Abstract – Transfer pricing has becoming a great fear among companies in Indonesia, especially when Indonesian Tax Office launched its significant initiatives back in 2009 / 2010, where it required companies which submitted their annual tax return to be attached with transfer pricing documentation for company’s related party transactions. Though it has be to admitted that related party transactions mostly used by multinational companies to set up the profit level at the maximum by utilizing different tax regimes of the countries where the companies domiciles.Focus of this final project are maintained on major related party transactions, which are: 1) sales, 2) management and technical assistance fee, 3) charge related to shared services performed by related party domiciled in Malaysia. This is in accordance with tax regulation recently issued in 2011, stating that only transactions > IDR10 billion that required transfer pricing analysis / documentation. The first result of the analysis showed that it will be financially advantageous for the Company to increase the sales price which will affect decrease in global tax expense. However, given the complexities of changing the sales contract with the shareholder, tax implication for Japan business unit, it is advised that the Company maintain its sales price at the current level. The second result is to recommend the Company to revise its transfer pricing method for its MTA fee to a cost based / cost plus method as it would give better rationale of the transaction for Indonesia Tax Office. The third result is to deny the proposal of setting up the shared service organization in Malaysia for Indonesia business unit as it is financially inefficient and making further complexity on the tax administration in Indonesia.

Keywords: transfer price, related party transactions, transfer pricing, arm’s length transaction

I. INTRODUCTION

Interdependency among subsidiaries / affiliates or issue always creates challenge for group headquarters to handle them. This takes form, among other, in the usage of one subsidiary’s intermediary product by another subsidiary to produce final product. Another form is the usage of services provided by parent company of using the brand, management expertise, network or even the “trending” shared administrative services such as procurement, accounts payable or some HR administrative function by its subsidiaries.

As multinational companies (“MNC”) becomes larger and expands throughout the world, many of them are using the decentralization style in managing the corporations in each country. Reasons behind this action may include easy access to local information, less time in decision making in local level, giving head quarter the “space” to concentrate on strategic issues at global level, providing training ground for junior level managers to enable them to grow their capacity in decision making process as well as increasing their motivations. Lastly, this style could also enforce competition among subsidiaries to be more efficient and more profitable, which will further affect local management bonus.

On the other hand, income tax is often seen as a burden on profit and for this reason many MNCs perform strategies to reduce its income tax or to maximize profits by maintaining an efficient effective tax rate. One of the strategies is by maximizing the profit in low / zero tax countries using the transfer pricing mechanism. In overall, it is the profit after tax of the group that matters
and used as a performance measurement tool for management of head office.

Even though it may sound fair for a holding company to set their own pricing policy among its subsidiaries, this pricing mechanism can also cause unfairness in taxation due to tax regulation differences in each countries. Countries that have no significant potential income may arrange a zero or low percentage of tax rate scheme to attract MNCs to setup their companies there to allow employment opportunities for its citizen.

On the contrary, countries having higher income tax rates where MNCs usually operate experience a decreased tax income due to some profit were allocated to those zero-taxed countries. This creates disagreement for those countries as they are trying to protect their national economic interest – which is a normal thing to do.

Indonesia marks a significant development in the transfer pricing subject, indicated initially by the revised income tax law at the end of 2008 that put more emphasize on related party transactions. Since then and for 2009 annual corporate income tax return submission which were reported in April 2010, companies engaged in related party transactions are required to maintain transfer pricing documentation, including a number of several other disclosures such as transactions with tax haven countries. Failure to comply with the requirement could cost a significant amount of tax assessments.

Despite many negative practices of transfer pricing, it is not wise to conclude that every related party transaction is inclined with the intention of transferring profit to a lower tax bracket countries. There are also many occasions that related party transactions serve as a tool for performance measurement or a term called “cost centre” system, simplification of transactions (for example rather than using voluminous actual data, it uses certain percentage from sales figure) or cost savings (for example establishment of shared service organization in one country that serve many countries in the region).

The object of this final project is PTXX, a producer of “NM” from ores at its integrated extraction and processing facilities in the eastern part of Indonesia. “NM” is an intermediate product containing on average 78% “NM” and 20% “SU”. The entire production of PTXX is sold in United States dollars (US$) under long-term contracts.

