Drivers of the Intensity of Transfer Pricing: An Indonesian Evidence

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Abstract
Transfer pricing policy can help multinational enterprises (MNEs) take advantage in managing costs and risks in the complex international market imperfections. However, research on the factors driving the existence of the transfer pricing were scare, particularly in the Indonesian context. Review literature also revealed that future studies needed to include some non-tax factors and gathered data from financial statements. The purpose of this study was to scrutinize determinants of the intensity of the transfer pricing. The populations in this research were all publicly-listed companies in the Indonesian Stock exchange Bank. Using purposive sampling, 259 public companies were selected as the sample covering the period of 2011-2015. The data were from the financial statements and annual reports of the companies. A path regression using with the help of PLS software was employed to analyze the driver impacts on the intensity of the transfer pricing. The findings show that tax avoidance, intangible assets, firm size, and profitability significantly enhanced the intensity of the transfer pricing. The study results draw some implications academically and practically.

Key Words: Transfer pricing, tax avoidance, profitability, intangible asset and firm size.
JEL Classification: M16, M21, M40
1. Introduction

Globalization has created a considerable opportunity for businesses leading them to have divisions all over the world to increase their profitability through transfer pricing (McMahon, Corcelius, & Smith, 2013). According to Holtzman and Nagel (2014), transfer pricing is inter-company pricing arrangements relating to the transactions between related business entities in term of transfers of intellectual property, tangible goods, services, and loans or other financing transactions. In addition, transfer pricing can be defined as the pricing of goods exchanged between related parties to allocate incomes across affiliated entities in different tax jurisdictions (Cristea & Nguyen, 2013). Transfer pricing comes into prominence since it has function to target good coordination among divisions, managers’ awareness of goods and service value in term of customer focalization, profit maximization and well-allocated organization’s resources in form of satisfactory performance (Fernandes, Pinho, & Gouveia, 2015).

Nevertheless, Gilbert et al. (2013) stated that transfer pricing may raise ethical issues even though it can be used as a positive tool that works in the best interest of the overall organization. According to Richardson, Taylor, and Lanis (2013), a multinational enterprise (MNEs) may conduct intra-firm trade by involving price payments to facilitate tax avoidance through artificial inter-company transfer prices. In Indonesia, Ministry of Finance recorded that around 2,000 foreign-owned companies have not paid their obligatory payment in the form of tax for 10 years. Most companies tend to avoid income tax mathematically can contribute as much as Rp25 billion to the state income per year (Sari, 2016). In addition, one of the major causes is the practice of transfer pricing from Indonesia-located companies to their parents in foreign country. This will lead the companies to have relatively small profit in Indonesia (Suroyo and Danubrata (2016). In another occasion, many Indonesian firms, particularly those in the coal, palm oil, cocoa and other commodities sectors, were avoiding corporate taxes by means of transfer pricing. Under transfer pricing practice, Indonesian companies sell its goods to their subsidiaries in other countries below market prices, and the subsidiaries in turn sell them to the market. This strategy effectively reduces company’s profits in Indonesia but increases them in the overseas.

Due to the significant role of transfer pricing in the global business environment, there have been many studies conducted regarding to the internal and external factors leading to transfer pricing. Studies have been conducted by foreign researchers such as Davies, Martin, Parneti, & Toubal (2015), De Simone (2015), Dudar, Spengel, and Voget(2015). Meanwhile Kiswanto and Purwaningsih (2015), Hartati (2014), and Marfuah and Azizah (2014) have scrutinized the determinants of transfer pricing for Indonesian companies. In general, previous studies on the drivers for transfer pricing have shown inconsistent findings. These factors include profitability (Mohammadi et al., 2015; Holtzman & Nagel, 2014; Blouin, Robinson, & Seidman, 2013;
Richardson et al., 2013, Schäfer, Petri, Gasparetto, and Mattos, 2015 and Cecchini et al., 2013), firm size (Davies, Martin, Parneti, and Toubal, 2015; Cecchini et al., 2013; Richardson et al., 2013; Kiswanto and Purwaningsih, 2015; Rusydi and Martani, 2014), tax (Kiswanto & Purwaningsih, 2015; Sari & Hunar, 2015; Chen Ye Ekström et al., 2014; Hartati, 2014; Doğan et al. 2013; Klassen, Lisowsky, &Mescall, 2013; and Richardson et al., 2013; Marfuah and Azizah, 2014; Klassen, Lisowsky, and Mescall, 2013, Cecchini et al., 2013, and Rossing 2013). Accordingly, these inconsistent variables lead to a further reexamination. In addition, the previous study by Doğan et al. (2013) has suggested to include other factors such as sales, profitability, asset structure and size of the firms. They also have recommended using the instrument of published financial reports of multinational corporations detect those factors.

