

# The Effect of Tax, Profitability, Tunneling Incentive, and Good Corporate Governance on Transfer Pricing

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**Abstract:** This study aims to examine the effect of tax, profitability, tunneling incentive, and Good Corporate Governance (GCG) on transfer pricing. The data used in this study was secondary data obtained by accessing the Indonesia Stock Exchange website, [www.idx.co.id](http://www.idx.co.id). The research population was manufacturing companies listed on the Indonesia Stock Exchange on the 2015-2019 period. The data collection method used a non-participant observation with a purposive sampling technique. The number of research samples was 14 companies. The data analysis technique used multiple linear regression. The results of this study show that tax and profitability did not affect transfer pricing, tunneling incentive has a negative effect on transfer pricing, and Good Corporate Governance (GCG) has a positive effect on transfer pricing.

**Keywords:** Transfer Pricing, Tax, Tunneling, GCG.

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## I. INTRODUCTION

Globalization accompanied by rapid advances in technology, information systems, and communications has removed the dividing walls between countries, including in the economic sector. Globalization has opened up easier ways to establish subsidiaries, affiliated joint ventures, special-purpose entities, and trusts in jurisdictions that benefit from low tax rates (Amidu et al., 2019). On the other hand, the rapid development of technology, especially in digital regulation and e-commerce, raises significant challenges for the tax system in a country (Juranek et al., 2018). Globalization has also caused many national companies to develop into multinational companies that are centralized in several countries. It causes multinational companies to create systems to integrate their business activities. Multinational companies located in several countries will face several obstacles, one of which is the difference in tax rates between countries. Therefore, transfer pricing activities are carried out to overcome this problem.

Transfer pricing is a financial management method that allows a multinational company to transfer funds internationally (Chan et al., 2015). Transfer pricing has become an important problem for multidivisional companies because transfer pricing is also used to optimize division operations and its profits based on the principle that transfer pricing allows managers to evaluate the performance of the manufacturing division as a profit center (Hamamura, 2019). Transfer pricing functions to allocate profits between divisions by aligning the interests of the parties in the company, namely the interests of the division manager with the interests of the company and its shareholders (Williamson in Hussein, et al., 2017). Modern transfer pricing methods divided into two broad categories, namely negotiated and managed (Liu et al., 2015).

Transfer pricing practices allow companies to reduce their tax obligations, thus tax revenue in a country is reduced that makes researchers interested in researching transfer pricing decisions for manufacturing companies in Indonesia. Previous studies generally calculated transfer pricing using a dichotomy approach, namely by looking at the existence of sales to parties who have a special relationship, but this study proxy the transfer pricing variable with the value of related party

transactions. This study is a development of previous studies that provide inconsistent results on variables that may affect transfer pricing, including tax, profitability, tunneling incentive, and GCG.

Taxation is one of the most effective ways of mobilizing resources in a country towards the promotion of economic growth and development (Akinleye et al., 2018). Multinational companies tend to reduce their tax base in higher tax rate jurisdictions by shifting them to countries with lower tax rates or even tax-free with transfer pricing techniques and policies (Merle et al., 2019). Multinational companies carry out transfer pricing as an effort to divert revenues across countries to minimize their tax burden. Transfer pricing provides an opportunity for companies to allocate revenue across affiliated entities in various tax jurisdictions (Cristea & Nguyen, 2016).

Agency theory that explains how the relationship between agent and principal can be used to describe how the parties related to the company will act because of different interests. The existence of different interests will cause agency problems as a result of the inequality of information held by these parties. Different interests held by companies with tax authorities related to tax compliance will lead to companies' attempts to carry out transfer pricing as a form of avoiding large tax burdens. High tax rates cause the tax burden to be borne by companies to become bigger, thus companies tend to choose transfer pricing as an alternative to overcome it (Sundari & Susanti, 2016). Nguyen et al. (2019), Saraswati & Sujana (2017), and Sundari & Susanti (2016) found the results that taxes have a positive effect on transfer pricing.

H<sub>1</sub>: Tax has a positive effect on transfer pricing.

Profitability describes the effectiveness of management in managing the company, thus it can to achieve the targets expected by the company owner. Good profitability allows investors to be interested in investing in a company because profitability can provide an overview of how the company generates a certain amount of profit. Stewardship theory is based on established psychology and sociology in which executives as stewards are motivated to act as desired by the principal to achieve the targets set by the company (Donaldson & Davis, 1991). This theory states that company executives will seek to protect the interests of owners or shareholders and make decisions on behalf of shareholders. Related research has been conducted by Cahyadi & Noviyari (2018) and Sari & Mubarak (2018) which states that profitability has a positive effect on transfer pricing.

