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Multinational Firms' Losses and Profit Shifting Behavior in Indonesia: Some Comments

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Multinational Firms' Losses and Profit Shifting Behavior in Indonesia:
Some Comments:

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Corporate income tax is one of the major tax revenue sources in Indonesia. Up to January 2015, more than 4000 multinational corporations or firms that their shareholders or ultimate owner are foreign entities (Penanaman Modal Asing/ PMA), suffered lossess. This situation made them did not pay their income tax.

Some say this is happened because of the macroeconomic downturn and business environment, the others murmur about the worries of behavior of profit shifting in undertaking. In this paper, tax and non-tax motives of multinational firms' losses will be elaborated. Financial loss become the issue that will be described in business framework, also will be framed as profit shifting strategy.

Furthermore, how Government of Indonesia (Directorate General of Taxes/ DGT) should react on those particular issues? Should DGT have effective anti-avoidance rules and improve their tax administration system? Detail rules and administration strategy will be beyond the scope of this paper.

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1. Background

This year, Directorate General of Taxes (DGT), Indonesia has been set an ambitious target by the Government of Indonesia to collect approximately Rp 1,294 trillion. This is not an easy task considering a number of fundamental difficulties, such as low tax compliance, massive informal sector and institutional problems that Indonesia tax landscape is known for. Similar with other developing countries, one of the major tax revenue sources in Indonesia is the corporate income tax (±40%).[1] The argument is simple: most of the firms that contribute to corporate income tax operate in the formal business system; however a substantial dependency on revenue from corporation, particularly multinational firms, is not immune from risk and challenges, since they have more sophisticated tax planning.[2]

Up to January 2015, there are more than 4,000 multinational firms (firms with foreign entities as shareholders or ultimate owners) in Indonesia that suffered losses. Consequently, such multinational firms have not paid any income tax in the relevant tax year. There is a speculation as why such a significant number of firms have suffered losses, some argued that this is due to macroeconomic downturn and business environment; but, some also suspect that multinational firms undertake profit shifting behavior. The debate is not new and Indonesia is not alone.

In the mid 90's, China struggled with the same issue. During 1988-1993, 35-40% of multinational firms that operated in China suffered financial losses. The figure was increased to 60-70% during the next five years. The Government of China estimated that nearly 60% of those multinational firms intentionally created losses by using transfer price manipulation scheme.[3] The questions are: is it true that the multinational firms' losses in Indonesia can be simply associated with any effort to shift profit behavior to their affiliation abroad just like in China? If yes, what are the channels of this behavior? How should the DGT (or Ministry of Finance) react to this problem?

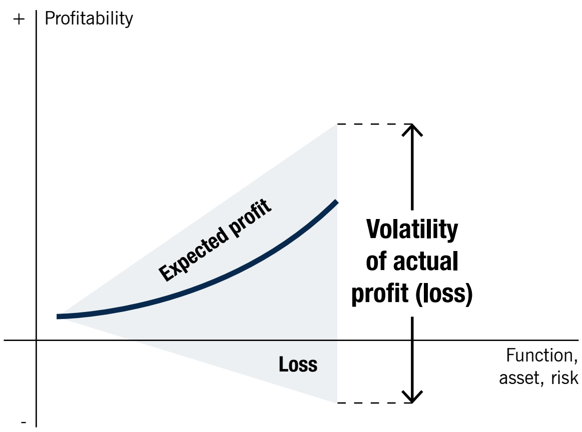
This article will elaborate tax and non-tax motives of multinational firms' losses. The author argues that financial losses could not be directly associated with tax planning strategy to increase tax saving (profit shifting). On the other hand, a careful perspective that multinational firms –with their ability to optimize their global profit by utilize various national tax system- can have profit shifting strategies mainly via transfer price manipulation and thin capitalization, should be addressed. Further, in order to combat such practice, Indonesia tax legislation should have effective anti-avoidance rules and the DGT should improve their tax administration system on those particular issues. The detailed rules and administration strategies will be beyond the scope of this article.

