for tax evasion, thereby undermining state revenue (Budiman & Bandi, 2022). Implementing the Arm's Length Principle in order to address transfer pricing abuse is found to present greater complexity in Indonesia when juxtaposed with the guidelines set forth by the OECD (Komarudin et al., 2022). The rise in transfer pricing disputes within Indonesia is linked to aggressive tax audit practices, resulting in less dependable audit outcomes and erratic decisions by tax courts (Bhuana Islami & Hartono Paulus, 2022).

In Malaysia, transfer pricing has emerged as a notable concern, prompting heightened scrutiny and oversight from regulatory bodies. To address this, the government has introduced guidelines and legislation on transfer pricing to mitigate manipulation and misuse in transactions involving related parties. (Dahlan et al., 2020). The imposition of penalties is a prevalent issue resulting from transfer pricing adjustments (Hamid et al., 2016). Studies indicate that transfer pricing procedures within Public Listed Companies in Malaysia could evolve into a significant tax evasion strategy without adequate regulation and oversight (Hamid et al., 2016; Jomo, 2006). The transfer pricing practice by multinational



corporations in Malaysia can disguise capital outflows and reduce tax revenue (Talha et al., 2005). Companies in Malaysia voluntarily disclose the basis of setting up transfer prices, but there is room for improvement in disclosing the taxation implications of transfer pricing in segmental reporting.

The relationship between effective tax rates (ETR) and transfer pricing in Indonesia and Malaysia has been investigated in several studies. A study in Indonesia found that the effective tax rate affects transfer pricing, but the exchange rate and tunnel incentives do not have a significant impact (Yumna et al., 2021). Another study conducted in Indonesia found that the ETR has a positive and significant impact on the practice of transfer pricing, especially for the food and consumption sector (Hertanto et al., 2023; Rosmawati & Pinting, 2022). A study conducted in Malaysia found that the level of effective tax rate achieved is influenced by variables such as the presence of subsidiaries in tax havens and gross profit margins. These results suggest that transfer pricing practices may be exploited for tax evasion (Hamid et al., 2016). These results suggest that effective tax rates play a role in transfer pricing decisions in both Indonesia and Malaysia, with potential implications for tax planning and tax evasion.

Several studies have explored tunnelling incentives within the context of transfer pricing in Indonesia. The research concluded that tunnelling incentives did not exert a significant impact on transfer pricing decisions among manufacturing companies listed on the IDX (Jayanti & Supadmi, 2023). Another study similarly determined that tunnelling incentives did not demonstrate a significant influence on transfer pricing within manufacturing companies listed on the IDX (Waluyo et al., 2023). However, a study found that tunnelling incentives had a positive effect on transfer pricing decisions in manufacturing companies listed on the IDX (W. C. Putri & Lindawati, 2023). Therefore, the association between tunnelling incentives and transfer pricing in Indonesia is inconclusive, with some studies finding no significant effect and one study finding a positive effect. Based on the abstracts provided, there is insufficient information regarding the association between tunnelling incentives and transfer pricing in Malaysia.

The presence of debt covenants has been identified as significantly positively associated with transfer pricing practices in Indonesia (Ayem & Ningsih, 2022; Nuradila & Wibowo, 2018; Pramono Sari et al., 2022). The studies conducted on Indonesian companies have shown that debt covenant positively influences the decision to use transfer pricing (Aryati & Harahap, 2021; Khoirunisa & Wahyudin, 2022). However, it is crucial to acknowledge that the effects of debt covenants on transfer pricing could be impacted by additional variables, including tax liabilities and the implementation of sound corporate governance principles. In the context of Malaysia, there is no explicit mention of the relationship between debt covenants and transfer pricing in the previous research. Therefore, additional research may be required to understand the connection between debt covenants and transfer pricing within the Malaysian context.

The purpose of this study is to analyze the impact of effective tax rates, tunneling incentives, and debt provisions on companies' transfer pricing decisions. This study further develops the previous study (D. A. Putri, 2023) in several ways: (1) Adding the independent variable tunnel incentive (2) Food in Indonesia and Malaysia from

2020 to 2022 and beverage companies as research samples. This can provide valuable insight into the dynamics of transfer pricing in this specific industry and geographic context.

