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Transfer Pricing: The Role of Tax Income and Tunneling Incentive

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ABSTRACT

The purpose for this investigation is to examine the impact of income tax, bonus mechanism, motivating force burrowing to tunneling incentive. The sample choice utilizing purposive examining technique and examined 23 manufacturing companies recorded in Indonesian Stock Exchange (IDX). The samples are chosen by using purposive sampling method and the companies chosen are the among top 30 companies LQ 30 Index in Indonesia Stock Exchange. The information are obtained from optional information of yearly report of fundamental and manufacturing companies recorded in Indonesia Stock Exchange from 2012-2016. The investigation method utilized in this exploration is binary logistic regression analysis. The resultofthisinvestigationdemonstratesthattheincometaxis significant and noteworthy to the transfer pricing, tunneling incentives powerful and critical to transfer pricing, while the bonus mechanism does not influence the transfer pricing.

Keywords: *transfer pricing, tax planning, tunneling incentive, bonus mechanism and IDX*

1.0 INTRODUCTION

The rapid growth of international economic activity has contributed to the growth of global companies (Global Economics Outlook, 2017). In the corporate, conglomeration and divisionalization environment occurs various transactions involving the sale of goods and services, rights and other intangible property rights, the provision of loans and others to be used in the pricing to be transferred

(Marfuah & Azizah, 2014).

Transfer pricing is a transaction of goods and services between several divisions in a business group at an unreasonable price, either by raising (markup) or lowering the price (mark down). There are several objectives of Indonesian companies to transfer pricing, first, to outsmart the amount of corporate profits so that tax payments and dividend payouts are low. Second, inflates profit for window-dressing of financial statements. The State loses trillions of rupiahs due to the practice of transfer pricing of foreign companies in Indonesia, all the way through selling prices, purchase prices, overhead costs, interest-shareholder loans, royalty payments, service fees, sales through third parties with no effort. Transfer pricing determined by determining the amount of income earned by each company involved and income tax receipts in exporting and importing countries and mostly by multinational companies (Noviastika, et al., 2016). The phenomenon associated with transfer pricing in Indonesia that 60% of taxpayers in Indonesia to practice transfer pricing.

Almost all exporters in Indonesia transfer pricing so that the state losses reach 25% of the value of the expansion to avoid royalties paid to the country of the republic of Indonesia.

There are several reasons or factors of multinational companies doing transfer pricing, one of which is tax (Noviastika, et al., 2016). Tax on income earned or received by a business entity located in Indonesia. The amount of income depends on the amount before tax (Ranawati & Hernawati 2015). And do so by transferring the income and expenses of a company that has a special relationship to companies in other countries whose tax rates are different (Hartati et al., 2015). This is supported by research (Rahayu 2010), he found that the mode of transfer pricing is done by manipulating the price of intercompany transactions with related parties. With the aim to minimize the overall tax burden. The tax phenomenon that occurred in Indonesia conducted by PT Adaro Indonesia in 2008 where in his case allegedly sold under the market price of coal to its affiliated companies in Singapore in 2005 and 2006. But then sold again to the market according to market prices. This is intended to avoid royalties paid to the republic of Indonesia.

In addition, the bonus mechanism is also one of the factors affecting transfer pricing. Bonus is a one-time payment given for meeting the company’s performance goals (Mispiyanti, 2015). This bonus system effected the management in engineering industry. They will received the net profit in maximizing the bonus including transfer pricing (Hartati et al., 2015).

As a company that aims to obtain maximum profit, the company will try to minimize the tax burden, one of them by utilizing the transfer pricing mechanism. Maximum profit will reflect the performance of the company and it will increase the bonus that will be accepted by the management company. This will provide a high profit to the company; high profits can increase the value in bonuses to the company management for the results of the act of transfer pricing.
Tunneling also affects transfer pricing. Tunneling incentives is a behavior of a majority shareholder who transfers company assets and profits for their own benefit, but minority shareholders share the costs they incur (Hartati et al., 2015). Tunneling can be a transfer to the parent company through a related party transaction or dividend distribution. Related party transactions are more commonly used for that purpose than dividend payments because companies listed on the Exchange must distribute dividend to the parent company and other minority shareholders (Yuniasih, et al., 2012).

