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The Determinants of Transfer Pricing in Multinational Companies

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ABSTRACT

This study aims to examine the effect of tunneling incentives, institutional ownership, exchange rates, profitability, and leverage on companies' decisions to transfer pricing to multinational companies. The population in this study is multinational companies listed on the Indonesia Stock Exchange (IDX) in 2014-2018. The purposive sampling method is used as a sampling technique obtained by 60 companies or 272 units of analysis as the object of observation. Data collection techniques using documentation techniques with secondary data sourced from financial reports. The data analysis technique used panel data regression. The results of this study prove that institutional ownership and leverage have a significant positive effect on transfer pricing. Tunneling incentives and profitability do not affect transfer pricing. However, the exchange rate has a significant negative effect on transfer pricing. The conclusion of this research is that transfer pricing will increase if institutional ownership and leverage are high. Meanwhile, transfer pricing will decrease if the exchange rate increases. However, transfer pricing is not influenced by tunneling incentives and profitability. Multinational companies can increase profitability and institutional ownership by paying attention to exchange rates and reducing tunneling incentives and leverage in order to generate greater corporate profits and minimize transfer pricing practices.

INTRODUCTION

The rapidly growing economic sector, which takes place without knowing national boundaries, occurs due to the influence of globalization. As a result, global economic growth is marked by large companies doing business between countries. Many national companies are now turning into multinational companies which are characterized by companies establishing subsidiaries and branches companies in various countries (Refgia et al., 2017). Multinational companies apply transfer pricing in order to maximize global income by minimizing taxes to affiliated companies which have low or zero taxes (Amidu et al., 2019).

The transfer pricing case happened to PT Adaro Energy (ADRO). PT Adaro was indicated to conduct transfer pricing with its subsidiary in Singapore namely Coaltride Service International Pte. Ltd in 2009-2017. In this case, PT Adaro sold coal to an affiliated company. The Directorate General of Taxes (DGT) found evidence that the products transferred to Singapore were sold at a price below the market price of US$125 million or less than they should have been in Indonesia. Then by Coaltride Service International Pte. Ltd, resold to the buyer at market price (merdeka.com).

The objective of multinational companies implementing transfer pricing practices is to transfer profits or income earned to affiliated companies located in other countries so that the company's tax burden will be smaller and higher profits will be increased by the company (Anggraeni & Lutfillah, 2019). Transfer pricing is the price paid between two or many companies to send goods or services to other related companies (Talab et al., 2017). However, the practice of transfer pricing is applied by some multinational companies in order to avoid high tax collections through efforts to minimize taxes which causes some countries to lose money in tax revenues.

Law No. 36 of 2008 concerning Income Tax also regulates transfer pricing, namely Article 18. Transfer pricing rules consist of definition of special relationship, authority to determine the ratio of debt and capital, and authority to conduct corrections in the event of transactions that are not arm's length. In accordance with Law

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Number 36 of 2008 which is regulated in Article 18 paragraph 4, namely the occurrence of a special relationship between corporate taxpayers due to ownership or control of share capital of an entity by another entity of 25% or more, or between a number of entities which is 25% or more the shares are owned by an entity.

According to the research of Anggraeni & Lutfillah (2019) and (Azzura & Pratama, 2019) prove that tunneling incentive affects transfer pricing positively. However, the research of Ayshinta et al., (2019) and Khotimah (2018) shows that tunneling incentive does not affect transfer pricing. Furthermore, Putri & Putra (2017) and Dewi (2019) confirm that institutional ownership has a positive effect on tax avoidance. Meanwhile, Fiandri & Muid (2017) and Merslythalia & Lasmana (2017) confirm that institutional ownership does not affect tax avoidance. Hereafter, Alino & Lane, (2015), as well as Cravens & Shearon, (1996) in their research results, confirm that exchange rate affects a firm's determination in implementing transfer pricing. Meanwhile, Azzura & Pratama, (2019) and Tjandrakirana & Ermadiani (2020) show that exchange rates failed to affect transfer pricing. Research conducted by Cahyadi & Noviari (2018) and (Richardson et al., 2013) show that profitability affects transfer pricing significantly and positively. This is not in sync with the research of Waworuntu & Hadisaputra, (2016) and Azzura & Pratama (2019) which actually show that profitability does not affect transfer pricing. Meanwhile, Richardson et al., (2013) and Cahyadi & Noviari (2018) found that leverage positively affects a firm's decision to apply transfer pricing. A different finding was obtained in the research of Shodiq et al., (2017), which proves that there is no effect between leverage and transfer pricing.

