



## The Effect Of Tax, Tunneling Incentive, Bonus Mechanisms, And Firm Size On Transfer Pricing (Indonesian Evidence)

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Transfer Pricing, Tax, Tunneling Incentive, Bonus Mechanisms, Firm Size.

### **Jel Classification**

H26.

### **Abstract**

Transfer pricing is the transaction price in the form of tangible goods, intangible goods or the provision of services between parties that have a special relationship. Transfer pricing used by companies in order to avoid tax payments that can cause problems for the tax authorities in their efforts to maximize revenue from the tax sector. This study aims to analyze the effect of taxes, tunneling incentives, bonus mechanisms, and firm size on transfer pricing in manufacturing sector. This study selected 28 manufacturing companies that were selected by using purposive sampling technique from a population of 153 companies listed on Indonesia Stock Exchange of the period 2013-2017. The results of the panel data regression with random effect model shows that taxes, bonus mechanisms, and firm size have a significant positive effect on transfer pricing. However tunneling incentives do not affect transfer pricing.

## 1. Introduction

The inability of the government and tax authorities in achieving the tax revenue target can be caused by various factors. One of these factors is the existence of transfer pricing actions by companies. For companies, the tax burden is considered to inhibit the development of the company, therefore the company in this case the management is trying to minimize their tax burden by tax avoidance one of them is through transfer pricing (Nurazi, Santi, Usman, 2015).

Interdependence between countries is followed by increasingly rapid trade and economic relations, especially in the capital sector has led to the development of a new order in the global economy, namely the emergence of a unification of the global economy with a tendency towards regionalization and globalization (Uyar, 2014). Increased cross-border transactions result procurement of the flow of goods, people, services and investments between countries. In this multinational transaction, the role of transfer pricing is very important.

Transfer pricing is the determination of the exchange price for a product or service of a different business unit in the company exchanging it (Augusto & Rathke, 2015). This causes State losses due to lack of paid-in calculation of tax on corporate income from the transferred income.

There are several motivations to do transfer pricing, one of them is the motivation of tax avoidance. Tax is a mandatory contribution to a country that is owed by an individual or an entity based on the Law, by not getting compensation directly and used for state purposes for the greatest prosperity of the people. The greater tax burden causes companies to transfer pricing in the hope of minimizing the burden. The decision to do transfer pricing will result in lower global tax payments in general.

Another factor that allows companies to make decisions about transfer pricing is tunneling. Tunneling is the transfer of resources from within the company to the controlling shareholder. The transfer of resources can be done in various ways, one of them is through transfer pricing (Noviastika, F, Mayowan, & Karjo, 2016).

The decision to do transfer pricing is also influenced by bonus mechanism. Bonuses are rewards given by the Annual General Meeting to members of the board of directors every year if the company earns a good profit (Mispiyanti, 2015). The bonus compensation

system will influence management to manipulate profits. Managers will take action to regulate net income in order to maximize the bonus they will receive. Management can utilize transfer pricing as a mechanism for transferring profits between companies in order to reduce taxes, increase management bonuses and divert resources from one company to another that still in one ownership.

The difference between this study and previous research is the additional the firm size as one of the independent variables. The firm size is chosen as an independent variable because not many research that uses firm size as a variable that is suspected to affect transfer pricing.

Large companies have operational activities that are more complex than small companies, more likely to do complex tax planning as well. Large-sized companies tend to have main companies or subsidiaries in other countries, so the tax planning will involve inter-company such as transfer pricing.

Due to the unavailability of standard rules, cases of transfer pricing transaction examinations are often won by taxpayers in a tax court, this causes the company to be motivated to do transfer pricing. (Dogan & Deran, Ali & Ayse Gul, 2013). Intense and continuous research on transfer pricing will greatly assist the tax authorities in drafting regulations that are able to control transfer pricing activities among companies that have special relationships, so that tax revenue will be maximized.

This study focuses on analyzing to find out how the influence of tax, tunneling incentive, bonus mechanism, company size on transfer pricing on manufacturing companies listed on the Indonesia Stock Exchange in 2013-2017.

Section 2 of this study presents a literature review of the effects of the tax, tunneling incentive, bonus mechanism, and firm size on transfer pricing. Section 3 presents the methodology used in the study. Section 4 presents the result and discussion. Section 5 of this study presents the conclusions, the limitations of this study, as well as the recommendations for further studies.