As for the phenomenon that occurred in Indonesia in 2011, the dividend value of Rp 39.8, with the composition of ownership of PT Central Agromina about 55.53%, the rest by local and foreign public with ownership of less than 5% each. Although the case in Indonesia share ownership of the company Tbk. above 50% on average owned by other companies but does not rule out the possibility that ownership on behalf of other companies is actually owned by certain private individuals behind it for their own benefit (Halim & Wardhani 2015).

2.0 LITERATURE REVIEW

2.1 Agency Theory

The agency theory explains the contract between principals, i.e. the party that employs another party called the agent that involves the decision-making delegation (Jensen & Meckling, 1976). The principal-agent problem is also an essential element of the incomplete contracts view of the firm developed by Coase (1937), Jensen and Meckling (1976), Fama and Jensen (1983 a,b), Williamson (1975,1985), Aghion and Bolton (1992), Hart (1995) and Shubhi (2020). Agency theory is also an economic theory underlying differences in conflict of interest in the company or organization (Lestari & Wirawati, 2016). In certain situations, both the principal and the agent will maximize their personal interests and there is no reason for the principal to believe that the agent will always act in the interests of the principal (Scott, 2012). The divergence of interest between the owners and the managers, due to the separation of ownership from control, results in the agency costs (Rohit, 2019). Management as an agent prioritizes its interests over the interests of shareholders and because management is authorized to manage the assets of the company so that management has an incentive to transfer pricing in order to lower the tax to be paid (Yuniasih et al., 2012).

2.2 Transfer Pricing

There are various definitions of transfer pricing as suggested by Suandy (2006) transfer pricing is the act of allocating profits from corporate entities in order to minimize and even avoid taxes. Furthermore, according to Fuadah (2008) transfer pricing can also be called intercompany pricing, intercompany pricing, interdivisional or internal pricing which is the price calculated for management control of goods and services transfers between members (group companies). As per Terzioglu, and Inglis, (2019) characterized that "move cost as a charge by one division (moving division) to another division (getting division) inside a similar association"

2.3 Income Tax

According to the Law of the Republic of Indonesia Number 16 Year 2009 article 1, it is explained that, "tax is a compulsory contribution to a country that is owed by an individual or a coercive body under the Act, by not obtaining direct remuneration and being used for state purposes for the great prosperity of the people".

Income tax (PPH) of the entity is tax on income earned or received business entity located in Indonesia. The amount of income is dependent on the amount before tax (Ranawati and Hernawati 2015). Aditama and Purwaningsih (2014) Taxes are an important source of state revenues for the financing of state development. One of the largest tax sectors gained by the state is income tax. James and Alley (2018), defined tax compliance as "the willingness of the taxpayer to act in accordance with both the 'spirit' and the 'letter' of the tax law and administration without the application of enforcement activity".

2.4 Bonus Mechanism

In order for motivated managers to work better and harder than the owner promises a number of bonuses that will be given if the performance is above the average of the previous period (Sulistyanto, 2008). The bonus mechanism is one of the popular accounting policies to improve the performance of the board of directors in improving corporate profits and this maximizes the rewards of bonus compensation to the board of directors for a good performance result of the company, as it concerns the welfare of executives in the company's internal (Gayatrie 2014).

2.5 Tunneling incentive

Tunneling incentives is a behavior of the majority shareholder transferring assets and profits to the company for their own benefit, but minority shareholders share the costs they pay (Hartati et al., 2015). Mutamimah (2019) claims that tunneling opportunity is the action of majority shareholders who move business assets and income for their own benefit, but minority shareholders still bear the burden of moving assets and income to majority shareholders. Transfer of assets and profits can be done in various ways, one of which is through transfer pricing (Noviastika et al., 2016) This transaction is used for the purpose of increasing profit majority shareholders. According to Wafiroh and Hapsari (2015).

3.0 HYPOTHESIS STATEMENTS

3.1 The Effect of income tax on transfer pricing

In Indonesia, multinational companies do not escape engineering transfer pricing, the reason is to reduce the burden of taxes is greater because in business practices, entrepreneurs generally identify tax payments as an expense so that it will always try to minimize the tax burden (Mispiyanti , 2015). If the tax can be reduced, it can reduce the company's cost (Marfuah & Azizah, 2014).

Increasing tax burden prompted the company to transfer pricing in the hope of minimizing the corporate tax burden that must be paid to the destination country to optimize the increase in corporate profits. Based on the above formulation, the hypothesis in this study is as follows.

Ho1: Taxes have no effect on transfer pricing
Ha1: Taxes affect the transfer pricing.