This study aims to examine the effect of tunneling incentive, institutional ownership, exchange rate, and financial performance on transfer pricing transactions. The originality of this study presents institutional ownership as an independent variable to determine the effect of institutional share ownership on transfer pricing. Institutional ownership is chosen as an independent variable since it is part of the ownership structure that is considered to have a significant effect in controlling companies that can prioritize their welfare. In addition, almost all companies whose share ownership comes from institutions where controlling shareholders can sell products at unreasonable prices, from controlled companies to affiliated companies.

Agency theory and positive accounting theory become the basis for this study. Agency theory assumes that each individual wants to fulfill their own needs, where shareholders as principals are only interested in increasing profits and investment values, while agents are considered only interested in financial compensation in the form of work rewards (Lambert, 2001). The relationship between the two is caused by the emergence of information asymmetry which triggers agency problems. Watts & Zimmerman (1986) explained that Positive Accounting Theory emphasizes more on the agency relationship between managers and other groups. Positive accounting theory there is a debt contract hypothesis that underlies the leverage relationship to transfer pricing.

There are several factors that influence transfer pricing. One of them is tunneling incentive variable. Tunneling incentive of resources transfer from within the company to controlling shareholders (Johnson et al., 2000). Tunneling incentives will affect transfer pricing because companies with concentrated share ownership that focus on one party tend to experience tunneling. This is since the needs and goals of each party are not the same. Thus, tunneling is used by companies to conduct transfer pricing practices to companies with the same ownership to benefit the majority shareholder. This is in line with agency theory that the relationship between principal and agent where when the companies have a concentrated ownership structure, then the agency disputes that arise are not the same, namely the problem of managers with shareholders turning into problems of majority shareholders. Research conducted by Anggraeni & Lutfillah, (2019), Refgia et al., (2017), Waworuntu & Hadisaputra (2016) reveal the results that tunneling incentives positively affect transfer pricing.

H_1: Tunneling incentive has a significant positive effect on transfer pricing

Share ownership by governments, legal entities, financial institutions, foreign institutions, and trust funds, or other institutions is known as institutional ownership (Ngadiman & Puspitasari, 2014). The institutional ownership relationship is explained in agency theory that the nature of the ownership structure of a company can determine the type of agency conflict which is most likely a conflict between shareholders and managers (Claessens et al., 1999). The agency problem arises because the manager as an agent is responsible for maximizing profit for the owners (principals), but on the other hand, the manager also has an interest in maximizing their prosperity so that the agent may not always behave for the principal's personal needs (Jensen & Meckling, 1976). Institutional investors want to get as much profit as possible which results in a high corporate tax burden. Therefore, the company is trying to minimize the amount of tax paid so that it will affect the company's decision to carry out the practice of transfer pricing. Putri & Putra (2017) and Dewi (2019) in their research result prove that institutional ownership has a positive effect on tax avoidance.

H_2: Institutional ownership has a significant positive effect on transfer pricing

Currency exchange rates from one country to another are very fluctuating. It can be used as a consideration for a multinational company to implement transfer prices or not (Wicaksananingtyas & Sari, 2019). When there is an exchange rate instability, it will affect the price of goods or services traded. The risk is that the total unit of currency from the country of origin needed to pay for materials from abroad may vary even though the supplier does not change the price of the goods. This is in accordance with agency theory which explains the existence of motivational factors where managers can determine one way to optimize or minimize the use of the exchange rate to conduct transfer pricing practices. Multinational companies apply transfer pricing to minimize exchange rate risk by sending funds to strong currencies (Chan et al., 2002). Alino & Lane, (2015), Cravens & Shearon, (1996), and Devi & Suryarini (2020) in their research prove that exchange rate affects corporate decision to apply transfer pricing.

H_3: Exchange rate has a significant positive effect on transfer pricing

The relationship between profitability variable is based on agency theory where shareholders want high company profits then the principal pressures management to do things that shareholders want. This causes management to carry out various strategies according to the wishes of the shareholders. The strategy taken will affect the profits earned by the company. The agent wants to pay the lowest possible tax to maximize profits and increase the company's profitability. Large profitability indicates the profit earned by large companies as well. It causes the company to apply transfer pricing. Cahyadi & Noviari (2018) and Richardson et al., (2013) explained that profitability positively affects the company's determination to carry out transfer pricing.