The purpose of this study is to scrutinize determinants of the intensity of transfer pricing. However, this study adds new variables as suggested Doğan et al., (2013) and provide non-tax factors to give more comprehensive deliberation on transfer pricing practices as suggested by Kiswanto and Purwaningsih (2015) and Chen Ye Ekström et al. (2014). Thus, this study examines the drivers of the intensity of the transfer pricing. This article is structured as follows. We formulate and present the hypotheses in the section 2. Section 3 provides the conceptual model, the variables and empirical results and discussion. Finally, we summarize and recommend for future research in the last section.

2. Literature Review

As the global economy expands significantly into every corner of the world, any parties such as multinational enterprises (MNEs) must take strategic actions. In running global business, MNEs should maximize the opportunity to exploit wide market sizes by operating in many countries to pursue competitive advantage (Cecchini, Leitch, & Strobel, 2013). They also argue that the transfer pricing policy can help MNEs take advantage in managing costs and risks in the complex international market imperfections. According to Holtzman and Nagel (2014), transfer pricing is inter-company pricing arrangements relating to the transactions between related business entities in terms of transfers of intellectual property, tangible goods, services, and loans or other financing transactions. In line with the previous definition, Blouin, Robinson, and Seidman (2013) defines transfer pricing as the price attached to the operations of multinational enterprises entailing numerous transactions among affiliated entities located in different jurisdictions but within the same controlled group. The following section discusses the factors that enhance transfer pricing that appear in the previous accounting, business and economic literatures and empirical studies.
2.1 Tax Avoidance

Tax can be defined as mandatory contributions to the state owed by the individual or entity that is enforceable under the Act – legislation. The taxpayers will not get the rewards directly and the payment will be used to finance the government expenditures and to achieve the society welfare. The taxpayers may use legal methods to modify their financial situations to lower the amount of owed. This tax avoidance can be accomplished by claiming the permissible and utilizing unregulated transactions such as transfer prices. According to Klassen, Lisowsky, and Mescall (2013) transfer prices have been used as tools for multinational enterprises to reduce global taxes. The reason behind this relationship between tax avoidance and transfer pricing is that high tax burden will trigger multinational firms to impose lower selling prices among affiliated firms and transfer the profit to the low tax rate countries. This transfer is to minimize tax expenses and thus maximizes parent company’s profit (Kiswanto and Purwaningsih, 2015). In addition, tax can influence transfer pricing through tax avoidance that can be achieved by transferring goods to countries having low income tax rates at the lowest possible transfer price and by transferring goods out of these countries at the highest possible transfer price (Richardson et al., 2013). Furthermore, the profit maximization goal will reflect the internal motive of the transfer pricing manipulation. In addition, the difficulty to apply the arm’s length principle provides external environments for multinational firms to manipulate transfer pricing in order to avoid corporation taxes (Chen Ye Ekström, Dall, and Nikolajeva, 2014).