Interdependency issue also occurred in PTXX as the Company produces intermediary / semifinal product that is later sold to parent company. The Company also has interdependency with the parent company in form of getting its product sold to international market, technical expertise related to realization of Company’s projects and lastly assisting the Company in obtaining the financing for its projects. Lastly, the Company was also assisted by one of its affiliates to manage its trade payable payment processing and expatriate payroll.

Therefore, significant related party transactions within the Company comprise mostly of three components, which are sales to two main shareholders of the Company, management and technical assistance fee to one main shareholder and lastly a support service provided by an affiliated company. These three transactions would be the main focus of the analysis provided in this research.

II. BUSINESS ISSUE EXPLORATION

The final project is to evaluate and answer the following questions:

1) Is the Company’s previous assessments regarding its transactions with related parties are still relevant for the current period and meet with the current arm’s length principle? If not, what should be the transfer pricing for its transactions with related parties? What methods give the best return for the Company’s shareholders?

2) What options does the Company have? Is it necessary to revise its transfer price policy for the related party transactions or just let the transactions as they currently are and deal the challenges as they come? What are the approximate financial impacts of tax assessments if Indonesia Tax Office (“ITO”) does not accept the transfer pricing treatment?

3) If the Company elected to use the new pricing mechanism, how does the Company cope with its implementation challenges for its related party transactions?

Most significant related party transactions are based on the assessments performed long time ago, which may not be relevant anymore in present time. Therefore, the main benefit of this research is to give the Company a solid ground
over its related party transactions based on current time perspective. As the Company is currently in the process of negotiating one of its related party transactions, this research could give a consideration for the Company regarding what pricing should be accepted or denied by the Company over the pricing proposal from the related party. Using the company stand alone perspective, Company would choose the lowest price possible for any services used, however Company may also want to consider the head office perspective, which is provided by this research.

This research is expected to give awareness of the potential financial and other risks of Company’s related party transactions, and to be more specific, in regard of its potential tax exposures for those related party transactions. Having a documented transfer pricing assessment would give the Company “ammunition” to at least knowing the potential tax assessments raised during any tax audits that can occurred anytime ITO wants to.

III. BUSINESS SOLUTION

Research Methodology
Similar to other quantitative researches, the approach would be collecting financial data such as financial reports for the related company and its competitor for comparative purpose, “NM” commodity prices, tax rate from various related countries, time-sheet from related parties that charged PTXX and several payroll employee data related to department being charged.

Aside the quantitative method, qualitative method is also used for this final project. This data collection will also rely on subjective point of view, political condition in the central or regional, legal perspective, as well as ultimate shareholder strategy. Several interviews were performed with Chief Financial Officer, Head of Finance, Head of Tax as well as Company’s consultants to obtain their views and perspectives regarding transfer pricing as well as to reveal the performance objective set by group management to local management.

Theoretical Framework
OECD defines transfer price as “a price, adopted for book-keeping purposes, which is used to value transactions between affiliated enterprises integrated under the same management at artificially high or low levels in order to effect an unspecified income payment or capital transfer between those enterprises” (http://stats.oecd.org).

OECD also defines related companies or related parties, as the commonly known term, as “companies that do not have an arm’s length relationship (e.g. relationship involving independent, competing interest). This could be due to both companies being part of the same business group or could stem from family or personal ties between officials of two companies.” (http://stats.oecd.org).

Based on OECD glossary of statistical terms (http://stats.oecd.org), “arm’s length principle is a valuation principle commonly applied to commercial and financial transactions between related companies. It says that transactions should be valued as if they had been carried out between unrelated parties each acting in his own best interest.”

According to Indonesian Tax Office, through its regulation by the Directorate General of Taxation No. PER-32/PJ/2011 article 11, the determination of transfer price that can be accepted by them are as follow:
1) Comparable Uncontrolled / Market Price
2) Resale Price (Sales minus Related Margin)
3) Cost (Plus Margin)
4) Profit Split
5) Transactional Net Margin / Others

Data Analysis & Business Solution
As the purpose of this analysis is to provide preliminary transfer pricing documentation to satisfy the ITO requirements, therefore all methods used in the analysis are in accordance with the methods required by ITO / Indonesian tax regulations (PER-32/PJ/2011).