## **2. Lictérature Review**

### **2.1. Agency Theory**

Jensen & Meckling (1976) explain the agency relationship in agency theory that a company is nexus of contract between the owners of economic resources (principal) and managers

(agents) who take care of the use and control of these resources. In an effort to overcome or reduce agency problems this raises the agency costs that will be borne by both the principal and agent.

After the author reviewed several previous studies, the authors found in the study (Tiwa, Saerang, & Tirayoh, 2017) who have also reviewed other studies, say that agency theory can be used in taxation research with the assumption that agents are taxpayers and principals are the Directorate General of Taxation.

This theory attempts to describe the main factors that should be considered in designing incentive contracts (Harimurti, 2012). Although agency theory in accounting case studies focuses on the relationship of managers and their companies, taxpayers can also be seen as agents. In research Sari (2012), said that the relationship between principal and agent can be found between tax authorities and taxpayers. The role of the tax authorities to collect taxes, and the role of the taxpayer is to report the tax payable and pay the tax to the government. In the study using the taxpayer compliance model, the tax authorities as principals want maximum tax revenue, but do not know the actual income of the taxpayer as an agent.

One of the assumptions of agency theory in this study is that principal objectives and different agent objectives can lead to conflict because company managers tend to pursue personal goals. Which results in the tendency of companies to finalize their taxes or even not pay taxes, is to transfer to subsidiaries outside the main company area to minimize tax payments, while the tax authorities tend to continue to calculate and investigate the taxable assets of a company with regulatory provisions.

## **2.2. Empirical Research**

Research by Kusuma & Bayu (2017), which aims to analyze the determinants of transfer price intensity shows that tax avoidance, intangible assets, firm size, and profitability significantly increase the intensity of transfer prices. Research by Saraswati & Sujana (2017), concluded that taxes and tunneling incentive have a positive effect on indications of transfer pricing. However the bonus mechanism has no effect on indications of transfer pricing.

Other research that aims to prove and analyze the influence of tax and foreign investment on the transfer pricing in the multinational companies engaged in manufacturing shows

the results of regression that tax has a significant positive effect on the implementation of transfer pricing, while the foreign investment does not have significant effect on implementation of transfer pricing (Tiwa et al., 2017).

On research by Marisa (2017), with title the influence of tax, bonus plan, tunneling incentive, and firm size on transfer pricing found that the size of the Company has a significant effect on Transfer Pricing, it says because large companies also tend large profits with a small amount of tax, large companies also certainly has the ability to build a branch of the company both domestically and abroad and also in tax heaven country with lower tax rates to dividing the profits so that the amount of tax paid will be lower, or even to avoid paying taxes in the country.

Noviastika, F et al., (2016), say that companies with good implement Good Corporate Governance tend not to manipulate earnings. And shows that taxes and tunneling incentives have a significant effect on transfer pricing. However good corporate governance does not have significant effect on transfer pricing. According to Waworuntu & Hadisaputra (2016) The main determinants of transfer pricing aggressors in Indonesia are firm size and leverage that are positively related to transfer pricing aggressors, while intangible and multi-citizenship assets are negatively associated. This study also shows that profitability and tax haven are not related to the aggressive transfer pricing.

Based on research by Wafiroh & Hapsari (2016) tax variables show a positive and significant effect on transfer pricing, tunneling incentive variables show a positive and significant effect on transfer pricing, bonus mechanism variables show a negative and insignificant effect, meaning the bonus mechanism does not affect on transfer pricing.

Other research that analyze the influence of taxes, tunneling incentives and bonus mechanisms on transfer pricing decisions of manufacturing companies listed on the Indonesia Stock Exchange researched by Mispiananti (2015) show that tax and bonus mechanism does not have effect on transfer pricing. However, tunneling incentive has significant effect on transfer pricing.

Hartati, Desmiyawati, & Julita (2015) said that transfer pricing can occur due to management motivation for tax avoidance between related party transactions or opportunistic behavior, especially to increase management compensation. The size of bonus mechanism seen from Net Profit Trend Index will affect on transfer pricing decision.

Because in giving bonuses to directors, owner will see the whole profits as an assessment for the directors performance.

However from research by Marfuah & Azizah (2014), From the results of logistic regression analysis it was found that there was a positive effect of tunneling incentives on transfer pricing. And taxes have a significant negative effect on the company's transfer pricing decision. While the effect of exchange rate on transfer pricing shows a positive direction but insignificant. In research by Dogan & Deran, Ali & Ayse Gul (2013), the factors that influence transfer pricing are classified as legal, political, internal and external factors.