The principle of arm's length is a widely accepted approach used to evaluate the equitableness of pricing in transactions involving affiliated entities. This is used in transfer pricing cases to ensure that transactions are treated as if they were between independent parties. This principle is recognized by OECD member countries as an international standard for tax purposes. A variety of methods are used to assess compliance with the arm's length principle in transfer pricing cases. These include the price comparison method, resale price method, cost-plus method, profit sharing method, and net transaction profit method. However, the application of the principles may vary from country to country, potentially giving rise to international double taxation issues. To prevent and resolve transfer pricing abuses, the arm's length principle can be supplemented by bilateral or unilateral agreements between countries. In Indonesia, the technical rules for applying the arm's length principle are more complex than the OECD guidelines (Apollo, 2023; Hickman & Moura, 2023; Permatasari & Husnasari, 2022; Tambunan, 2022).

Transfer pricing is the process of setting prices for transactions between related parties that have a special relationship, such as a subsidiary and its parent company. It is used by companies to allocate and manage earnings within capital groups. However, transfer pricing is often associated with tax avoidance practices. Tax authorities have introduced regulations such as the arm's length principle to ensure that transactions take place at market prices and to prevent tax abuse. Companies use a variety of methods to set transfer prices for transactions between related companies, including cost-based transfer pricing and negotiated transfer pricing. International and national regulatory frameworks regarding transfer pricing were analyzed and penalties for violations were discussed. The COVID-19 pandemic has also led to changes in transfer pricing practices (Anggraeni & Lutfillah, 2019; Bhuana Islami & Hartono Paulus, 2022; Devi & Noviari, 2022; Hardiyanto, 2019; Mahmudi, 2022).

Transfer pricing measurements involve determining the prices at which goods or services are transferred between different segments of an organization. (Moina, 2020). It is a method used to measure company performance and can be manipulated for tax purposes (Dewi & Mustikasari, 2020). The selection of transfer pricing methods can vary among multinational enterprises and there is a lack of uniformity in their adoption (Tono et al., 2018). Factors influencing the determination of transfer pricing within a company include special relationships among entities, bonus structures, acquisition of abnormal profits, foreign ownership, and political considerations (Skoglund, 2010). Conflict of interest can arise between divisions or companies when determining transfer prices, but the role of top managers and selected performance measurement tools can help overcome these conflicts (Kosar & Parzheen, 2020). This research measures transfer pricing with the ratio between related party receivables and total receivables.

Transfer pricing can be used to measure related party transactions, including accounts receivable, between affiliated entities (Ying & Yuan, 2017). The concept of transfer pricing is vital for companies to allocate revenue and retain control.



However, it's also acknowledged as a potential risk for tax avoidance (Sówka, 2022). Rules and regulations have been established to control these transactions and prevent abuse, both domestically and internationally (Uyar, 2014). Accounting for transfer pricing transactions is indeed crucial, and entities should adhere to a meticulous recording process, considering both the simultaneous movement of on-balance sheet and off-balance sheet accounts (Ilham et al., 2022). Nevertheless, it's crucial to recognize that the identification of related parties and the interpretation of transfer pricing can differ between countries, potentially affecting the resolution of transfer pricing disputes via the Mutual Agreement Procedure (MAP) (Dahlberg, 2003). In conclusion, transfer pricing plays a crucial role in distributing profits and taxation responsibilities within multinational enterprises. As such, it is imperative for companies to ensure compliance with relevant regulations.

The effective tax rate (ETR) is a metric that quantifies the proportion of tax expenses incurred by a company relative to its overall net income. It is used to compare the tax burden with the company's profitability. Numerous factors can impact the ETR, such as liquidity, leverage, profitability, capital intensity ratio, and the presence of independent commissioners. The analyzed studies offer valuable insights into how these factors influence the ETR. For instance, certain studies have indicated that liquidity and leverage exert an influence on the Effective Tax Rate (ETR), whereas others have found no significant impact from these factors. Similarly, the presence of independent commissioners and the capital intensity ratio were found to have no effect on the ETR in some studies. Overall, the ETR is an important measure for companies to assess their tax burden and make informed decisions regarding tax management and investment strategies (Andreas & Savitri, 2017; Pristanti et al., 2020; Purwanti et al., 2022; Susilo & Sari, 2022). This study measures ETR with the ratio between tax expense and earnings before tax.

The impact of ETR on transfer pricing has been shown to be contradictory in various studies. Some studies suggest that effective tax rates affect transfer pricing (Cahyani et al., 2023), while others suggest that the effect is positive but not significant (Jayanti & Supadmi, 2023). Indeed, a single research investigation revealed that ETR exerts a detrimental influence on a company's inclination towards engaging in transfer pricing activities. (D. A. Putri, 2023). These results highlight the complex nature of the relationship between ETR and transfer pricing and suggest that additional factors may also contribute to transfer pricing decisions. Given these mixed results, it is important to conduct further research to gain a comprehensive understanding of the impact of effective tax rates on transfer pricing.