Sales Transaction
Sales are made based on long term, “must take” sales contract with price determined by a formula that is based on the London Metal Exchange (“LME”) cash price or XX Ltd average net realized price for “NM”. An article in the 196x sales agreement stated that the Company is obliged to sell its product at prices and on terms compatible with world market conditions. The article also states that the Government has the right to review adjustments in the pricing formula. All sales amounts represent sales to related parties, which are XX Ltd and YY Ltd.
Sales - Resale price method
The resale price method produces higher earnings before tax in Indonesia, compared to the actual earnings before tax in year 2010 and 2009. This happened due to processing cost outside Indonesia that was practically minor against the total cost as whole. Japan business unit only processes 22% of the total finished goods, while Indonesia business units processed 78% of the total finished goods.

The sales price / unit generated from this method in 2010 and 2009 are US$17,231/MT and US$10,217/MT consequently, compared to current price of US$16,568/T for year 2010 and US$11,227/T for year 2009.

Applying 81% pricing (US$17,231) from LME price may be advantageous from Indonesia point of view as this will generate more earnings that further increase taxes paid in Indonesia and ITO will be very supportive towards this action. Additionally, corporate income tax rate in Indonesia is lower than one in Japan (25% versus approximately 40%). Therefore, shifting the profit to Indonesia will be more profitable from headquarter point of view as global taxes paid in 2010 using this 81% LME price is approximately US$164 million, compared to 78% LME price method that generated higher tax figure of US$170 million. The same condition happened in 2009 if this method was applied, resulting a global tax figure of US$42 million, compared to 78% LME price method that generated the tax figure of US$59 million. This resulted from a poorly performed LME price and the headquarter already incurred loss in 2009, therefore it was assumed that no taxes were paid in Japan. Increasing the sales price in Indonesia would only increase earnings before tax and tax expense figures, without being offset by Japan’s portion.

Applying this method is beneficial for head quarter point of view by shifting the profit to Indonesia and utilizing the lower tax rate in Indonesia compared to Japan. However, business unit in Japan must also be considered, as it will likely to have challenges from Japan tax agency as it will incur less profit that further impact its lower tax paid to Japan tax agency. This can cause, among others, tax audit by Japan tax agency, accusation of profit shifting and therefore the transfer price can be claimed non arm’s length.

Sales - Cost (plus market margin) method
Market margin for EBITDA in 2010 was averagely 32%, compared to 14% in 2009. Company’s EBITDA margin was 28% in 2010, a slight difference with the market while in 2009 the Company beat the market with 17% EBITDA margin (while market was 14%). Indonesia actual EBITDA margin was around 54% in 2010 and 44% in 2009. Pricing using this method will be simply adding the 31% in 2010 and 8% in 2009 margin over the cost of goods sold minus depreciation per unit figure.

Sales price / unit will be around US$11.1K/T (52% LME price) compared to current price of US$16.6K/T for year 2010 and US$6.8K/T (47% LME price) compared to current price of US$11.2K/T for year 2009. Application of this method to 2010 and 2009 calculation would result in a lower sales figure in both 2010 and 2009, as discussed in the above calculation. Thus, corporate income tax figure will also be impacted / lower than the actual figure in both 2010. Commodity industry, including “NM” metal will always be marked by the “roller-coaster” price ride, as a result from balance mechanism of product supply and demand. Growing economy, the availability of substitute product or recession could heavily impact the supply and demand graph.

Using this method will result in increase of tax payment in global scale in 2010 at US$231 million, compared to 78% LME price method that generated the tax figure of US$168 million. While for 2009, the figure was also higher, US$85 million, compared to 78% LME price method that generated the tax figure of US$59 million. This was due to major portion of the profit was moved to a higher tax country.