Political cost hypothesis can also explain the relationship between tax avoidance and transfer pricing. According to this hypothesis, the greater the political costs faced by the company, the greater the tendency of companies to use accounting choices that could lower profits. This is because the companies having high profit rates will receive extensive attentions from stockholders, the media, government and regulators. This circumstance will enhance high political costs for the firms such as government interventions, the imposition of higher taxes and various other demands. Under political cost hypothesis, thus tax avoidance by selecting accounting methods to lower profits thus enhances transfer pricing. Studies by (Davies et al., 2015; Sari & Hunar, 2015; Kiswanto & Purwaningsih, 2015; and Chen Ye Ekström, Dall, & Nikolajeva, 2014) support the positive relationship between tax and the intensity of the transfer pricing. This study examines the following hypothesis:

\[ H_1 : \text{the higher firm's tax avoidance, the higher intensity of the transfer pricing.} \]

2.2 Firm Profitability

Profitability can be defined as an ability to make profit from all the business activities of an organization, company, firm, or an enterprise. Firm’s profitability becomes a commonly method to determine firm’s performance and overall efficiency (Niresh & Velnampy, 2014). Holtzman and Nagel (2014) and Blouin, Robinson, and Seidman (2013) observed the link between firm’s affiliated profit abilities and tax rates. Firms that are more profitable may adjust
transfer prices to reduce (increase) profits in high-tax (low-tax) jurisdictions by considering their pre-tax incomes. Multinational companies also try to reallocate their income from higher tax jurisdictions to lower ones in order to minimize their total tax burden and maximize profit (Mohammadi, Ahmed, and Habib, 2015). Richardson et al. (2013) gave the real example of highly profitable firms such as Apple, Google and Microsoft that have been able to favorably locate profits in low-tax jurisdictions and increase tax-deductible expenditures in high-tax jurisdictions to reduce taxable profits accordingly. Therefore, there is a positive correlation between tax avoidances and profitability of the company in the transfer pricing practice.

Stewardship theory can also explain the relationship between firm’s profitability and its transfer pricing. Following this theory, executives of the multinational enterprise protect the interests of the owners or shareholders and make decisions on their behalf. Their main objective is to create and maintain a performance of the enterprise so the shareholders prosper. A multinational enterprise group publicly held may feel the pressure from shareholders to show high profitability at the parent company level. Simultaneously, company’s profitability may have impact on its effort to sign future expectations of the interested outsiders such as investors, creditors, and potential investors and creditors. In the context of the transfer pricing, more profitable firms may alter transfer prices to reduce reported profits in high-tax jurisdictions by considering their pre-tax income. In addition, firms with high profit before tax are more likely to avoid the taxable income taxes paid to improve its profitability. These firms then use tax avoidances opportunity in the transfer pricing mechanism to improve shareholder prosper. Thus, to formally test the impact of firm’ profitability on transfer pricing, the following hypothesis is developed:

\[ H_2 : \text{Higher firm’ profitability, higher the intensity of the transfer pricing.} \]

2.3 Intangible Assets

The OECD (2010) defines intangible property as the right to use industrial property such as patents, trademarks, trade names, designs and models. It also encompasses literary and artistic property rights and intellectual property rights. In this case, commercial intangibles consist of marketing intangibles and trade intangibles. Those are intangible assets having substantial values of the company services. The Intangible assets become one of the important key issues regarding related party transactions of multinational enterprise groups. These groups can strategically distribute their intangible assets to their members in low-tax jurisdictions, which then receive royalty payments from the affiliates that are located in high-tax countries (Dudar, Spengel, & Voget, 2015). Because intangible assets are lack of well-established markets but subjective valuations, these firms can also exploit simultaneously in several jurisdictions through a transfer pricing mechanism. In other words, intangible assets can be used for shifting profits between affiliated companies with a goal of minimizing global tax liability of a multinational group. Previous studies also support the relationship between
intangible asset and transfer pricing. Intangible assets are positive and significantly associated with transfer pricing aggressiveness (Taylor, Richardson, and Lanis, 2015; and Richardson et al., 2013). Using Norwegian tax return data, the flexibility in transfer pricing is greater for intangible goods than tangibles since arm’s length prices are more difficult to be determined for intangibles (Hopland, Lisowsky, Mardan, & Schindler, 2014). Study by Beer and Loeprick (2014) stated that intangible assets was significant determinants of profit-shifting activities. Therefore, those previous studies mentioned studies are consistent in deliberating roles of intangible assets affecting the transfer pricing.