H<sub>2</sub>: Profitability has a positive effect on transfer pricing.

Tunneling is an activity of transferring assets out of the company for the benefit of the majority shareholder or better known as the controlling shareholder. Agency theory can describe tunneling incentives in terms of influencing the company's decision to carry out transfer pricing. The assumptions about human nature, namely human nature that prioritizes their interests (self-interest), illustrates the tendency of majority shareholders and minority shareholders to prioritize their interests through tunneling incentives. Related research has been conducted by Hidayat et al. (2019), Santosa & Suzan (2018), and Saraswati & Sujana (2017) which state that tunneling incentives have a positive effect on transfer pricing.

H<sub>3</sub>: Tunneling incentive has a positive effect on transfer pricing.

GCG is a system that controls a company that creates added value for stakeholders (Monks in Noviyari & Suaryana, 2019). GCG is a system that provides direction or supervision to companies (Sakhya & Rasmini, 2020). The implementation of GCG in the company emphasizes two parties, namely shareholders and other stakeholders and company management. GCG implementation also aims to encourage the creation of an efficient, transparent, and consistent market with laws and regulations. The implementation of GCG in the company is also influenced by agency problems as a result of the information asymmetry between the agent and the principal, where the agent has more information about the company than the principal. Thus, GCG principles will provide better transparency regarding how the agent manages the company. Amarta et al. (2020) and Wijaya & Amalia (2020) found the results that good corporate governance has a negative effect on transfer pricing.

H<sub>4</sub>: Good Corporate Governance has a negative effect on transfer pricing.

## **II. RESEARCH METHOD**

In this study, the research design uses a quantitative approach in the form of associative. This study was located in the Indonesia Stock Exchange (IDX) which provides information on the company's financial statements by accessing the official Indonesia Stock Exchange website, namely [www.idx.co.id](http://www.idx.co.id). The data collection method used in this study was a

non-participant observation. The population in this research were all manufacturing companies listed on the Indonesia Stock Exchange of the 2015-2019 period. The sample in this research was determined using a non-probability sampling method with a purposive sampling technique. The criteria for the sample in this research as follows: 1) Manufacturing companies listed on the IDX of the 2015-2019 period respectively; 2) Manufacturing companies that report consecutive annual financial reports in the 2015-2019 period; 3) Manufacturing company that uses the rupiah currency in presenting its financial statements; 4) Manufacturing company that did not experience a loss during the observation period (2015-2019); 5) Manufacturing companies that are under the control of foreign companies with an ownership percentage of 20% or more (PSAK 15) during the observation period (2015-2019). The data analysis technique used in this research was multiple linear regression analysis.

The transfer pricing variable in this research was proxied by the value of related party transactions because transfer pricing is a transaction carried out with parties who have a special relationship (Refgia et al., 2017).

$$TP = \frac{\text{Related Party Transaction Receivables}}{\text{Total Account Receivables}} \times 100\% \dots\dots\dots(1)$$

The tax variable in this research was measured by the proxy effective tax rate (ETR). ETR is calculated based on financial information generated by the company (Indriaswari & Aprillia, 2017).

$$ETR = \frac{\text{Tax Expenses}}{\text{Profit Before Tax}} \dots\dots\dots(2)$$

Profitability in this research was measured by Return on Asset (ROA) ratio because this ratio was closely related to management efficiency to generate profits with the wealth it has.

$$ROA = \frac{\text{Net Income After Taxes}}{\text{Total Assets}} \times 100\% \dots\dots\dots(3)$$

Tunneling is the behavior of transferring company assets and profits for the benefit of the majority shareholder who controls the minority shareholder (Johnson et al., 2000). The tunneling incentive variable in this research was based on the amount of foreign share ownership that exceeds 20% (twenty percent) (Saraswati & Sujana, 2017).

GCG in this research was measured using a dummy variable proxied by audit quality where the financial statements audited by the big ten public accounting firms are given a value of 1 (one) and if the financial statements are not audited by the big ten public accounting firms are given a value of 0 (zero) (Rosa et al., 2017). The public accounting firms which are included in the big ten, namely: Ernst & Young, Deloitte, KPMG, PricewaterhouseCoopers, Grant Thornton, BDO, Crowe Horwath, RSM, Baker Tilly, and Nexia International (Nanda Widiiswa & Baskoro, 2020).