2. Financial Loss in Business Framework

When multinational firms suffer financial losses (negative profit); no tax should be paid by them to the government. Unsurprisingly, consistent loss situation could trigger scrutiny from tax authorities. Yet, in business realities, multinational firms –like any other independent firms- could also have fiscal trouble. The following are some justifications why multinational firms could have suffered losses.

First, the profits of a multinational firm depend on the functions performed, assets (economic and/or legal) owned and risks assumed. The complexities of functions, assets and risks (FAR), have a positive correlation with the expected profit. Please note, that there is no firm that will assume to suffer financial loss, in other words all firms operates with the assumption that it will make profits. However, at the same time, the complexities of FAR will have a direct impact and influence on the gap between the expected and actual profit. Therefore, actual profit is more volatile under a complex FAR condition because in such a condition

Figure 1 - Relationship between FAR, Expected and Actual Profit (Loss)



1. If we divide the figure into both domestic and foreign firms, 10 – 11% of government revenue in developing countries or approximately around US$ 725-730 billion, are contributed by multinational enterprises each year. Estimation based on contribution method and FDI-income method. See UNCTAD, "FDI, Tax and Development – The Role of Multinational Enterprises: Towards Guidelines for Coherent International Tax and Investment Policies," *UNCTAD Investment and Enterprise Division Working Paper* (26 March 2015): 13-15.

2. Carlo Cottarelli, "Revenue Mobilization in Developing Countries," *IMF Staff Paper* 8 March 2011: 9. Available online at: http://www.imf.org/external/pp/longres.aspx?id=4537.

3. See Jian Li and Alan Paisey, *Transfer Pricing Audits in China* (New York: Palgrave Macmillan, 2007).

a higher risk is assumed.[4] Therefore, multinational firms with simple FAR, such as commission agent or toll manufacturer should have a normal profit but have less probability of financial loss.

Secondly, the impact of business cycle and strategy should be considered. Every industry sector have their own particular business cycle patterns, for instance: the tourism section is greatly influence by seasonal demand. Even within a sector each firm have own particular life-cycle, starting from start-up phase, growing phase, matured company, decline phase, and finally when the enterprise is shut-down. Business life cycle also have an impact on how firms design and formulate their business strategy.[5] For instance, a firm that is contemplating to enter into a new market (start-up phase) would probably interested in implementing a market penetration strategy, either by offering products to the customers with significant lower prices than existing products from competitors or to offer significant discount. Such strategy could create a financial loss for the firm.

Thirdly, the impact of extraordinary market conditions should be considered. In their operations, firms would always anticipate their future operations by making market projections based on most recent economic conditions, for instance, when setting their pricing policy. However, in the case of market volatility (disequilibrium) projections might fail and lead into financial loss. The global financial crisis during 2008-09 could be robust illustration.[6] Both multinational firms and independent firms are impacted by the probability of unexpected risk in abnormal situation. There are three different sources of abnormal situations: (i) internally from the company (e.g. fraud or inefficiencies); (ii) industry or sector (volatility of price for raw material); and (iii) macroeconomic condition.[7]

Fourthly, non-economic conditions should be considered. For multinational firms, political risk could also create uncertainties to their business. Furthermore, there is a negative relationship between corruption and corporate tax payment.[8] From business perspective, corruption is sometimes considered as informal tax to the government. Stable political environment and good governance influences business decision making and discourages multinational firms to allocate profits abroad.

Based on the above arguments, it could be observed that losses could have been driven by non-tax factors. However, the next question would be: for how long, could a multinational firm, from economic rationale perspective, suffer such losses? Two, five, ten years or even longer? Again, it depends on the whether such losses could be tolerated thereby taking into consideration remuneration from future profits. From economic rationale perspective, when multinational firms continue to operate their business, while most of independent firms are not; this could be an indication of profit shifting strategy (tax motive).