3.3 The effect of tunneling incentive on transfer pricing

If the majority shareholder owns a large shareholding, in other words they have invested heavily in the company. It means that they want a great return or dividend. Therefore, when the dividends distributed by the company must be shared with the minority shareholders, the majority shareholder prefers to transfer pricing by transferring the company's wealth to its own interests rather than dividing the dividends to minority shareholders. Therefore, the greater shareholder ownership will further trigger the practice of transfer pricing (Hartati et al., 2015)

Based on the above formulation, the hypothesis in this study is as follows.

Ho3: Tunneling incentive has no effect on transfer pricing
Ha3: Tunneling incentive affects the transfer pricing

4.0 RESEARCH METHODOLOGY

The population in this study is manufacturing companies. Previous study were from manufacturing companies in 2011-2013, so in this study researchers were used manufacturing companies in 2012-2016 to distinguish from the previous research sample. Sampling technique used was purposive sampling method. Purposive sampling is a technique of determining the sample with certain considerations (Sugiyono, 2012).

The sample criteria are as follows:

1. This research uses a manufacturing company listing on the Indonesia Stock Exchange in 2012-2016.

2. The sample company is controlled by a foreign company with ownership interest of 20% or more. This is in accordance with SFAS No. 15 stating that the controlling shareholder is a party owning equity shares or securities of 20% or more.

3. The sample company did not experience any losses during the observation period. This is because companies that suffer losses have no tax obligations at the corporate level so that tax motivation becomes irrelevant. Therefore, companies that suffer losses are excluded from the sample.

4.1 Operationalization of Research Variables

Dependent Variable

The dependent variable studied in this research is Transfer Pricing. Transfer pricing is a price transaction contained in any product or service from one division to another within the same company or between related companies. Transfer pricing is calculated by dichotomous approach, by looking at the existence of the sale to a related party. Companies that make a sale to a related party are rated 1 and not rated 0. (Hartati et al., 2015).

Independent Variables

Income Taxes

The taxes in this study constitute a corporate pension tax constituting a compulsory contribution to the state and are of a statutory nature, with no direct reward and used for state purposes for the greatest possible prosperity of the people. The tax in this study is proxy by effective tax rate which is the ratio of tax expense less deferred tax expense divided by taxable income (Yuniasih et al., 2012).
Income Taxes = (tax expense-deferred tax expense)/ (taxable income)
Bonus Mechanism

Bonus is a one-time payment provided for meeting company performance goals. Bonuses provided by a company can be in the form of allowances, commissions, sales incentives, or employee benefits. Bonus compensation is measured by dummy, where a value of 1 is awarded to a company with foreign ownership giving bonus, anthem, commission, or sales incentive to management, while the other is 0.
Tunneling Incentive

Tunneling Incentive is a behavior of the majority shareholder transferring assets and profits to the company for their own benefit, but minority shareholders share the costs they pay (Hartati et al., 2015). Tunneling can be a transfer to the parent company through a related party transaction or dividend distribution. Related party transactions are more commonly used for that purpose than dividend payments because companies listed on the Exchange, the company distribute dividends to the parent company and other minority shareholders (Yuniasih, et al., (2012).This variable is measured using the percentage of ownership of shares above 20% as a controlling shareholder by a foreign company.

4.2 Regression Model

So, the regression model used in this research is as follows:

$\text{Log}(Y) = \ln[Y/(1-Y)] = \beta 0 + \beta 1X1 + \beta 2X2 + \beta 3X3 + e$
Information:
Y = Transfer pricing

$\beta 0$ = Constant
$\beta 1$- $\beta 3$ = Regression coefficient
X1 = Tax
X2 = Bonus mechanism
X3 = Tunneling incentive
e = Error term

This study used annual data of tax, bonus mechanism and tunneling incentive covering period 2012 – 2016. The choice of the period was governed by the availability of data. In this research binary logistic regression analysis was used to determine the significant determinants in affecting the income tax. All p-values were rounded by three decimal places and all statistical tests and confidence interval were performed at significance level 0.05.

Last but not least is the use of Hosmer and Lemeshow Goodness of fit and Nagelkerke R- squared. The use of this method is to provide an indication of the amount of variation in the response variable explained by the model. The value of this R^2 must be positive and less than 1.