Sales - Profit split method (by production)
Indonesia’s production in 2010 and 2009 were 78.4KT and 68.8KT consequently. Compared to head quarter production in 2010 and 2009 of 178.7KT and 186.7KT, Indonesia represents about 44% and 37% in 2010 and 2009 from global production. Head quarter EBIT was US$165 million or 4% from sales (EBIT margin) in 2010, while in 2009, corporate experienced loss with EBIT loss figure of US$361 million. Using this proportion to the pricing formula, Indonesia portion of the headquarter EBIT in 2010 is around US$72 million and shared the loss of corporate of US$133 million in 2009.
By adding this shared corporate EBIT to the total cost, and divided by the units sold would result in a price / unit of US$10K/T (47% LME price) in 2010 and US$5.8K/T (40% LME price) in 2009.

In overall, the earning before tax and corporate income tax generated from this method is lower than current method of 78% LME price. Additionally, global tax expense also increases to US$245 million and US$112 million in 2010 and 2009, compared to 78% LME price method of US$168 million and US$59 million consequently. This was due to major portion of the profit was moved to a higher tax country.

Profit split method (by company’s margin)
Headquarter margin in 2010 and 2009 were 4% and loss 9% consequently. Using this method will make Indonesia business unit to apply the same profit margin as head quarter.

By adding this margin to the total cost, and divided by the units sold would result in a price / unit of US$9.3K/T (44% LME price) in 2010 and US$7.1K/T (40% LME price) in 2009.

Similar with profit split method, the earning before tax and corporate income tax generated from this method is lower than current method of 78% LME price. Global tax expense increases to US$252 million and US$77 million in 2010 and 2009, compared to 78% LME price method of US$168 million and US$59 million consequently. This was also due to major portion of the profit was moved to a higher tax country.

Business Solution for Sales
It is very obvious that increasing the transfer price in Indonesia will be advantageous for head quarter as it will generate lower global income tax expense and Indonesia will be impacted positively by the increase of taxes paid to ITO. Therefore, resale price method will be the method of choice for ITO if the calculation is presented, assuming the transfer price will be higher than 78% LME (current) price. However, other factors that must be put into considerations are tax complexities in Japan due to the change in pricing that may be deemed non arm’s length by Japan tax agency.

With the progress of renegotiation of the Company’s contract on going, as well as sales contracts with the shareholders kept preserved as original, it is wise for the Company to maintain its sales pricing policy consistent with previous year practices, which is 78% from LME price. As long as the Company can prove that the product is technically 78% of the finished price to Indonesia and Japan tax agencies, the current pricing policy already sufficient to meet the definition of arm’s length principle.

MTA fee
Management and technical assistance (“MTA”) represents XX Ltd's assistance for realization of the Company's projects, its financing scheme, the construction and operation of the Company's facilities and the marketing of the Company's products. The management and technical assistance fee is calculated as the lower of 1.8% of net sales or 4% of net taxable income, provided that the amount payable for each quarter should not be less than US$25,000.

Therefore services performed by XX Ltd to the Company mostly relates to the daily operational of the Company, which include human resources, internal audit, legal, corporate affairs / external relations, taxation, treasury and IT. Allocation method used for these services are mostly either time spent, direct cost of user count.

Based on the collection data for transfer pricing study development, the cost associated with the above services is as the following, including the comparative actual charges of MTA fee from XX Ltd to the Company:

<table>
<thead>
<tr>
<th>Year</th>
<th>MTA 1</th>
<th>MTA 2</th>
<th>Diff</th>
</tr>
</thead>
<tbody>
<tr>
<td>2006</td>
<td>N/A</td>
<td>N/A</td>
<td>N/A</td>
</tr>
<tr>
<td>2007</td>
<td>5,929</td>
<td>18,424</td>
<td>12,495</td>
</tr>
<tr>
<td>2008</td>
<td>6,522</td>
<td>9,013</td>
<td>2,491</td>
</tr>
<tr>
<td>2009</td>
<td>7,174</td>
<td>22,974</td>
<td>15,800</td>
</tr>
<tr>
<td>2010</td>
<td>41,862</td>
<td>24,079</td>
<td>17,783</td>
</tr>
</tbody>
</table>

MTA 1) Based on actual time sheet with margin of 10%. Data collection were performed only in 2008, while starting 2009, the Company changed its strategy to deem the current MTA fee as royalty transaction instead of management fee, therefore no data collection were performed. However, for the purpose of this calculation, it was assumed there was 10% compound increase for year 2009 and 2010