3. Financial Loss as Profit Shifting Strategy

When multinational firms suffer losses, they may not be receiving adequate compensation from the multinational group of which it is a part in relation to the benefits derived from its activities.[9] Multinational firms' losses can therefore be associated with profit shifting strategy. Profit shifting is a strategy to minimize the multinational firm's global corporate tax burden by placing or allocating profit to the entity that operates in the country that provides the most favorable tax regime. As a result, profit shifting can erode a country's tax base. From basic economic model of profit shifting, multinational firms' reported profit was a result between 'true profits' minus the shifted profit. Thus, financial loss (negative profit) might be the outcome of excessive profit shifting strategy. Discussion on such issue in the context of Indonesia, need further understanding on why and how profit shifting can be occurred, beforehand.

3.1. The Causes

Interdependency of the world economy marked by global value chain and free movement of products and production input has brought more concern on international aspect of public finance. Tax policy is extended from local to global, from national to international.[10] It is merely concern that any country's corporate

4. See Romi Irawan, "Analisis Fungsional" in *Transfer Pricing: Ide, Strategi, dan Panduan Praktis dalam Perspektif Pajak Internasional,* eds. Darussalam, Danny Septriadi, and B. Bawono Kristiaji (Jakarta: Danny Darussalam Tax Center, 2013), 107-135.

5. Robert Feinschreiber, "Life-Cycle Analysis and Transfer Pricing," in *Transfer Pricing Handbook*, *3rd Edition: Volume 1*, ed. Robert Feinschreiber (New Jersey: John Wiley & Sons, Inc., 2001), 37.9-37.10.

6. Christian M. Scholz, "Recession Transfer Pricing Returns," in *Transfer Pricing in Recession. Tax Planning: Special Report*, ed. Lilian Adams (Washington D.C.: BNA International Inc., 2009).

7. Deloris R. Wright, "Extraordinary Market Condition," in *Transfer Pricing Handbook*, *3rd Edition: Volume 1*, ed. Robert Feinschreiber (New Jersey: John Wiley & Sons, Inc., 2001), 16.3-16.4.

8. See Clemens Fuest, Giorgia Maffini, and Nadine Riedel, "How Does Corruption in Developing Countries Affect Corporate Investment and Tax Compliance?" *Beiträge zur Jahrestagung des Vereins für Socialpolitik* No. A17-V1 (2010): Ökonomie der Familie - Session: Corporate Taxation, No. A17-V1.

9. OECD *Transfer Pricing Guidelines* 2010, Paragraph 1.71.

10. Richard A. Musgrave and Peggy B. Musgrave, *Public Finance in Thory and Practice*: 4th edition (New York: McGraw-Hill, 1984), 759-760.

income tax policy could not be seen as isolated expanse as it also affected other countries, and *vice versa*.

Under globalization, multinational enterprise could utilize asymmetrical tax systems that will bring the highest economic return. Such asymmetrical system starts with national tax sovereignty to design their tax policy, irrespective of the other country's policy. The interaction between these national tax systems then creates tax distortionary effect, since there are possibilities to over taxation (double taxation) and under taxation (double non-taxation).The current international tax system also creates opportunities to profit shifting, namely by separate accounting approach[11] and treatment of interest expense[12].

Furthermore, the intense of tax competition to attract capital yet permits countries to maintain different corporate tax rates, which distort business decision making.[13] All else being equal, profit shifting is a corporate tax rate sensitive activity. In general, with consideration of various empirical results, 1% increase of tax rate difference will have impact of 0.8% decrease in pre-tax profitability.[14] This is exacerbated by the existence of tax haven countries. Study by Jansky and Praats found that Indian multinational firms with tax havens network would result in 1.5% less profit and have 11.4% higher debt ratios than with no connection.[15] In the end, it is worth noting that international evidences on profit shifting strategies provide ample proof of the fact that corporate tax rate differences tend to be followed by aggressive tax planning.