The bonus plan hypothesis can also explain the relationship between intangible asset and transfer pricing. According to this hypothesis, companies using the bonus plan would be likely to use accounting methods that can increase in reported earnings in the current period. Since intangible assets are difficult to value, the transfer of payments such as royalties attributed to intangibles are also difficult to value at arm’s length prices. Therefore, the multinational companies having policies of bonuses based on the accounting earnings will tend to choose accounting procedures such as amortization method to increase firm’ profitability for the year. At the same time, the multinational enterprises are can allocate their intangible assets to group members in low-tax jurisdictions through a transfer pricing mechanism (Dudar et al., 2015). Therefore, the bonus plan hypothesis predicts a positive relationship between intangible asset and transfer pricing. To formally test the impact of intangible assets on the intensity of the transfer pricing, the following hypothesis is developed:

\[ H_3 : \text{Higher firm’ intangible assets, higher the intensity of the transfer pricing} \]

2.4 Firm Size

The size of a firm can be defined as the amount and variety of production capacity and the ability of a firm possesses or the amount and variety of services of a firm can provide concurrently to its customers (Niresh & Velnampy, 2014). In other words, firm size is an indicator for a condition or characteristic of an organization or a company using several parameters that can be used to determine the scale of a firm. Firm size can become one of the determinants of transfer pricing. For example, a multinational firm normally involves in more business activities, financial transactions and different business locations. This firm can take, additional opportunities to significantly avoid corporate taxes across different tax jurisdictions. In addition, a multinational firm having a large amount of firm size shows its maturity of long-term prospective cash flows. This firm size then will lead to the firm’s stability and ability to generate higher profits through a transfer price mechanism (Kiswanto & Purwaningsih, 2015). Previous studies supports this positive relationship between firm size and transfer pricing (While Davies, Martin, Parneti, and Toubal, 2015; Cecchini et al., 2013; and Richardson et al., 2013). According to them, this relationship exists because multinational firms tend to have
substantial intercompany transactions that may have transfer pricing, tax-advantaged leasing and financing arrangements.

Nevertheless, previous studies also show a negative relationship between firm size and transfer pricing. According to Kiswanto and Purwaningsih (2015), large firms may tend to avoid earning management through a transfer pricing mechanism because these firms get more public attentions and supervisions from the market and society. The firms also tend to disclose their financial statements carefully. In line with the previous explanation, Rusydi and Martani (2014) and Xiaoling Chen et al. (2013) further state that big firms tend to follow tax compliance instead of tax avoidance. These arguments, however, seem weak. Outsiders of the multinational firms cannot observe the existence of tax avoidance through transfer pricing because they are internal transactions between affiliated and parent companies. Only the firm management knows intercompany transactions that may have transfer pricing. Similarly, multinational firms will avoid disclosing the unethical issue such as shifting the profit across different tax jurisdictions. Furthermore, the management of the firms works and be on behalf of shareholder and therefore it maximize firm’s profitability by taking advantage of tax arbitrage opportunities that may exist across different tax jurisdictions. Thus, to formally test the impact of firm size on the intensity of the transfer pricing, the following hypothesis is developed:

\[ H_4 : \text{Higher firm size, higher the intensity of the transfer pricing} \]

3. Methodology

The target population of this research were all companies listed on the Indonesia Stock Exchange for the fiscal year of 2011 to 2015. The study employed purposive sampling method with the following criteria:

1. Excluding financial institutions (banking, financing, investment, insurance and others).
   These industries have different characteristics form others,

2. Having reported annual report and financial statements during research period,
3. Having profits during the observation period because companies that suffered losses do not have a tax liability at the corporate level tax and therefore the motivation of transfer pricing is irrelevant.

The data obtained from the Indonesian Capital Market Directory (ICMD) and the Indonesian Stock Exchange official website of www.idx.co.id. This study uses 259 companies meeting the criteria.