MTA 2) Based on current practice charge

XX Ltd is domiciled in Canada and its corporate tax rate is 40% (Canada Revenue Agency – approximate percentage from federal and
It is clear from the sales transaction calculation above that allocating more revenues – in this case MTA fee for XX Ltd – in high tax countries such as Canada will create additional tax expense. Thus, the higher the MTA fee being charged by XX Ltd to Indonesia business unit will also create higher tax deductible expense, which is advantageous for Indonesia business unit. Below is the illustration for year 2008:

<table>
<thead>
<tr>
<th></th>
<th>Malaysia</th>
<th>Indonesia</th>
</tr>
</thead>
<tbody>
<tr>
<td>Payroll expense 1)</td>
<td>US$73,498</td>
<td>US$64,611</td>
</tr>
<tr>
<td>Shared services 2)</td>
<td>US$1,296,000</td>
<td></td>
</tr>
<tr>
<td>Difference 2)</td>
<td>US$1,222,052</td>
<td></td>
</tr>
</tbody>
</table>

The amount being charged by Malaysia business unit is not only payroll expense of US$64,611. It charged approximately US$108,000 per month for rendering such services, totaling around US$1,296,000. The reason for this big gap is the overhead cost of management team members in Malaysia that oversees the whole entire operations in Asia Pacific. Plus, Indonesia is the largest operating unit that the HQ has in the Asia Pacific region.

Business Solutions for Support Service
Similar with MTA fee, the suitable method for the support service transactions would be purely cost plus method, rather than market price or profit split method, as currently no market price information for such activities available that can be utilized.

It is clearly explained in the above calculation that current practice is much efficient than if it was operated by Malaysia business unit. One factor that caused this significant difference is the management cost for Malaysia business unit that is included in the monthly charge to Indonesia business unit. Other than that, Malaysia total team compensation is lower than Indonesia’s total team compensation (salary survey Kelly Services 2009 / 2010 Malaysia compared to simulated Indonesia compensation expense). However, Malaysia business unit is not only serving Indonesia business unit, but also for several countries in Asia Pacific region. Therefore, having a support service centre in...
Malaysia is actually efficient from headquarters' point of view as one staff can handle several countries' transactions.

Under Indonesia tax regulation, every foreign company that renders services to Indonesian companies is subject to a time test to ensure its legal tax form of its operating form in Indonesia, whether it is going to be a foreign company (foreign tax subject) or permanent establishment (domestic tax subject). Specifically for Malaysia, the time test for these kinds of service is 3 months (PwC Indonesia, Indonesian Pocket Tax Book 2011). Therefore, if Malaysian company rendered services to Indonesia companies for a period below than 3 months, the company would be deemed as foreign tax subject and the applicable taxes would be withholding tax (“WHT”) article 26 of 20% or less, subject to the availability of tax treaty between the related countries. Malaysia reduced rate could be as low as 12.5% depending on the nature of transactions.

However, if this Malaysian business unit operated more than 3 months, the entity would be deemed as domestic tax subject and would have to follow Indonesia tax regulations in a wholly basis that consists of WHT, corporate income tax (“CIT”), value added tax (“VAT”) and perhaps several other regional taxes / levies.

If Malaysia business unit is going to give a continuous service to Indonesia, ITO will deem Malaysia business unit having a permanent establishment (“PE”) in Indonesia. PE will also be subject to corporate income tax at the same rate of 25%. The difficulty will then be on how to separate the cost associated to Indonesia and other countries as several staffs will be doing services not only to Indonesia but also to other countries. Plus there will be administration matters that need to be complied with – that will require additional tax team to handle such as corporate income tax, value added tax and withholding tax on service.

If the service performed by Indonesia business unit, there is only one non-direct tax applied, which is withholding tax on personal income.

Having the difficulties in tax administrations, it may be wise to stay the current operations at its current form, which is less complex than if it is going to be handled by Malaysia business unit.