3.2. The Schemes

Multinational firms own various channels to shifting profit.[16] However, two popular profit shifting strategies are: transfer price manipulation and debt shifting, since opportunities and incentives are greater for both schemes. Supremacy of both schemes can be traced from number of disputes, limelight, or any empirical studies.[17]

Transfer price manipulation is an effort to over or under invoice a related party in order to exploit cross-border differences in corporate tax rates.[18] Transfer price manipulation is not only about the pricing of product or service; currently, migration of intangible property, business restructuring, and payment of management fee without substance are getting popular. Intangible property -which is the most disputable area in transfer pricing nowadays- involves debates on legal and economic ownership, as well as valuation technique.[19] Moreover, commercial dynamics would most often render business restructurings unavoidable and often serves as a scheme to transfer price manipulation. Changing business scheme (legal form) without reallocation of functions, assets, and risks (economic substance) potentially will change allocation of remuneration within the multinational enterprises in an unfair way.[20]

On the other hand, financing strategy through debt is more preferable since debt is a tax base reduction element, and as a consequence, lowers the cost of capital.[21] Moreover, incentives to fund their foreign related party by intercompany loan increases

11. Separate accounting approach warrants variation of calculation of taxable profit for each country, as to determine the amount of tax to be collected by tax authority. With separate accounting system, internal transactions within a multinational enterprise will much depend on tax consideration, since no countries apply unitary framework to comprehend the business as a whole and see how multinational enterprise allocates their profit. See Arnaud de Graaf, "International Tax Policy Needed to Counterbalance the 'Excessive' Behaviour of Multinationals", *EC Tax Review,* Vol. 22, Issue 2 (2013): 106.

12. Tax treatment of interest and dividend payments is commonly distinguished. The first will be deductible when computing corporate income tax liability, the second will not. For multinational enterprise, this situation incentivized them to fund their subsidiaries (intra-group) with excessive debt (thin capitalization).

13. Arthur J. Cockfield, "Introduction: The Last Battleground of Globalization," in *Globalization and Its Tax Discontents: Tax Policy and International Investments,* ed. Arthur J. Cockfield. (Toronto: University of Toronto Press, 2010), 5.

14. See Jost H. Heckemeyer and Michael Overesch, "Multinational's Profit Response to Tax Differentials: Effect Size and Shifting Channels," *ZEW Discussion Paper,* No. 13-045, (2013).

15. Petr Jansky and Alex Prats, "Multinational Corporations and the Profit-Shifting: Lure of Tax Havens," *Christian Aid Occasional Paper,* No. 9 (2013): 9.

16. Kimberly A. Clausing, "Multinational Firm Tax Avoidance and Tax Policy," *National Tax Journal* Vol. LXII, No. 4, (2009): 703-725. At the scene, Google, Amazon, Starbucks, and Apple were among the most popular example on how the business takes opportunity from mismatch of tax policies across countries. See detail profit scheme by Google in Clemens Fuest, et al., "Profit Shifting and 'Aggressive' Tax Planning by Multinational Firms: Issues and Options for Reform," *ZEW Discussion Paper,* No.13-044 (2013).

17. For instance, see trend in transfer pricing disputes as discuss in detail in Eduardo Baistrocchi and Ian Roxan (eds), *Resolving Transfer Pricing Disputes: A Global Analysis* (Cambridge: Cambridge University Press, 2012).

18. Lorraine Eden, "Taxes, Transfer Pricing, and the Multinational Enterprise," in *The Oxford Handbook of International Business*, ed. Alan M. Rugman. (New York: Oxford University Press, 2009), 593.

19. Loek Helderman, Eduard Sporken dan Rezan Okten, "The Revised OECD Discussion Draft on Transfer Pricing Aspects of Intangibles," *International Transfer Pricing Journal,* Vol. 21, No.1 (2014): 5.