In addition, the current study employed four main independent variables and one control variable. These variables show the inconsistent and contrary results from previous studies. Table 1 shows the measurements and references of each of variables used in this study.
This study employed Partial Least Squares (PLS) an analytical tool because of its powerful in predicting a certain model under certain theory development (Ghozali, 2006). It was chosen too since some variables in this research contain more than one indicators. Specifically, this research used some formative indicators to represent the composite measures found in various economics literatures. Equations 1 reflected the model testing to test the hypotheses. It was expected that coefficient variables $\beta_2-\beta_4$ had positive values and significant while coefficient variable of $\beta_1$ is negative.

$$RPT = \beta_0 + \beta_1 Tax + \beta_2 Profit + \beta_3 Tang + \beta_4 Size + \beta_5 Cape + \epsilon$$

(1)

Where:

- $RPT$: Transfer Pricing
- $\beta_0$: Constanta
- $\beta_1-\beta_5$: Coefficient of variables
- Profit: Firm profitability
- Tang: Intangible Assets
- Size: Firm size
- Tax: Tax avoidance
- Cape: Capital Structure
- $\epsilon$: the error term

<table>
<thead>
<tr>
<th>Variables</th>
<th>Indicators</th>
<th>Measurement</th>
<th>References</th>
</tr>
</thead>
<tbody>
<tr>
<td>Transfer pricing</td>
<td>Dummy</td>
<td>Sales to related parties are rated 1 otherwise 0. (\frac{RPT\text{ Receivables}}{Total\text{ Receivables}})</td>
<td>Yuniasih, Rasmini, and Wirakusuma (2012)</td>
</tr>
<tr>
<td>Profitability</td>
<td>Return on Assets</td>
<td>(\frac{Net\text{ Profit after Tax}}{Total\text{ Assets}})</td>
<td>Niresh &amp; Velnampy (2014)</td>
</tr>
<tr>
<td></td>
<td>Return on Equity</td>
<td>(\frac{Net\text{ Profit after Tax}}{Total\text{ Equity}})</td>
<td></td>
</tr>
<tr>
<td></td>
<td>Net Profit Margin</td>
<td>(\frac{Net\text{ Profit after Tax}}{Total\text{ Sales}})</td>
<td></td>
</tr>
<tr>
<td>Intangible Assets</td>
<td>Intangible Assets</td>
<td>(\log(\text{Intangible Assets}))</td>
<td>Rotkowski (2015)</td>
</tr>
<tr>
<td>Firm Size</td>
<td>Firm size</td>
<td>(\log(\text{Total Assets}))</td>
<td>Niresh &amp; Velnampy (2014)</td>
</tr>
<tr>
<td>Tax</td>
<td>Effective tax rate</td>
<td>(\frac{(Income\text{ Tax Expense} - Deferred\text{ Tax Expense})}{Profit\text{ before income tax}})</td>
<td>Yuniasih, Rasmini, &amp; Wirakusuma (2012)</td>
</tr>
<tr>
<td>Capital structure</td>
<td>Debt to equity</td>
<td>(\frac{Total\text{ Debt}}{Shareholders\text{'Equity}})</td>
<td>Cecchini, Leitch, &amp; Strobel (2013)</td>
</tr>
</tbody>
</table>
4. Results and Discussions

This section contains the research findings and discusses about the result of the research. Table 2 shows limited data concentrations such as minimum value, maximum value, mean, and standard deviation. This table gives the general depiction and description of the data.

Table 2: Descriptive Statistics Analysis

<table>
<thead>
<tr>
<th>Variable</th>
<th>Minimum</th>
<th>Maximum</th>
<th>Mean</th>
<th>Std. Deviation</th>
</tr>
</thead>
<tbody>
<tr>
<td>RPT Dummy</td>
<td>0</td>
<td>1</td>
<td>0.6800</td>
<td>0.4680</td>
</tr>
<tr>
<td>RPT Ratio</td>
<td>0.0000</td>
<td>0.9875</td>
<td>0.1605</td>
<td>0.2527</td>
</tr>
<tr>
<td>TANG</td>
<td>5.9542</td>
<td>13.4603</td>
<td>10.4099</td>
<td>1.23397</td>
</tr>
<tr>
<td>TAX</td>
<td>-1.2700</td>
<td>0.9800</td>
<td>0.2384</td>
<td>0.2251</td>
</tr>
<tr>
<td>SIZE</td>
<td>11.0229</td>
<td>14.3899</td>
<td>12.5323</td>
<td>0.6732</td>
</tr>
<tr>
<td>ROE</td>
<td>-4.4311</td>
<td>1.2581</td>
<td>0.1261</td>
<td>0.32093</td>
</tr>
<tr>
<td>NPM</td>
<td>0.0003</td>
<td>45.0869</td>
<td>0.5168</td>
<td>3.49328</td>
</tr>
<tr>
<td>ROA</td>
<td>0.0001</td>
<td>0.6100</td>
<td>0.0759</td>
<td>0.08347</td>
</tr>
<tr>
<td>CAP</td>
<td>-73.8788</td>
<td>8.8475</td>
<td>0.7007</td>
<td>5.60279</td>
</tr>
</tbody>
</table>