Research by Richardson et al., (2013) shows that the effect of company size, profitability, leverage, intangible assets, and multinational are significantly positive on transfer pricing. Regression results also show that firms increase the aggressiveness of their transfer prices through the combined effects of intangible assets and multinationality.

### **2.3. Hypotheses Development**

#### **2.3.1. The Effect Of Tax On Transfer Pricing**

In transfer pricing activities, companies with several branches in various countries choose to shift their tax obligations from countries that have high tax rates to countries with low tax rates (Marfuah & Azizah, 2014). Research by Tiwa et al., (2017) indicates the bigger of amount from tax that must be paid by the company, makes the company willing to implement transfer pricing in case to minimize tax burden.

Tax has a positive effect on the company's decision to transfer pricing. The bigger amount of tax burden makes companies take transfer pricing in case to reducing tax burde (Hartati, Desimyanti, & Nur, 2014). Because in business practices, company generally identify tax payments as expense so management tries to minimize these expenses in order to optimize profits.

H1: Tax has a positive effect on transfer pricing.

#### **2.3.2. The Effect Of Tunneling Incentive On Transfer Pricing**

Based on the agency theory, the largest shareholders usually have high participation rights in decision making, and act opportunistically towards the principal and causes the information asymmetry between the agent and the principal (Wafiroh & Hapsari, 2016). The majority shareholders will do many ways to generate high profits and sacrifice the rights of minority shareholders. One of the ways is transfer pricing.

Saraswati & Sujana (2017) found a positive effect from tunneling incentives on corporate transfer pricing decisions. Related party transactions are more commonly used for the purpose of wealth transfers rather than dividend payments. An unique condition where share ownership in public companies in Indonesia are concentrated, so there is a tendency of the majority shareholders to do tunneling.

H2: Tunneling incentive has a positive effect on transfer pricing

### **2.3.3. The Effect Of Bonus Mechanism On Transfer Pricing**

The bigger of profits, it will make the better image of the directors to company owner. Because of that, directors able to lift profits by selling inventory to one group company on the price that below market price. With the right bonus policy, the owner hopes that management can improve the company's performance through tax payment efficiency. From research by Hartati et al., (2015) found that bonus mechanism has effected on transfer pricing decision, bonus mechanism can be seen from Net Profit Trend Index will be effected on transfer pricing. In this case, the owners of the company will seen the whole profit company as based to calculate the performance of directors. Because of that, directors will try as much as possible so that the profits company can be maximize, including by doing Transfer Pricing.

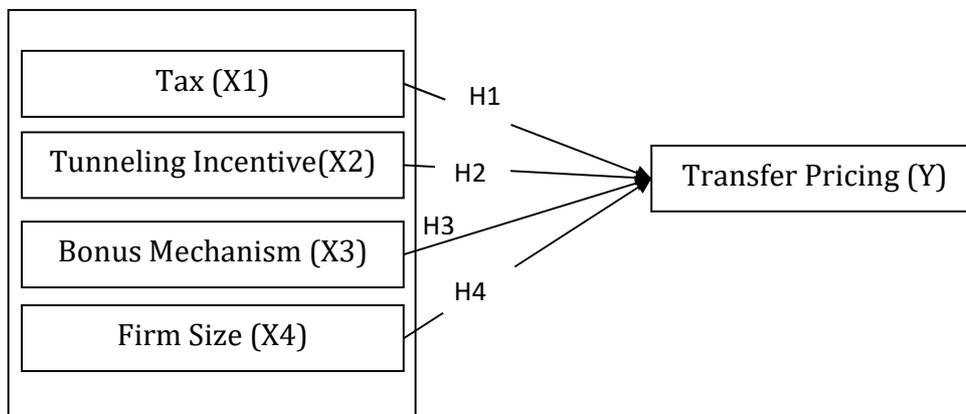
H3: Mekanisme Bonus berpengaruh positif terhadap *transfer pricing*.

### **2.3.4. The Effect Of Firm Size On Transfer Pricing**

In large companies that have large profits tend to be involved in transactions or schemes designed to significantly avoid tax payments (Kusuma & Bayu, 2017). Large companies have complex tax payment problems because of that there are several companies that do various ways to make corporate tax payments lower. One of them is transfer pricing decision.

In research by Marisa (2017), found that firm size has significant effect on Transfer Pricing, it's because the large company owners wants to make the bigger profit with smaller amount of tax burden, the owners has the ability for make anothers company on the other country that have the lower tax rates or called tax haven country in case for devided the profit company so the amount of tax burden will be minimize or even to do tax avoidance.

H4: Firm size has a positive effect on transfer pricing.