*H1: Effective tax rate has a positive association on transfer pricing decisions*

Tunnelling incentives refer to the motivations or incentives for certain actions that allow individuals or entities to transfer funds or assets from one entity to another, often to the detriment of the entity being transferred from. These incentives can arise in various contexts, such as transfer pricing decisions in multinational companies (Hafira Isnain et al., 2022; D. A. Putri, 2023; Sari & Puryandani, 2019;

Suryarini et al., 2020). Tunnelling incentives can also be affected by factors such as tax minimization strategies and the existence of bonus mechanisms. Overall, tunnelling incentives involve actions that allow for the transfer of funds or assets in a way that may not be in the best interest of all parties involved.

Foreign investment can indicate tunnelling incentives. Foreign institutional investors (FIIs) play a role in weakening political connections to tunnelling, reducing the likelihood of tunnelling activities (Anshuman & Sinha, 2012; Hasibuan & Purba, 2021; Nuraina et al., 2022). In emerging economies like China, FIIs' trading activities have an inverted U-shaped relationship with the extent of tunnelling by controlling shareholders (Huang, 2016). Additionally, foreign investment in Chinese IPO firms is associated with opportunistic tunnelling behavior, where related party sales are used to manage earnings upwards in the pre-IPO period and exploit minority shareholders' resources in the post-IPO period (Zhang et al., 2017). These findings suggest that foreign investment can influence the occurrence of tunnelling activities in different contexts. This study measures tunnelling incentives with the ratio between foreign ownership and the number of outstanding shares.

Research shows that tunneling incentives have a significant positive impact on transfer pricing decisions (Tarmidi et al., 2023). In contrast, another study found that tunnel incentives do not influence firms' decisions to adopt transfer pricing practices (Ramdhany & Andriana, 2022). Furthermore, one study found that transfer pricing activities is execute using tunneling incentives (D. A. Putri, 2023). Therefore, the impact of tunnel incentives on transfer pricing may vary depending on the specific circumstances and factors involved.

## *H2: Tunnelling Incentive has a positive association on transfer pricing*

In transfer pricing research, debt covenant refers to a contractual agreement between a borrower and a lender that imposes specific limitations or requirements on the borrower's financial actions. Indeed, it serves to safeguard the lender's interests by ensuring that the borrower adheres to particular financial ratios or fulfills designated financial commitments. In the realm of transfer pricing research, scholars have delved into the examination of how debt covenants affect decisions related to transfer pricing. Research findings have indicated that debt covenants play a crucial and noteworthy role in influencing firms' choices regarding transfer pricing practices. (Ayem & Ningsih, 2022; Nurafipah & Ferdiansyah, 2023). Nevertheless, it has been noted that the reduction of taxes does not diminish the impact of debt covenants on the determination of transfer pricing (D. A. Putri, 2023).

Leverage ratios and other financial ratios in debt contracts have relationship to debt covenant restrictions. A study confirms that leverage ratios are correlated with the presence of and proximity to debt covenant restrictions (Law et al., 1996; Yudhistira et al., 2023). Another study indicates that loan agreements incorporate covenants with ratios that provide valuable insights into credit risk, depending on borrower-specific or contract-related characteristics (Demerjian, 2007; Helwege et al., 2017;



Yumna et al., 2021). This research measures debt covenant with the ratio between total debt and total equity.

Debt covenant has been found to have a influence on transfer pricing decisions in several studies (D. A. Putri, 2023; Ramdhany & Andriana, 2022; Tarmidi et al., 2023). The research findings indicate that companies consider debt covenant as a factor in determining their transfer pricing strategies (Pandia et al., 2022). This suggests that companies may use transfer pricing as a means to comply with the terms and conditions of their debt agreements. The relationship between debt covenant and decisions regarding transfer pricing is further supported by the finding that debt covenant exerts a significant and positive influence on transfer pricing. However, it's essential to acknowledge that not all studies have identified a significant influence of debt covenant on transfer pricing. In conclusion, the evidence indicates that debt covenant influences transfer pricing decisions, but additional research is necessary to comprehensively grasp the extent and mechanisms of this influence.