H_{4a}: Profitability has a significant positive effect on transfer pricing

The leverage variable appears in this study because the researchers assume that the debt contract hypothesis underlies the relationship between leverage and transfer pricing. Referring to the hypothesis, the larger the company's debt will minimize the tax burden owned by the company because the element of business costs increases and the reduction is very useful for companies subject to high taxes. Therefore, the higher the company's debt for working capital, the greater the profit earned. Thus, the higher the company's leverage ratio, the company's determination to carry out transfer pricing with affiliated parties will also increase. Richardson et al., (2013) and Cahyadi & Noviari (2018) found empirical evidence that leverage positively affects the firm's determination to apply transfer pricing.

H_{4b}: Leverage has a significant positive effect on transfer pricing

RESEARCH METHODS

This study was an empirical study conducted on multinational companies listed on the Indonesia Stock Exchange (IDX) in 2014-2018 by using secondary data. This study applied a quantitative approach with a hypothesis testing design. The sample selection was done through a purposive sampling technique. The following criteria for determining the sample are described in table 1.

Table 1. Sampling Criteria

No.	Criteria	Number
1.	Multinational companies listed on the Indonesian Stock Exchange (IDX) from 2014-2018	76
2.	Companies that display the amount of asset and liability related relationships continuously during the period 2014-2018	(6)
3.	Company data in the form of annual reports available on the IDX have the necessary data in the research	(10)
Number of sample companies		60
Number of research analysis units (5 years x 60 company)		300
Companies with compensation for losses in a row during the period 2014-2018		(28)
The final total of research analysis units during the period 2014-2018		272

Source: Previous research processed 2020

Referring to table 1, the sample in this study amounted to 272 analysis units during the 2014-2018 period. This research consists of a dependent variable namely transfer pricing with tunneling incentive, institutional ownership, exchange rate, profitability, and leverage as independent variables. The operational definitions of research variables are presented in table 2.

The data collection technique through documentation technique. Secondary data in the form of corporate annual reports obtained from the IDX official website and the websites of each company were used in this study. The data analysis techniques for checking the research hypothesis were descriptive statistics to describe the profile of the research variables individually and inferential statistics in testing hypotheses. Inferential statistical analysis used in this study was the Random Effect Model (REM) using Eviews 9, with a significance level of 0.05 (α = 0.05)

RESULTS AND DISCUSSIONS

Descriptive statistics present data about the description of the dependent and independent variables, namely the minimum, maximum, mean, and standard deviation values. Transfer pricing is the dependent variable in this research, which is measured by Related Party Transaction Assets and Liabilities (RPTAL). The independent variables in this research are tunneling incentive, institutional ownership, exchange rate, profitability, and leverage. The results of descriptive statistics are described in table 3.

The transfer pricing variable with the RPTAL indicator has a minimum value of 0.000 that is, the value of PT Argha Karya Prima Industry Tbk (AKPI) in 2016. This condition indicates that the company carries out transactions with related parties which is the lowest than the other sample companies. The owner of the maximum RPTAL value is PT Bank Negara Indonesia (Persero) Tbk which is valued at 2,781 in 2017. The high RPTAL value indicates that the company conducts transactions with related parties more intensely when compared to other sample companies. The mean value

Table 2. Variable Operational Definition

Variables	Definition	Measurements
Transfer Pricing (RPTAL)	The price paid between two or more companies to deliver goods or services to another company that has a special relationship (Talab et al., 2017).	RPTAL = (RPT Asset + RPT Liabilities) / Equuities (Utama, 2015)
Tunneling Incentive (TNC)	The activity of transferring assets and/or distribution of profits and/or granting a number of privileges that are directly distributed to majority shareholders without regard to various rights of minority shareholders (Khotimah, 2018).	TNC = The largest number of shareholdings / Total shares outstanding (Wicaksananingtyas & Sari, 2019)
Institutional Ownership (KI)	Share ownership by the government, financial institutions, institutions with legal entities, foreign institutions, and trust funds, and other institutions (Ngadiman & Puspitasari, 2014).	Institutional Ownership = Total institutional shareholdings / Total shares outstanding (Ngadiman & Puspitasari, 2014).
Exchange Rate (EXC)	Currency exchange rate against current or next-day payment between currencies each country or region Cahyadi & Noviari (2018)	Exchange rate = Profit and loss on foreign exchange / Profit and loss before tax (Ayshinta et al., 2019)
Profitability (PROF)	The relationship between business income and business capital assets (Hussain et al., 2016)	ROE = Net profit after tax / Total equities (Halim & Hanafi, 2009)
Leverage (LEV)	The amount of debt used by the company to finance its assets (Hussain et al., 2016)	DER = Total Debt / Total Equities (Pamungkas & Nurcahyo, 2018)

Source: Previous research processed 2020

of transfer pricing is 0.163 and the standard deviation is 0.303.