During the period of 2011 – 2015, there are 176 of 259 companies having related party sales transaction (RPT). Table 2 shows mean of RPT is 0.1605961 with its standard deviation 0.25277129. Meanwhile, the intangible asset variable has mean value as much as 10.4099197 and standard deviation of 1.23397537. Furthermore, the mean of effective tax rate is 0.2386 and its standard deviation is 0.22495. At same time, the variable of size indicates the average value of 12.532313 and 0.6732043 of standard deviation. Table 2 shows three profitability measures. ROE has a value of 0.126133 and 0.3209416 of standard deviation. The average value of NPM is 0.516800 and its standard deviation of 3.4932856. The variable of ROA has an average value of 0.0759765 and 0.08347393 of standard deviation. Lastly, the mean of CAP is 0.7007131 and it has a 5.60279582 of standard deviation.

To investigate the factors influencing the intensity of the transfer pricing we employed equation 1. Table 3 indicates the result of the test. Table 3 indicates that the result of inner weights that shows the power of estimation among latent variables based on substantive theory (Ghozali & Latan, 2012). Table 3 also shows that firm profitability, intangible assets, firm size, tax, and capital structure can explain 3.1% of transfer pricing intensity after controlling the sample size and number of variables. This result calls for additional variables for further studies.
<table>
<thead>
<tr>
<th>Independent Variables</th>
<th>Coefficients (t-statistics)</th>
<th>Expected sign</th>
<th>Hypothesis</th>
</tr>
</thead>
<tbody>
<tr>
<td>Tax</td>
<td>-0.150 (10.870)*</td>
<td>-</td>
<td>supported</td>
</tr>
<tr>
<td>Size</td>
<td>0.101 (3.842)*</td>
<td>+</td>
<td>supported</td>
</tr>
<tr>
<td>Profit</td>
<td>0.111 (8.488)*</td>
<td>+</td>
<td>supported</td>
</tr>
<tr>
<td>Tang</td>
<td>-0.083 (3.924)*</td>
<td>+</td>
<td>Not supported</td>
</tr>
<tr>
<td>Capital Structure</td>
<td>-0.032 (3.037)*</td>
<td>-</td>
<td>supported</td>
</tr>
</tbody>
</table>

* Significant at 1% level

### 4.1 Firm Profitability and Transfer Pricing

As Table 3 shown, the coefficient value of the firm profitability variable was 0.111 and it was significant at 1%. This result indicates that this study supported the positive relationship between firm profitability and the intensity of the transfer pricing. This significant positive relation of firm profitability and the intensity of the transfer pricing is consistent with the findings of Mohammadi, Ahmed, and Habib (2015); Chen Ye Ekström, Dall, and Nikolajeva (2014); Holtzman and Nagel (2014); Blouin, Robinson, and Seidman (2013); and Richardson, Taylor, and Lanis (2013).