IV. IMPLEMENTATION PLAN

In general, the first stage of the implementation would be to prepare such transfer pricing documentation for significant transactions. For reference, the significant transaction could refer to recently issued regulation of DGT regulation no. 32 / PJ 2011, mentioning that any related party transactions above IDR10 billion must have a transfer pricing documentation prepared. The preparation of such documentation must be done in line with the consulting activities with the HQ in order to comply with the Group global strategic policy. This would also include a consideration to revise the “old” agreement between the Company and HQ as well as its impact to agreement made between the Company and the Government, as inside this agreement also stipulates about the pricing mechanism in general – that may or may not have an impact to the compliance aspect.

The second activities would be to setup a procedure where transaction between related parties can only occurred after a placement of contract. This to ensure that Company is not exposed to a risk of tax audits that can further lead to significant tax assessments as Company deemed to perform profit shifting, non-arm’s length transactions or any other accusations.

Sales transaction

Specifically for sales transaction, from the analysis done in Chapter III, it is clearly mentioned that Indonesia has corporate tax advantage compared to Japan, which is 25% against around 40%. Therefore, it would be obviously advantageous to build a 100% finished NM refinery plant in Indonesia, compared to current practice of sending the 78% finished NM to Japan to be further processed to 100% NM.

The plan may also want to include a feasibility study to conclude whether a construction of the plant would have a positive NPV calculation, considering the time to operate in Indonesia, the ore reserves, the commodity price as well as the cost structure to produce. These factors would be further compared to the cost of constructing the processing facility in Indonesia.

Additionally, building a further processing facility would give the Company “a clearance” to export its product to overseas, considering the late issuance of Reg No.7/2012 regarding Increase in Value-Add from Minerals through Mineral Processing and Refining. Though at its
current practice, the Company already had a clean and clear certificate to export its product to overseas, considering the Company already produced a processed metal as required by the Reg No.7/2012.

If the Company elected to build a further processing plan, then the Company must also setup a new sales agreement with its shareholders.

**MTA transaction**

Continuing the current practice of MTA transaction is definitely not efficient. Currently this transaction is being treated as royalty expense, which is theoretically not right, as the creation of this MTA fee is to simplify / eliminate the administration matters that may take place if the Company elected to use the revised plan as below. The tax applicable for this mechanism is 10%, while for the revised plan below is 2% percent. As the related party is receiving the net amount – the Company bears the tax, the less tax would mean more favorable option.

A revised implementation plan for MTA transaction would include instruction from Indonesia business units to XX Ltd to properly document in timesheets regarding any service activities performed for Indonesia business unit. The documentation may include the person conducting the services, the type of services, any third party invoices related to the services and most of all the time spent for these services. Off course such exercises require discipline and effort in administrating the time sheets.

Preparation of these documents would give Indonesia business unit a better ammunition when ITO challenged the MTA transactions, as it previously had.

**Shared services transaction**

As it was previously mentioned, the shared service transaction has not yet occurred therefore, the implementation plan would be simple, which is not to implement the plan as it would create tax administration challenges for the Company, despite the minimal tax savings if the shared service operations performed in Malaysia, compared if it was operated from Indonesia.

**Budget and Organization Consequences**

There is not much impact to organization as these activities can be localized as much as to finance department, specifically tax department. However it must bear in mind this final project only discussed significant related party transactions of more than US$1million. There are several other related party transactions, such as expatriate secondment, back charges, insurance premium that could also lead to questions from ITO regarding its pricing policy.

In relation to budget, there is not much budget to be allocated for this exercise. We believe it is necessary to engage a tax consulting firm to help the Company to develop such transfer pricing documentation, however based on the research of such services provided in Indonesia, the range of such consulting fee would not be more than US$200,000, including review of ad-hoc related party transactions as discussed above.

**Closing**

At some extent, MNCs are not solely the subject to be blamed as they are only utilizing various tax schemes around the world – this is debatable. On the other hand, it is normal for every country to protect their national economy interest. What needs to be maintained is the balance between both. The existence of such list of tax haven countries, for example, is a form of dictation of majority countries to minority countries. Thus, there are several countries who have similar characteristics of those mentioned as tax haven countries, are not included in the list – as a result of intense lobbying or a particular member of those majority countries have their own interest in those type of countries.

As for the Company, preparation of such transfer pricing documentation long before the transaction exists is a must to evade any tax exposure in related party transactions.

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