20. Anuschka J. Bakker and Giammarco Cottani, "Transfer Pricing and Business Restructuring: The Choice of Hercules before the Tax Authorities," *International Transfer Pricing Journal,* Vol. 15, No. 6 (2008): 276; and Joel Cooper and Shee Boon Law, "Business Restructuring and Permanent Establishments," *International Transfer Pricing Journal*, Vol. 17, No. 4 (2010): 249.

21. Aswath Damodaran, *Applied Corporate Finance* (John Wiley and Son, 2010), 493.

along with the gap of tax rate between the domestic and the country where their related party operates.[22] This is also supported by the idea of optimal value cost of capital which can be measured through weighted average of cost of debt and cost of equity (weighted cost of capital), where cost of debt considers after tax cost of debt. [23] As a result, firms would prefer debt in their capital structure, particularly in the context of cross-border financing.

Comparing between those two, there is a general consensus that transfer price manipulation is the main technique to shifting profit. From meta-data analysis based on various previous studies on profit shifting, transfer price manipulation is a dominant profit shifting strategy accounted for 72% of all cases[24], while in developing countries this figure is higher.[25]

3.3. The Cures

It should be emphasized that decision to have profit shifting strategies can be reduced by creating anti avoidance rules. There is an increasing trend among countries to set specific anti avoidance rules (SAAR) and general anti avoidance rules (GAAR). SAAR is meant to focus on specific (individual) tax avoidance practice, such as transfer pricing rules, thin capitalization rules[26], and others. With regards to the dominant schemes of profit shifting, this article only deals with transfer pricing and thin capitalization rules.

Concerned with the possibility for manipulation of internal group transactions, there is a tremendous growth of transfer pricing rule across countries. The fundamental basis for transfer pricing rule is the arm's length principle (ALP), which mainly refers to the Article 9 of either OECD or UN Model Tax Convention about associated enterprise.[27]

Today, more than 70 countries in the world have mentioned ALP on their tax law. There are tendencies that transfer pricing regulations in various countries are getting stricter, exposed by the obligation for multinational enterprise to submit transfer pricing documentation. Before 2001, only 14 countries that have transfer pricing documentation requirement for affiliated transactions. In 10 years (2011), the figures quadruple to 58 countries.[28] Several countries had also armoured themselves with penalty and other re-characterizing clauses.[29]

Many countries today also apply domestic rules to prevent intra-group excessive debt, which refers to thin capitalization measures. The most common approach to test whether the firms have reasonable financial structure and interest payment is rely on a fixed ratio of debt to equity (DER).[30] Limit of the appropriate debt to equity ratio is quite intriguing. The mark between the 'appropriate' and 'excessive' debt is hard to measure. From government's perspective, efforts to take into account all business model and economic sectors will result in numerous ratio, which indeed will create more administrative inconveniences, especially when assessing complex business model. Therefore, many countries only set up one single debt to equity ratio, mostly around 3:1.[31]

How about the effectiveness of these rules? Lohse and Riedel estimate that transfer price manipulation channel could be reduced up to 50% with stricter transfer pricing legislation.[32] Studies on foreign affiliates of US multinationals in 54 countries during 1982 – 2004 also showed that thin capitalization regimes restrict the ratio of an affiliate's total debt to assets up to 43% of the case.[33] Moreover, in developing countries context, application of transfer pricing and thin capitalization rules simultaneously can reduce

22. John R. Graham, "Taxes and Corporate Finance: A Review," *The Review of Financial Studies,* Vol. 16, No. 4 (2003): 1101.

23. Peter H. Blessing, "The Debt-Equity Conundrum – A Prequel," *Bulletin for International Taxation,* Vol. 66, No. 4/5 (2012): 200.

24. See Jost H. Heckemeyer and Michael Overesch, "Multinational's Profit Response to Tax Differentials: Effect Size and Shifting Channels," *ZEW Discussion Paper* No. 13-045, (2013).