This finding may have implications. The underlying rationale behind this is that more profitable firms have the capacity and incentive to engage in transfer pricing (Richardson, Taylor, & Lanis, 2013). In the same fashion, signaling theory states that the good quality company would purposefully give a signal to the market in terms of good profitability presented in the annual reports since they will influence shareholders’ perception. A multinational enterprise group publicly held may feel the pressure from stakeholders to show high profitability at the parent company level. Simultaneously, this company’s profitability may have impact on its effort in giving the signal for the interested outsiders such as investors, creditors, and other stakeholders. In addition, firms that are more profitable may alter transfer prices to reduce reported profits in high-tax jurisdictions by considering their pre-tax income. Rego (2003) stated that firms with high profit before tax are more likely to avoid the taxable income taxes paid. Consecutively, firms that are more profitable will increase profits in low-tax jurisdictions to minimize their total taxes burden and maximize profits. Furthermore, Holtzman and Nagel (2014) pointed out that many decentralized organizations should determine the profitability of each subunit by considering appropriate pricing of services or product calculation of related entities.
4.2 Intangible Assets and Transfer Pricing

It is expected that intangible assets had positive impacts on the firm’s transfer pricing. Table 3, however, shows that the coefficient of intangible asset variable is negative and significant at 1%. It indicates that the higher the intangible assets owned by companies, the more reluctant the companies commit to implementing a transfer pricing mechanism. This result is consistent with the study conducted by Kodongo et al. (2014). Nevertheless, this finding contradicts to the results by Dawson and Miller (2015); Dudar, Spengel, and Voget (2015); Mohammadi, Ahmed, and Habib (2015); Taylor, Richardson, and Lanis (2015); Beer and Loeprick (2014); Hopland, Lisowsky, Mardan, and Schindler (2014); and Richardson et al. (2013) even though those studies were conducted in countries out of Indonesia.

A probable reason behind this contradictive result is due to the perception high tax rate. The Indonesian income tax rate is approximately as high as ±25%. This rate may impulse companies to shift their income to the countries that have significantly lower tax countries. Therefore, the amount of intangible assets owned by companies (such as tax deferred charged) reported in financial statement shows relatively small amount. Another possible explanation may be a low recognition of intellectual assets or any other kinds of intangible assets owned by companies. Most of the companies are not concerning deeply on the research and development activities that can contribute to the high intangible assets. Lastly, the bonus plan hypothesis suggests that companies will be more opportunistic by using accounting methods that can increase the reported earnings in the current period. Since intangible assets are difficult to value, the transfer of payments (i.e. the royalties attributed to intangibles) are also difficult to value at arm’s length prices. Therefore, multinational enterprises are strategically reallocating their intangible assets to group members in low-tax jurisdictions, which then receive royalty payments from the affiliates that are located in high-tax countries (Dudar, Spengel, & Voget, 2015).

4.3 Firm Size Positive and Transfer Pricing

Larger firms normally involve in more business activities and financial transactions than smaller firms, including wide business locations. These firms provide additional opportunities to significantly avoid corporate taxes across different tax jurisdictions. In other words, higher firm size, higher the intensity of transfer pricing. Table 3 shows the positive correlation between firm size and transfer pricing. The coefficient value of the firm size is 0.111 and it is significant at 1% level. The underlying rationale behind this is that larger firms that have great amount of assets and sales are more likely to engage in greater intensity of transfer pricing.

This finding supports the studies by Davies, Martin, Parneti, and Toubal (2015); Kiswanto and Purwaningsih (2015); Rusydi and Martani (2014); Cecchini et al. (2013); Richardson et al. (2013); and Xiaoling Chen, Chen, Pan, and Wang (2013). According to them, larger firms that have big amount of total assets show the firm’s maturity of long-term prospective cash flows. This leads to the firm’s stability and ability to generate higher profits. Correspondingly, this
finding is in line with the agency theory stating that managers tend to grow the firm beyond its optimal size or to maintain unutilized resources with the purpose of increasing personal utility from status, power, compensation, and prestige (Jensen 1986; Stulz 1990; Masulis, Wang, & Xie 2007; Hope & Thomas 2008). To sum up, larger firms have greater ability in generating profit compared to smaller firms since. Larger firms operate in global scopes and therefore can boost the sales. Simultaneously they can protect their high incomes by shifting to low tax countries.

4.4 Tax Avoidance and Transfer Pricing

It was hypothesized that tax avoidance increase the intensity of transfer pricing. This study measured tax avoidance by using the tax effective rate representing the tax compliance motive by the companies. Thus, the less compliant the companies in terms of taxation, the more likely the companies will engage in transfer pricing mechanism. Inversely, there is a positive relationship between the tax avoidance and the tendency to do transfer pricing. Therefore, the coefficient of the tax avoidance variable in the equation 1 is expected to have a negative sign. Table 3 shows that the coefficient value for the tax avoidance variable was -0.150 and significant at 1% level. This result confirms the hypothesis.