5.0 RESULTS AND DISCUSSION

5.1 Test Multicollinearity

		B	S.E.	Wald	df	Sig.	Exp(B)	95% C.I.for EXP(B)	
								Lower	Upper
Step 1[a]	X1	-27.909	13.830	4.072	1	.044	.000	.000	.448
	X2	-.602	.600	1.006	1	.316	.548	.169	1.775
	X3	-2.215	1.096	4.084	1	.043	.109	.013	.935
	Constant	9.247	3.400	7.396	1	.007	10373.457		

a. Variable(s) entered on step 1: X1, X2, X3.

The test results using SPSS is no multicollinearity problem, so the test results are said to be reliable or reliable. Then the value of the partial regression coefficient is said to be reliable and robust or immune to changes that occur in other variables in multiple regression models.

5.2 Test Overall Test 1

Iteration		-2 Log likelihood	Coefficients			
			Constant	X1	X2	X3
Step 1	1	90.037	3.784	-8.033	-.336	-1.334
	2	86.351	6.671	-17.723	-.506	-2.043
	3	85.683	8.629	-25.396	-.583	-2.201
	4	85.646	9.209	-27.755	-.601	-2.215
	5	85.646	9.247	-27.908	-.602	-2.215
	6	85.646	9.247	-27.909	-.602	-2.215

a. Method: Enter

b. Constant is included in the model.

c. Initial -2 Log Likelihood: 97.308

d. Estimation terminated at iteration number 6 because parameter estimates changed by less than .001.

It shows a comparison of values between the initial -2 log likelihood blocks with -2 log likelihood final block. From the calculation value of log-2 likelihood seen that the value of the initial block (Block Number = 0) is 97.308 and the log-2 likelihood value in the final block (Block Number = 1) is 85.646, it shows -2 log likelihood decreased by 11.662 . Given this decline, the overall logistic regression model used is a good model or a hypothesized fit model with data (Ghozali, 2013).

5.3 Goodness of Fit

Hosmer and Lemeshow Test

Step	Chi-square	df	Sig.
1	13.492	8	.096

Hosmer and Lemeshow Goodness of fit statistics of 13.492 with probability significance 0.096 greater than 0.05 so Ho cannot be rejected or accepted because the regression model is able to explain the data. Based on this explanation, it can be concluded that the model is able to explain the effect of income tax, bonus mechanism and Tunneling Incentive to Transfer Pricing.

5.4 Nagelkerke R Square

Step	-2 Log likelihood	Cox & Snell R Square	Nagelkerke R Square
1	85.646[a]	.117	.181

a. Estimation terminated at iteration number 6 because parameter estimates changed by less than .001.

To see the ability of independent variables in explaining the dependent variable, the values of Cox & Snell R Square and Nagelkerke R Square are used. These values are also called Pseudo R-Square or if in linear regression (OLS) better known by the term R-Square.Nagelkerke R Square value of 0.179 which indicates that the ability of independent variables in explaining the dependent variable is equal to 0.181 or 18.1 % and there are

100% - 18.1% = 81.9% other factors outside the model that explain the dependent variable.

5.5 Classification Plot

Observed			Predicted		
			Y		Percentage Correct
			.00	1.00	
Step 1	Y	.00	0	20	.0
		1.00	2	72	97.3
	Overall Percentage				76.6

a. The cut value is .500

The data obtained by the overall percentage value of 76.6% which then the value indicates that the overall percentage value close to 100% which means that the results show the model used fit to the data.

5.6 Model Logistic Regression

The logistic regression model that is formed is as follows:

$$\ln [Y/(1-Y)] = 9.247 - 27.909X1 - 0.602X2 – 2.215X3 + e$$

Odds ratio in this study is used to measure the tendency of independent variables to the company's switching audit the value of odds ratio was interpreted as follows:

5.6.1 income tax

The regression coefficient for income tax variable is 27,909. This shows the value of odds ratio (probability) in this study is 0.000, meaning if the income tax coefficient decreased one unit, then the tendency of the company to transfer pricing will increase 0,000 times assuming the condition of other variables constant.

5.6.2 The bonus mechanism

The regression coefficient for bonus mechanism is 0.602. This shows that the odds ratio in this research is 0.548, meaning that if the coefficient of one-unit bonus mechanism, then the tendency of the company to transfer pricing will increase by 0.548 times with the assumption that other variable condition is constant.