The tunneling incentive variable is measured by the largest share ownership divided by share capital. The lowest score of 0.101 is owned by PT. Kalbe Farma Tbk. This minimum value indicates that KLBF has the largest share capital which is lower than other companies. The maximum value of tunneling incentive is 0.931 owned by PT Astra International Tbk. The largest share capital owned by the company also indicates high transfer pricing transactions between companies. The tunneling incentive value is 0.563, with a standard deviation of 0.181.

Institutional ownership is measured by looking for a comparison of institutional share ownership with share capital. The minimum value of institutional ownership is 0.000 by PT J Resources Asia Pacific Tbk (PSAB). The minimum value shows that PSAB in 2018, all shared capital comes from individual shares and no share capital originates from institutional. The largest value of 1,000 is occupied by PT Astra International Tbk (ASII) in 2018 meaning that all shares owned by the company are sourced from institutional shares. The mean value of the institutional ownership variable is 0.672 with a standard deviation of 0.192.

The variable exchange rate has a value scale from -0.625 to 1.643. The lowest value, which is -0.625, means that if the company suffers a loss of foreign exchange rate difference in 2015, namely the company PT Tunas Baru Lampung (TBLA). Meanwhile, the maximum value owned by PT Lautan Luas Tbk in 2015 is 1,643. The exchange rate has a mean of 0.001973 where the standard deviation is 0.181. This means that the resulting mean value is smaller than the standard deviation which shows that the data is heterogeneous, which means that the average exchange rate in the sample companies in 2014-2018 has a high level of deviation.

The lowest value of the profitability variable, which is 0.001 is owned by PT Darma Henwa Tbk (DEWA) in 2014. The highest profitability is 0.773 and is owned by PT Bayan Resources Tbk (BYAN) in 2018 of 77.3% of the profit earned by the company. The high level of profitability indicates an increase in transfer pricing transactions to affiliated companies. The profitability ratio has a mean value of 0.114. The standard deviation of profitability is 0.100, which means the mean

Table 3. Descriptive Statistical Analysis Results

	N	Minimum	Maximum	Mean	Std. Deviation
Transfer Pricing	272	0.000	2.781	0.163	0.303
Tunneling Incentive	272	0.101	0.931	0.563	0.181
Institutional Ownership	272	0.000	1.000	0.672	0.192
Exchange Rate	272	-0.625	1.643	0.002	0.181
Profitability	272	0.001	0.773	0.114	0.100
Leverage	272	0.071	6.652	1.248	1.155

Source: data processed 2020

value is greater than the standard deviation which indicates that the sample is below the average calculation.

The lowest leverage value is 0.071 which is occupied by PT Industri Jamu and Farmasi Sidomuncul Tbk. Meanwhile, the maximum leverage score is at 6,652 which is owned by PT Bank Negara Indonesia Tbk (BBNI) in 2017. If a company has high leverage, then the level of debt borne by the company is also high and vice versa. The mean of leverage variable is 1,248. The standard deviation value is at the number 1.155 which means it is smaller than the count mean value.

Based on the three tests that have been carried out including the Langrange multiplier (LM) test, the Chow test, and the previous Hausman test, the regression model selected in this research is the Random Effect Model (REM). This model produces an adjusted R^2 value of 0.176. The regression formula in this research is shown by equation (1). The results of the model selection test are detailed in table 4 and the results of hypothesis testing are presented briefly in table 5.

$$\begin{aligned} RPTAL = &-0.310986 + 0.181296\ TNC + 0.327363\ KI \\ &- 0.127361\ EXC + 0.027148\ PROF \\ &+ 0.118315\ LEV \quad \text{......................................(1)} \end{aligned}$$

Table 4. Model Selection Test Results

	Estimation Model	Prob	α	Selected Model
Chow Test	CEM-FEM	0.00	0.05	FEM
Hausman Test	FEM-REM	0.99	0.05	REM
Langrange Multiplier Test	CEM-REM	0.00	0.05	REM

Source: secondary data processed 2020

The Effect of Tunneling Incentive on Transfer Pricing

Tunneling incentive does not affect transfer pricing. The research result contradicts the agency theory which states that discretionary efforts can be carried out by managers through transfer pricing in terms of transferring assets owned by the company. The information obtained by the controlling shareholders is more than the minority shareholders. In addition, more and more companies are carrying out the Advance Pricing Agreement process as stated in the Income Tax Law Article 18 paragraph 3a that the authority of the director-general of taxes to enter into agreements with taxpayers and to cooperate with the tax authorities of other countries to determine the price of transactions between parties who have special relationships. Thus, the company is more vigilant and careful in carrying out transactions with foreign parties even though the relationship between the subsidiary and the parent. The finding of this study is in sync with studies from Khotimah (2018) and Pratiwi, (2018) which prove that tunneling incentives do not affect transfer pricing.