This result of the positive relationship between the tax avoidance and the tendency to do transfer pricing is also consistent to the works by Davies et al., (2015); Kiswanto and Purwaningsih, (2015); Sari & Hunar, (2015); Chen Ye Ekström, Dall, and Nikolajeva (2014); Hartati, (2014); Klassen, Lisowsky, and Mescall (2013); Nurhayati, (2013); and Richardson et al. (2013). According to the Marfuah and Azizah (2014), the companies having high tax avoidances are more intense of transfer pricing arrangement since they tend to shift their income from high-tax jurisdictions to low-tax countries to minimize their tax burden and, subsequently, maximize their profits. Under political cost hypothesis, the firms also tend to be more opportunistic. The greater the political costs faced by the company, the greater the tendency of companies to use accounting choices that could artificially lower profits which can increase the political costs. Bigger tax burden will trigger multinational companies to impose lower selling prices between affiliates and transfer the profit to the low tax rate country to minimize tax expenses and eventually company’s profit will be maximized (Kiswanto and Purwaningsih, 2015). Furthermore, the transfer pricing-related tax savings are greater when higher foreign income, tax haven use, and R&D activities are combined with a tax minimization strategy (Klassen, Lisowsky, and Mescall, 2013). Additionally, the tax avoidance can be achieved through transfer pricing manipulation by transferring goods to countries with low income tax rates (e.g. tax havens) at the lowest possible transfer price and by transferring goods out of these countries at the highest possible transfer price (Richardson et al., 2013). Lastly, Davies et al., (2015) and Nurhayati (2013) argue the same ideas that a difference between low-tax countries
and tax havens will provide a tax environment which is particularly amenable to the tax avoidance.

5. Conclusions and Recommendations

Transfer pricing is the price attached to the operations of multinational enterprises entailing numerous transactions among affiliated entities located in different jurisdictions but within the same controlled group. However, research on the factors driving the existence of transfer pricing is scare, particularly in Indonesian context. In addition, review literature reveals that future studies need to include some non-tax factors and gather data from financial statements. Surprisingly, the variables of firm profitability, intangible assets, firm size and tax avoidance significantly influence the intensity of transfer pricing. Overall, these results of the study support hypothesis expectations.

The result of this study may bring some implications. Academically, this study cover more comprehensive discussions in terms of determinants of transfer pricing and scopes of samples compared to previous studies. Prior works by Kiswanto and Purwaningsih (2015), Hopland, Lisowsky, Mardan, and Schindler (2014b), and Klassen, Lisowsky, and Mescall (2013) only focused on analyzing taxes, tunneling incentives, and bonus scheme on manufacturing companies and with relatively small sample size. In addition, this study includes the impact of variables of intangible assets and firm’s profitability on the transfer pricing. Therefore, this study fulfil the recommendations and consider the determinants of transfer pricing aggressiveness across different international jurisdictions as suggested Doğan, Deran, and Köksal (2013) and Richardson, Taylor, and Lanis (2013). In addition, this study shows that a tax-avoidance motive related to the transfer pricing mechanism. Tax authorities should revitalize their income tax systems and implementations to avoid the income shipment through transfer pricing. For example, tax authorities should increase their focus on firms whose income bunches around zero and scrutinize payments to non-haven affiliates that disclose operating losses.

This study may be subject to limitations and constraints that can influence the result of the study. All variables of this research can only contribute to 3.1% of variations of transfer pricing. This implies that further studies should consider other additional variables to include other financial and non-financial factors such as management style or leadership and customer satisfaction. Future studies can also include financial industries such as banking and insurance. These industries highly involve in overseas transactions that may engage in transfer pricing mechanism. Furthermore, the present study emphasized the factors driving the intensity of transfer pricing. Future research can be extended into the impact of the transfer pricing implementation on companies’ operational activities.
References