25. See B. Bawono Kristiaji, "The Incentives and Disincentives of Profit Shifting Strategies in Developing Countries" (Master Thesis, Tilburg University, 2015). Available online at: https://arno.uvt.nl/show.cgi?fid=137341.

26. The term thin capitalization rules referring to rules which restrict interest deductions. This rule commonly associated to a debt-to-capital ratio, an interest to-profit ratio (earning stripping), or an application of arm's length principle. See Chloe Burnett, "Intra-Group Debt at the Crossroads: Stand-Alone versus Worldwide Approach," *World Tax Journal,* Vol. 6, No.1 (2014): 43.

27. Article 9 (1) of OECD Model Tax Convention consist the concepts of associated enterprise and arm's length principle, while Article 9 (2) concern on corresponding adjustment to avoid economic double taxation.

28. UN, *United Nations Practical Manual on Transfer Pricing for Developing Countries (*New York: UN, 2013), 264.

29. See Theresa Lohse, Nadine Riedel, and Christoph Spengel, "The Increasing Importance of Transfer Pricing Regulations – A Worldwide Overview," *Oxford Centre for Business Taxation Working Paper* WP 12/27 (2012).

30. Please note that thin capitalization rules have many variations, such as: fixed interest to EBITDA ratio, targeted rules, worldwide debt, interest to assets ratio, and others.

31. It is ranging to 6:1 for normal firms. See Jennifer Blouin, et al., "Thin Capitalization Rules and Multinational Firm Capital Structure," *IMF Working Paper* WP/14/12 (2014): 23-24.

32. Theresa Lohse and Nadine Riedel, "Do Transfer Pricing Laws Limit International Income Shifting? Evidence from European Multinationals," *CESifo Working Paper,* No. 4404 (2013).

33. Jennifer Blouin, et al., "Thin capitalization Rules and Multinational Firm Capital Structure, *CEPR Discussion Paper,* No. 9830 (2014): 29-30.

the willingness to profit shifting up to 72%.[34]

Although anti-avoidance rules tend to lessen manipulation of transfer price, as well as changing capital structure into more a balanced one; these rules are difficult and not simple to implement, especially in developing countries that have weak tax administration system. There should be a distinction between enacting rules in one hand, and having the capacity to apply the rules on the other hand.[35]

4. What Should We Do?

The fact that many of multinational firms in Indonesia suffered losses should not be immediately associated with profit shifting strategies. There are numerous other factors that may bring financial distress. However, profit shifting is not a myth. Therefore, the Government of Indonesia, particularly DGT needs to be careful when dealing with such issues.

4.1. Tax administration improvement

This part is centralized on single solution which is: tax administration improvement. First of all in order to assess loss-making companies, DGT's auditor should **understand the business framework of a multinational enterprise**. Most of transfer price manipulation and debt shifting cases are hidden under commercial motives. It is important to bear in mind that financial loss could be driven by tax and non-tax motives.

Furthermore, in order to achieve such improvement, there are other factors that need to be considered:[36]

- Assessment of current capabilities and areas that need further improvements. An assessment is not limited to review the level of education and expertise of human resource, the legal environment, or network of bilateral tax treaties, but also includes the availability of information technology system to enforce compliance.
- Risk-based approach to audit compliance. Tax authorities should have a targeted approach to audit, i.e. predetermined criteria to identify transactions that are highly potential involved in profit shifting activities. For instance, audit priority for multinational firms that have affiliation in tax haven countries.
- Building team capability with training, recruitment expertise from various background, or access to research materials, databases, and case law. The effectiveness of anti-avoidance rules, particularly transfer pricing rule, will depends on the capability of DGT.