### III. RESULT AND DISCUSSION

Based on the sampling criteria and outlier data expenditure, 14 companies became the research samples with the observation period during 2015-2019, thus the sample amounted to 70 observations. The normality test in this research used the Kolmogorov-Smirnov test. The test results show that the significance value is 0.151, greater than 0.05 which means that the data were normally distributed. The autocorrelation test results show the Durbin-Watson (DW) value of 1.042. DW value < dL, which is 1.042 < 1.4943, then there is positive autocorrelation. Therefore, it is necessary to do away to overcome the autocorrelation problem. One method to overcome the autocorrelation problem is to use the “Cochrane Orcutt” method, in which data is transformed into a Lag form (Candradewi & Yasa, 2018). This data transformation will reduce the research sample size to 69 (n = 69). The autocorrelation test after cochrane orcutt method show that Durbin-Watson value is 1.783. If this value is compared with the DW table obtained dU < DW < 4-dU, namely 1.7343 < 1.783 < 2.2657, so there is no autocorrelation problem. The normality test is carried out again after performing the cochrane orcutt method, the test results shows that significance value is 0.067 which is greater than 0.05, which means that the data in this research are normally distributed. The multicollinearity test aims to test whether there is a correlation between the independent variables in the regression model. The test results show that all the independent variables used have a tolerance value > 0.10 and a VIF value < 10, it concluded that there is no multicollinearity problems. The heteroscedasticity test in this research used the glejser test. The test results show that all independent variables have a significance value greater than 0.05, it shows that heteroscedasticity does not occur.

Multiple linear regression analysis aims to examine the effect of the independent variable on the dependent variable. The results of multiple linear regression analysis in this study shown in Table 1.

**Table 1: Summary of the Results of Multiple Linear Regression Analysis**

Model		Unstandardized Coefficients		Standardized Coefficients	t	sig.
		B	Std. Error	Beta		
1	(Constant)	0.029	0.016		1.835	0.071
	LAG_ETR (X <sub>1</sub> )	0.073	0.049	0.171	1.471	0.146
	LAG_ROA (X <sub>2</sub> )	-0.075	0.046	-0.197	-1.635	0.107
	LAG_TUN (X <sub>3</sub> )	-0.108	0.044	-0.317	-2.462	0.016
	LAG_GCG (X <sub>4</sub> )	0.056	0.025	0.278	2.215	0.030
	<i>Adjusted R Square</i>	0.162				
	F count	4.290				
	Significance F	0.004				

Source: Research data, 2020

Based on the multiple linear regression test results, the model in this study can be seen as follows.

$$\text{LAG\_TP} = 0.029 + 0.073\text{LAG\_ETR} - 0.075\text{LAG\_ROA} - 0.108\text{LAG\_TUN} + 0.056\text{LAG\_GCG} + \varepsilon$$

Based on Table 1, the value of Adjusted R Square is 0.162 or 16.20%. It shows that the variation of the dependent variable transfer pricing (Y) is influenced by the independent variable tax (X<sub>1</sub>), profitability (X<sub>2</sub>), tunneling incentive (X<sub>3</sub>), and good corporate governance (X<sub>4</sub>) of 16.20%, while the rest of 83.80% is explained by other variables that are not included in the research model.

Based on Table 1, it can be seen that the F count value is 4.290 with a significance value of the F test of 0.004, which is smaller than the 0.05. It shows that tax (X<sub>1</sub>), profitability (X<sub>2</sub>), tunneling incentive (X<sub>3</sub>), and GCG (X<sub>4</sub>) simultaneously influence transfer pricing and the model in this research is feasible.

The analysis results on the partial test (t-test) in Table 1 indicate the significance value of the tax (X<sub>1</sub>) is 0.146 with a regression coefficient that is positive of 0.073. The significance value of the tax variable is greater than 0.05 indicates that tax does not effect on transfer pricing. Based on these results, the first hypothesis (H<sub>1</sub>) which states that tax has a positive effect on transfer pricing is rejected. Tax variable that does not effect on transfer pricing indicate that the company's decision to carry out transfer pricing is not a mechanism to minimize taxes by the company's sample in the research (Melmusi, 2016). The company's actions to minimize its tax burden can be carried out with tax management, which aims to implement the applicable tax regulations and efficiency efforts to achieve proper profit and liquidity (Suandy in Mispriyanti, 2015). Transfer pricing is more associated with an action that has a pejorative meaning, namely the transfer of a company's taxable profit to another company in the same group of companies in a country with low tax rates (Agustina, 2019). The practice of transfer pricing is defined as a company action aimed at implementing a tax saving mechanism. The objectives of transfer pricing, namely: 1) production efficiency, 2) securing a competitive position, 3) evaluating the performance of subsidiaries operating abroad, and 4) regulating the adequate cash flow of subsidiaries (Agustina, 2019). The research results reinforce the research conducted by Agustina (2019), Ginting et al. (2019), Melmusi (2016), and Mispriyanti (2015).