*H3: Debt Covenant has a positive association on transfer pricing*

## RESEARCH METHODS

This research uses quantitative methods and secondary data sourced from financial reports. The population for this study comprises food and beverage companies listed on both the Malaysia Stock Exchange and the Indonesia Stock Exchange from 2019 to 2022. Purposive sampling is employed as the sampling technique, with the following sample criteria:

1. The company must be listed on the Malaysia Stock Exchange and the Indonesia Stock Exchange in 2020-2022.
2. The company must always make financial reports in 2020-2022
3. The company did not experience losses in 2020-2022. The reason is because if the company experiences a loss, the company is not obliged to deposit taxes (Nurjanah et al., 2015).
4. Present financial statements in Rupiah or Malaysian Ringgit. Or can use conventional currency (according to the parent company).
5. The company sampled is a company controlled by the parent company with more than 20% ownership (Nurjanah et al., 2015).

The population obtained consists of 4 F&B companies in Malaysia and 8 F&B companies in Indonesia, making a total population of 12 companies. The analysis was conducted over 3 years, resulting in a sample size of 36 firm-years.

To test the research hypothesis, model (1) was used and estimate using panel regression.

$$TF_{it} = \beta_0 + \beta_1 ETR_{it} + \beta_2 FOREIGN_{it} + \beta_3 LEV_{it} + \varepsilon_{it} \quad \text{model (1)}$$



Hypothesis 1 is proven if the value of  $\beta_1$  is significantly positive, hypothesis 2 is proven if  $\beta_2$  is significantly positive, and hypothesis 3 is proven if  $\beta_3$  is significantly positive.

## **RESULTS AND DISCUSSION**

The first data analysis carried out was a mean difference test using an independent sample t-test (Table 1).

Table 1 shows no difference in transfer pricing (TF), Effective Tax Rate (ETR), and Tunelling Incentives (FOREIGN) decisions and in Malaysia and Indonesia. Debt Covenant (LEV) in Malaysia is significantly greater than Indonesia.

**Table 1 Mean difference between variables**

Variable	$\bar{x}$ Malaysia	$\bar{x}$ Indonesia	Probability
TF	0,2307	0,2398	0,709
ETR	0,5548	0,5931	0,451
FOREIGN	0,6734	0,2773	0,276
LEV	0,8125	0,2488	0,055**

\* significant at 10%, \*\* significant at 5%, \*\*\* significant at 1%

TF: Transfer Pricing, is measured with the ratio between related party receivables and total receivables, ETR: Effective Tax Rates, is measured with the ratio between tax expense and earnings before tax, FOREIGN: Foreign Ownership as the proxy of Tunelling Incentives, is measured the ratio between foreign ownership and the number of outstanding shares, LEVERAGE: Debt to Equity Ratio as the Proxy of Debt Covenant, is measured with the ratio between total debt and total equity.

Source: Research Data Analysis, 2023

Correlation analysis was conducted to see the relationship between variable (Table 2). Table 2 shows that there is no significant correlation between variables, except between Tunelling Incentives (FOREIGN) and Transfer Pricing (TF) variables towards positive and significant correlation. This is an indication that there is an influence between these variables.

**Table 2 Correlation Analysis**

	TF	ETR	FOREIGN	LEV
<b>TF</b>	1			
<b>ETR</b>	0,117	1		
<b>FOREIGN</b>	0,862**	-0,45	1	
<b>LEV</b>	-0,028	-0,025	-0,112	1

\* significant at 10%, \*\* significant at 5%, \*\*\* significant at 1%

TF: Transfer Pricing, is measured with the ratio between related party receivables and total receivables, ETR: Effective Tax Rates, is measured with the ratio between tax expense and earnings before tax, FOREIGN: Foreign Ownership as the proxy of Tunelling Incentives, is measured the ratio between foreign ownership and the number of outstanding shares, LEVERAGE: Debt to Equity Ratio as the Proxy of Debt Covenant, is measured with the ratio between total debt and total equity.

Source: Research Data Analysis, 2023



Hypothesis testing was conducted using panel regression (Table 3). Table 3 shows that Effective Tax Rate (ETR) and Debt Covenant (LEV) variables have no effect on transfer pricing (TF). However, Tunnelling Incentives (FOREIGN) variable has a significant positive effect on transfer pricing (TF) variable.