4.2. Transfer pricing rule

The general consensus that transfer price manipulation is dominant profit shifting strategy may be relevant in Indonesian case. Firstly, majority of technology and knowledge is held by multinational enterprise in developed countries, whereas research and development activities in Indonesia (or developing countries) are rarely found. From this perspective, transfer and lease of intangibles and technical services to affiliations in Indonesia are very intense and open opportunities to manipulate the 'price' and substance of the transactions. Secondly, ALP –as the main principle to assessed transfer pricing- is very hard to apply in practice, especially with the low capacity of tax administration. Further, ALP also assumed that open market provides comparables for any controlled transaction, which is not true especially in Indonesia. Thus, domination of transfer price manipulation (non-financial technique) is understandable because it is 'safer' and easier to employ.

In general, Indonesia has adequate transfer pricing rule but still not very effective to combat transfer price manipulation.[37] Aside from the DGT's capability to enforce the rule; the problem might be centralized in the ALP itself.[38] With regards to this problem, today, there is intense discussion on the Base Erosion and Profit Shifting (BEPS) Action Plan[39], particularly on Action 8, 9, 10 and 13, that is trying to revise the fundamental aspects of OECD Transfer Pricing Guidelines. Indonesia should consider the relevance of BEPS project and other OECD works on transfer pricing for its transfer pricing policy. Why? There are at least three arguments to support this view.

- Since 2012 OECD initiated the project of

34. See B. Bawono Kristiaji, "The Incentives and Disincentives of Profit Shifting Strategies in Developing Countries" (Master Thesis, Tilburg University, 2015). Available online at: https://arno.uvt.nl/show.cgi?fid=137341.

35. Carmel Peters, "Developing Countries' Reactions to the G-20/OECD Action Plan on Base Erosion and Profit Shifting," *Bulletin of International Taxation,* Vol. 69, No. 6/7 (2015).

36. See UN, *United Nations Practical Manual on Transfer Pricing for Developing Countries,* (New York: UN, 2013), 83 – 111.

37. See detail of Indonesian transfer pricing rule in Freddy Karyadi and Darussalam, "Indonesia-Transfer Pricing," *IBFD Topical Analyses,* (March, 2014).

38. The limitation of arm's length principle has been discussed by various scholars. For instance, see David L. P. Francescucci, "The Arm's Length Principle and Group Dynamics – Part 1: The Conceptual Shortcomings," *International Transfer Pricing Journal,* Vol. 11, No. 2 (2004): 55-75.

39. OECD, *Action Plan on Base Erosion and Profit Shifting* (Paris: OECD Publishing, 2013), 17 – 23.

simplification measures in transfer pricing. The project stands on the position that the application of arm's length principle should not increase compliance cost and administrative burden for the taxpayers. [40] Any thresholds for eligible taxpayers to submit documentation or safe-harbor measures (reference value that can be considered as arm's length value) are now acceptable and will be included on the revised version of the OECD Transfer Pricing Guidelines.

- More focus on value creation as stated in Action 8, 9, and 10 of BEPS. As a consequence, functional analysis and value chain analysis will play more important rule to allocate the profit. Again, value chain analysis is a tool to examine the contribution (value creation) of the entity within the multinational enterprise. Value creation also relates to the origin principle, where the substantial of economic-producing activity is take place, and ensure fairer share of profit across country.[41]
- Lastly, country by country reporting (CbCR). As emphasized on previous section, separate accounting approach (ALP) offers opportunity for the taxpayers to hide their income. In Action 13 of BEPS, OECD/G-20 promotes the modification of transfer pricing documentation into country-by-country reporting. The idea is to have transparency and allow tax administration in other jurisdiction to access financial information of their taxpayer's related party.

As a conclusion, the flexibility of the 'new' arm's length and alignments to value creation under OECD BEPS will provide great benefits for Indonesia.

4.3. Thin capitalization rule

Although not a dominant profit shifting strategy, debt shifting could also erode tax base through interest expense. Up to now, Indonesia does not have thin capitalization rule to tackle such problem. In the authors' opinion, Indonesia should use the combination of fixed debt to equity ratio with the arm's length test. There are two main considerations to support this view:.