The Effect of Institutional Ownership on Transfer Pricing

Institutional ownership significantly affects transfer pricing positively. This result is in line with agency theory that agency problems arise because managers as agents are obliged to maximize the principal's profits, but on the other hand, managers are also interested in maximizing their prosperity so that there is a great opportunity where agents do not always prioritize the principal's personal needs (Jensen & Meckling, 1976). Institutional investors generally want to get as much profit as possible, which results in a high corporate tax burden. Therefore, the company tries to minimize the amount of tax paid by implementing transfer pricing practices. The concentrated ownership structure has not succeeded in providing adequate control over earnings management activities by management. Therefore, the larger the percentage of institutional ownership will also increase the opportunity for companies to carry out transfer pricing practices.

The Effect of Exchange Rate on Transfer Pricing

Exchange rate has a significant negative effect on transfer pricing. Over time, the strengthening of the foreign exchange rate in the rupiah causes the burden on the company to increase so that the profit received is getting smaller. This causes the tax burden to be smaller and the potential for companies to carry out transfer pricing practices is lower. The finding of this study is not in line with agency theory which reveals that as a motivating factor, managers determine one method through transfer pricing in order to maximize or minimize the overall use of the exchange rate. The size of the exchange rate affects the company's provisions to stipulate the implementation of transfer pricing transactions or not to apply transfer-pricing transactions. The finding of this study is in line with the research of Tjandrakirana & Ermadiani (2020) which confirms that there is a significant negative effect of the exchange rate on the company's consideration to apply transfer pricing.

The Effect of Profitability on Transfer Pricing

Profitability does not affect transfer pricing. This is not in line with agency theory which describes that agency problems arise because of the difference in interests between the principal and the agent but still work together to do different tasks. This agency problem has the potential to harm company owners because they do not participate directly in managing the company so that the information collected is less detailed. Based on the research results, the higher the level of profitability of the company, this condition is not able to encourage companies to carry out transfer pricing activities. This is because the higher the company's profits obtained will have a larger source of internal funding so that the company uses capital sourced from the owner first rather than using funds sourced from external to the company. The findings that support this research are the research of Bava & Melchior, (2017), Azzura & Pratama (2019) and Waworuntu & Hadisaputra (2016) stated that there is no effect of profitability on transfer pricing.

Table 5. Hypothesis Summary

Hypothesis	Coefficient	Sig.α	Prob.	Result
H_1: Tunneling incentive has a significant positive effect on transfer pricing	0.18	0.05	0.16	Rejected
H_2: Institutional ownership has a significant positive effect on transfer pricing	0.33	0.05	0.00	Accepted
H_3: Exchange rate has a significant positive effect on transfer pricing	-0.13	0.05	0.03	Rejected
H_{4a}: Profitability has a significant positive effect on transfer pricing	0.03	0.05	0.85	Rejected
H_{4b}: Leverage has a significant positive effect on transfer pricing	0.12	0.05	0.00	Accepted

Source: Processed Secondary Data, 2020

The Effect of Leverage on Transfer Pricing

Leverage has a significant positive effect on transfer pricing. The finding of this study is synchronized with the agency theory stated in the debt contract hypothesis underlying the existence of leverage relationship to transfer pricing. Companies with high debt levels tend to try to convince the public that their companies are in good condition. In addition, the higher the level of funding from debt from third parties used by the company, the greater the interest costs arising from the debt. The high-interest costs have an effect on reducing the company's tax burden. The finding of this study is in line with the research of Richardson et al., (2013) and Cahyadi & Noviari (2018) which prove that leverage has a positive effect on transfer pricing activities. The high level of leverage will increase the company's opportunity to implement transfer pricing.

CONCLUSIONS

The findings from the research are that institutional ownership and leverage have a significant positive effect on transfer pricing. Meanwhile, tunneling incentives and profitability have not been shown to affect transfer pricing. However, the exchange rate significantly has a negative effect on transfer pricing. Research findings illustrate that multinational companies can increase profitability and institutional ownership while still paying attention to exchange rates and reducing tunneling incentives and leverage in order to generate greater corporate profits. Based on the research results, the low value of Adjusted R^2 indicates the influence of other factors beyond the independent variable used in this research. Suggestions for future research it is expected that using or adding other measurements to assess the practice of transfer pricing and can add other independent variables such as managerial ownership because many companies share ownership sourced from managerial companies that have the opportunity to practice transfer pricing.

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