**Table 3 Panel Regression Analysis**

Research Model:			
$TF_{it} = \beta_0 + \beta_1 ETR_{it} + \beta_2 FOREIGN_{it} + \beta_3 LEV_{it} + \varepsilon_{it}$			
Independent Variable	Expectation	Coefficient	Probability
Constan	(?)	-0,0296	0,0982
ETR	(+)	-0,7924	0,6023
FOREIGN	(+)	0,1357	0,0003***
LEV	(+)	-0,1146	0,1799
F Test	0,0002		
R Square	0,0907		

\* significant at 10%, \*\* significant at 5%, \*\*\* significant at 1%

TF: Transfer Pricing, is measured with the ratio between related party receivables and total receivables, ETR: Effective Tax Rates, is measured with the ratio between tax expense and earnings before tax, FOREIGN: Foreign Ownership as the proxy of Tunnelling Incentives, is measured the ratio between foreign ownership and the number of outstanding shares, LEVERAGE: Debt to Equity Ratio as the Proxy of Debt Covenant, is measured with the ratio between total debt and total equity.

Source: Research Data Analysis, 2023

## Discussion

If the decision-making process for transfer pricing is not impacted by the effective tax rate, organizations might choose to implement transfer pricing strategies that do not adhere to the arm's length principle. This may result in the transfer of profits to low-tax jurisdictions, reducing tax revenues in the country where the profits were legally earned (Nurjanah et al., 2015). Such a scenario could have a negative impact on affected countries' ability to finance public services and infrastructure. Additionally, companies that use transfer pricing practices that violate the arm's length principle may be subject to fines and penalties from tax authorities. Therefore, it is important for companies to consider effective tax rates when making transfer pricing decisions to ensure tax compliance and reduce the risk of potential penalties (McKinley, 2013).

Foreign direct investment, serving as a surrogate for tunnel incentives, has been noted to exert a favorable influence on the determination of transfer pricing. The



current body of research provides backing to the proposition that foreign ownership does have the ability to impact transfer pricing determinations. When foreign companies invest in a company, they have a significant influence on the company's decision-making process, including transfer pricing policies involving foreign parties (Purnamasari, 2020). Foreign ownership undoubtedly helps reduce agency costs and increase the profitability of companies (Purnamasari, 2020). However, this situation can also lead to scenarios where the dominant party uses its position to obtain further personal benefits at the expense of other stakeholders (Yuliana et al., 2023). It is therefore essential for companies to assess the potential impact of foreign ownership on transfer pricing decisions and ensure tax compliance. This is very important to reduce the risk of potential penalties and to prevent the loss of tax revenue in the country where the benefit was originally derived.

If leverage does not influence transfer pricing decisions, companies may adopt transfer pricing practices that deviate from arm's length principles. Leverage is a ratio that shows how much of a company's assets are financed by debt. It can be used to raise investment capital or generate income beyond a company's core business. If leverage does not affect transfer pricing decisions, companies may use debt to finance subsidiaries and transfer profits to lower tax jurisdictions. This could reduce the country's tax revenue, which would have originally benefited it, and impact its ability to fund public services and infrastructure. Additionally, companies that use transfer pricing practices that deviate from the arm's length principle may be subject to penalties and fines from tax authorities. Therefore, it is important for companies to assess the potential impact of leverage on transfer pricing decisions and ensure tax compliance. This is important to reduce the risk of potential penalties and prevent the loss of tax revenue for the country where the benefits are initially obtained (Fatmi & Amin, 2023; Kananto, 2019; Nisa et al., 2022).

## **CONCLUSION**

The effective tax rate, foreign ownership, and leverage each play a distinct role in transfer pricing decisions, influencing companies' adherence to the arm's length principle and compliance with tax regulations. While the effective tax rate may not directly impact transfer pricing decisions, neglecting its consideration could lead to practices that shift profits to low-tax jurisdictions, potentially diminishing tax revenue for the actual profit-generating countries and triggering penalties. On the other hand, foreign ownership tends to positively influence transfer pricing decisions, as foreign investment can shape a company's policies and enhance overall profitability. However, it is crucial to balance this influence to prevent any misuse of control. If leverage is not taken into account in transfer pricing decisions, companies may misuse debt to transfer profits, impacting their tax revenues and potentially incurring penalties. Companies should therefore carefully consider these factors to ensure tax compliance and avoid negative impacts on public services and infrastructure financing.

There are several limitations in this study: (1) there are only three variables used, effective tax, tunnelling incentive, and debt covenant to see how they affect the decision of companies to practice transfer pricing; (2) the data used is limited so



that researchers need to explore more data and not limited only to food and beverage companies but also to other sectors.

Based on some limitations in this study, the suggestions that can be conveyed are (1) other companies are added to the sample not only food and beverage companies but other sectors can also be used as objects in research such as manufacturing companies, energy and others; and (2) other researchers can also add other variables that can be an influence on transfer pricing such as bonus mechanisms and exchange rates between currencies.

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