Firstly, as proved on empirical study by Blouin et al., the thin capitalization rules were more effective if referred to automatic formula.42 Secondly, fixed debt to equity ratio approach provides great deal of certainty and simple to implement.43 Moreover, the impacts of this policy to firms' capital structure are relatively promising, at least it can ensure towards more balance between debt and equity, and therefore creates less macroeconomic risk (for instance: current account deficit or volatility of exchange rate). Thirdly, this reference point may not necessarily represent market reality.44 This was supported by the fact that in principle, fixed debt to equity ratio does not contemplate any circumstances of company, e.g., industry sector, development phase of firms, and others.45 On the other hand, another approach such arm's length capital structure, offers more comprehensive approach on how to assess excessive debt especially on dealing with intercompany loan.46

At the end, the combination between fixed debt to equity ratio and arm's length test is considerably the best solution, since both of them can cover each other's weakness. Combination in here refers to the flexibility for taxpayers to choose which approach is more suitable for them.

5. Conclusion

For Indonesia, tax revenue is a vital source to finance its development. Moreover, profit shifting problem is particularly important because the share of income tax revenue from corporation is large.

As with the case of independent firms, multinational firms could also sustain genuine losses whether caused by extraordinary market condition, business cycle, their function and risk, or driven by non-economic factors. However, when independent firms that are involved in the same business activities are not tolerable with such continued losses; then there will be an indication that multinational firms has intentionally created

40. The idea also supported by various tax stakeholders. See Michael C. Durst, "Pragmatic Transfer Pricing for Developing Countries," *Tax Notes International,* Vol. 65, No. 4 (2012): 249.

41. See Eric C.C.M. Kemmeren, *Principle of Origin in Tax Conventions: A Rethinking of Models* (Dongen: Mr. Eric C.C.M. Kemmeren/Pijnenburg vormgevers, 2001).

42. See Jennifer Blouin, et al., "Thin capitalization Rules and Multinational Firm Capital Structure," *CEPR Discussion Paper,* No. 9830 (2014).

43. OECD, "Thin Capitalization Legislation: A Background Paper for Country Tax Administrations", *Tax and Development – Draft,* (2012), 12.

44. Roberta Augusta Assad Dib, "The New Brazilian Thin Capitalization Rules and How the Other BRICs Approach the Subject," *Bulletin for International Taxation,* Vol. 64, No. 6 (2010): 340.

45. Detlev J. Piltz, "General Report, Subject II: 'International Aspects of Thin Capitalization'", *Cashier de droit fiscal international*, Vol. LXXXIb (The Hague: Kluwer Law International, 1996), 91.

46. Detlev J. Piltz, "General Report, Subject II: 'International Aspects of Thin Capitalization'", *Cashier de droit fiscal international*, Vol. LXXXIb (The Hague: Kluwer Law International, 1996),125. However, application of arm's length principle to limit intra-group excessive debt applies if and only if intercompany transactions existed. This rule seemed to neglect the facts that 'back to back loan' or independent loans with guarantee (collateral) are quite popular nowadays.

loss via profit shifting strategy. Therefore, DGT's auditor should have sound business understanding of their taxpayers.

Although that difference in tax rate among countries is inducing profit shifting behavior of multinational enterprise, the policy on reducing corporate tax rate with regards to profit shifting may not be so relevant for today's Indonesia agenda. In general, it would be better to align current anti-avoidance rules as applied in Indonesia with the international practice. As episodes of major international tax reforms are always driven by multilateral organizations (particularly OECD), in any case, Indonesia is should continuously monitor and ensure their involvement at the global level. The OECD/G-20 BEPS project is likely to be the fundamental source of design of international tax system in the future. Particularly, for transfer pricing and thin capitalization rule, the BEPS Actions are relevant to the tax situation in Indonesia.

The last broad point I would like to make is that Indonesia should improve their tax administration system. Even good anti-avoidance rule will not work if there is a lack of expertise, limited access to the database, or no willingness to understand the business behavior.

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