Table 1 shows the Profitability (X<sub>2</sub>) has a significance value of 0.107 with a regression coefficient value of -0.075. A significance value greater than 0.05 indicates that profitability does not affect transfer pricing, thus the second hypothesis (H<sub>2</sub>) which states that profitability has a positive effect on transfer pricing is rejected. This result means that the company carries out transfer pricing practices not influenced by the level of profitability owned by the company. Companies with high-profit rates will also have larger internal sources of funding. This allows companies to tend to use their internal funds first, thereby reducing the company's tendency to carry out transfer pricing (Ginting et al., 2019). This research is not in accordance with the stewardship theory which states that executives as stewards are motivated to act as desired by the principal. The research results reinforce research by Agustina (2019) and Ginting et al. (2019) which prove that profitability has no effect on transfer pricing but does not support research from Cahyadi & Noviyari (2018) and Sari & Mubarak (2018) which proves that profitability has a positive effect on transfer pricing.

Tunneling incentive (X<sub>3</sub>) has a significance value of 0.016 with a regression coefficient value of -0.108. It means that tunneling incentive has a negative effect on transfer pricing. Based on these results, the third hypothesis (H<sub>3</sub>) which states that tunneling incentive has a positive effect on transfer pricing is rejected. Tunneling incentives, which are based on the amount of foreign share ownership that exceeds 20%, indicate that the presence of controlling shareholders can influence

the company's decision to carry out transfer pricing. The research results show that tunneling incentive has a negative effect, which means that the practice of transfer pricing will decrease if the shares owned by controlling shareholders are getting bigger. Agency theory states that agency problems arise as a result of conflicts between majority shareholders and minority shareholders. One of the assumptions underlying agency theory is the assumption about human nature, which states that humans will put their interests first, indicates that the majority shareholder tends to perform tunneling incentives. The research results reinforce the research conducted by Darma (2020) which states that tunneling incentive has a negative effect on transfer pricing, but the result not in line with the research conducted by Hidayat et al. (2019), Santosa & Suzan (2018), and Saraswati & Sujana (2017) who obtained the results that tunneling incentive has a positive effect on transfer pricing.

Based on Table 1, Good Corporate Governance ( $X_4$ ) has a significance value of 0.030 with a regression coefficient of 0.056. It means that GCG has a positive effect on transfer pricing. Based on these results, the fourth hypothesis ( $H_4$ ) which states that GCG has a negative effect on transfer pricing is rejected. The analysis results show that GCG has a positive effect on transfer pricing, which means that companies with a good level of GCG tend to practice higher transfer pricing. A good audit quality does not guarantee that the company does not carry out transfer pricing. It because the function of the auditor only tests the fairness of the information contained in the financial statements of a company (Dewi & Sari, 2015). Companies that carry out transfer pricing apply PSAK 7 (Revised 2010) in which significant transactions related to related parties are disclosed in the financial statements (Rosa et al., 2017). The research results do not support agency theory which states that the implementation of good corporate governance will minimize agency conflict. The research results reinforce the research conducted by (Rosa et al., 2017), but the result not in line with research conducted by Amarta et al. (2020) and Wijaya & Amalia (2020) which obtained that good corporate governance has a negative effect on transfer pricing.

#### IV. CONCLUSION

Based on the results and discussion of research, tax and profitability do not affect transfer pricing of manufacturing companies listed on the Indonesia Stock Exchange which are the samples in this research. It means that the levels of tax and profitability do not necessarily cause the company to carry out transfer pricing. Tunneling incentive has a negative effect on the transfer pricing. It shows that an increase in tunneling incentives has caused a decline in transfer pricing practices. GCG has a positive effect on transfer pricing. This research has several limitations. First, the measurement of transfer pricing in this research uses a proxy for the value of related party transactions, further research is suggested to use another transfer pricing proxy if available. Second, the coefficient of determination in this research is only 16.2%. Further research is suggested to develop this research by adding other independent variables, thus it can increase the coefficient of determination.

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