5.6.3 Incentive tunneling

The regression coefficient for incentive tunneling is 2,215. This shows the odds ratio (odds ratio) in this research is 0.109, it means that if the coefficient of incentive tunneling decreases one unit, then the tendency of the company to transfer pricing will increase by 0.109 times assuming other variable condition constant.

6.0 ANALYSIS OF RESULTS

6.1 Effect of Income Tax on Transfer pricing

		B	S.E.	Wald	df	Sig.	Exp(B)	95% C.I.for EXP(B)	
								Lower	Upper
Step 1[a]	X1	-27.909	13.830	4.072	1	.044	.000	.000	.448
	X2	-.602	.600	1.006	1	.316	.548	.169	1.775
	X3	-2.215	1.096	4.084	1	.043	.109	.013	.935
	Constant	9.247	3.400	7.396	1	.007	10373.457		

a. Variable(s) entered on step 1: X1, X2, X3.

Based on the above partial test, the results of income tax variables in this study showed a negative and significant influence on indications of transfer pricing at manufacturing companies listed on the stock exchange of Indonesia it is shown with regression coefficient of -27.909 and probability of 0.044 is smaller than a significance level of 0.05. This means that the amount or the amount of tax burden affects the manufacturing company to perform transfer pricing action. This result is in accordance with research of Marfuah and Winda Hartati, Desmiyawati, Julita (2014) which states that taxes influence transfer pricing and Ni Wayan Yuniasih, Ni Ketut Rasmini and Made Gede Wirakusuma (2012).

The income tax is also reinforced in the grand theory described in the agency that the agent will do the best in the company especially by increasing the company's profit, one way by transfer pricing in the hope that it can minimize the corporate tax burden to be paid, the goal to be able to optimize increase in corporate profits so that agents can show good performance to the owners of the company.

6.2 Effect of bonus mechanism on Transfer pricing

Based on the above partial test, the variable results The bonus mechanism in this study showed no significant and negatively affect the indication of transfer pricing at the manufacturing company listed on the Indonesian stock exchange it is shown with the regression coefficient of - 0.602 and the probability of 0.316 is greater from a significance level of 0.05. That is, if only because the motive to get a bonus, should not directors dare to conduct transfer pricing transactions to increase corporate profits but the directors can do a good corporate management that can affect the achievement of maximum profit, considering this is very unethical because company management must maintain company value in the eyes of society. The results of this study in accordance with Mispiyanti 2015 and Novi Lailiyul Wafiroh and Niken Nindya Hapsari (2015) which states the bonus mechanism has no effect on transfer pricing.

6.3 Effect of incentive Tunneling on Transfer pricing

Based on the above partial test, the results of variable incentive tunneling in this study showed a negative and significant influence on the indication of transfer pricing at manufacturing companies listed on the stock exchange of Indonesia it is shown with regression coefficient of -2.215 and probability of 0.043 is smaller than a significance level of 0.05. This means that one of the purposes of transfer pricing transactions is to conduct tunneling to minority shareholders resulting in a loss to minority shareholders. And the results of this study in accordance with Mispiyanti (2015) which states tunneling incentive effect on transfer pricing.

The income tax return is also corroborated in the grand theory described in the agency that agents will be controlled by the majority shareholders for their own benefit by practice tunneling rather than paying dividend to minority shareholders.

7.0 MANAGERIAL IMPLICATIONS

Income tax has significant effect on transfer pricing. This identifies that the greater tax burden triggers the management of the company to transfer pricing through transactions between divisions or related parties outside of Indonesia so that profits are reduced, and tax expectations are paid less. Incentive tunneling has a significant effect on transfer pricing, it identifies that the controlling shareholder or called the majority shareholder can more control the company for the benefit and enrich them by transferring the company's assets and the company's profit to their own company, rather than paying the dividend to the holder minority shares.

8.0 CONCLUSION

Based on the results of the above analysis it can be concluded that: Income tax has a negative and significant effect on transfer pricing. The bonus mechanism has no negative and significant effect on transfer pricing. Incentive tunneling has a negative and significant effect on transfer pricing.

As for preparing this research is still very many limitations experienced by researchers. Because of that limitation, it is hoped that the next researcher will pay attention to the following matters which become the suggestion for the next researcher. Researchers interested in conducting studies in the same field may try to analyze the effect of tax on the implementation of transfer pricing by adding other independent variables, such as firm size, exchange rate, good corporate governance (GCG). Further research is suggested to enlarge the sample of research not only in the manufacturing company, but also in companies running in the mining, plantation, and other sectors.

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