**Figure1. Conceptual Frameworks**

Explanation:

—————> Influence of independent and dependent variables.

### 3.1. Research Methodology

This research is a quantitative research and the data used is quantitative data obtained from the annual reports of manufacturing companies listed on the Indonesia Stock Exchange in 2013 to 2017. This study uses secondary data sources obtained from financial reports and annual reports of companies that are the object of research. The data was obtained from the official website, <http://www.idx.co.id> or the company's website.

In this study the population used is manufacturing companies listed on the Indonesian stock exchange in 2013-2017 totaling 153 companies. The sampling technique used was purposive sampling technique. And the criteria that used are:

1. Manufacturing companies listed on the Indonesia Stock Exchange and not delisted during the study period, from 2013 to 2017.
2. The sample company does not experience losses during the observation period. This is because companies that experience losses do not have tax obligations at the company level so tax motivation becomes irrelevant.
3. The sample company is controlled by foreign companies with a percentage of ownership of 20% or more. According to Indonesian GAAP No. 15 which states that

the controlling shareholder is a party that has shares or equity securities of 20% or more.

From the criteria above, 28 manufacturing companies were selected to be the object of this research sample.

The dependent variable used in this study is transfer pricing that is proxied by Related Party Transaction. In ISA 550 states that a related party is a person or entity that has significant control or influence both directly and indirectly on one or more intermediaries in the entity that is reporting (client) (Noviastika, F et al., 2016). In this research, transfer pricing proxied using RPT, where the total receivables from special parties are divided by total corporate receivables.

In this study independent variable tax is proxied by effective tax rate. Effective tax rates are the amount of income tax payable owed by income before tax. The tax burden on income payable referred to in this study is the amount of income tax owed by the company in one period. Independent variable tunneling incentive is proxied by percentage of share ownership above 20% as controlling shareholder. Tunneling Incentive is measured by the percentage of how large the sample company is owned by a dominant shareholder with a minimum limit of 20%. Variable bonus mechanism in this study is proxied by component of Net Profit Trend Index calculation (ITRENDLB). The net profit trend index is calculated based on the percentage of achievement of net income for year t on net income of year t-1. In this study variable firm size is proxied log of total assets. The log of total assets is used to reduce the significant difference between the large company and the small company, the total value of the asset is formed into a natural logarithm (Marisa, 2017). The conversion that is formed aims to make the total asset data normally distributed.

The method of analysis used in this study is panel data regression. The model in this study is as follows:

$$TP = \alpha + \beta_1 TAX_{it} + \beta_2 TNC_{it} + \beta_3 BONUS_{it} + \beta_4 SIZE_{it} + \epsilon$$

In which TP is transfer pricing, TAX is tax (effective tax rate), TNC is tunneling incentive, bonus is bonus mechanism, size is firm size,  $\alpha$  is constants, i is an entity- i, t is t-period,  $\beta_1-\beta_4$  is a coefficient, and  $\epsilon$  is error term.

#### **4. Result and Discussion**

##### **4.1. Multicollinearity Test**

Multicollinearity test aims to test whether the regression model found a correlation between independent variables (Ghozali, 2013). If the correlation value of all independent variables has a value of <0.8 then multicollinearity does not occur. The following are the results of the multicollinearity test in this study:

**Table 1 Multicollinearity Test Result**

	TAX	TNC	BONUS	SIZE
TAX	1.000000	0.058261	-0.109125	-0.105092
TNC	0.058261	1.000000	-0.057093	-0.095773
BONUS	-0.109125	-0.057093	1.000000	0.012829
SIZE	-0.105092	-0.095773	0.012829	1.000000

Source: output evIEWS 8.0 (2018)

The test result in table 1 shows that all independent variables have correlation coefficient values < 0.8. It concludes that there is no multicollinearity among independent variables in this model.

#### 4.2. Best Model Selection Test

In this study, the regression method used is panel data regression. This is because this study uses a combination of data between cross-section and time series. Unlike the usual regression, panel data regression has several steps to determine the right estimation model. To determine the most appropriate model between common effect models, fixed effects, and random effects there are several tests that can be done, including:

##### 4.2.1. Chow Test

**Table 2 Chow Test Result**

Effects Test	p-value
Cross-section Chi-square	0.0000

Source: output evIEWS 8.0 (2018)

The test result in table 2 shows that p-value < 0.05 or 0.0000 < 0.05. So the fixed effect model is better used than the common effect model.

**4.2.2. Hausman Test**

**Table 3 Hausman Test Result**

Test Summary	p- value
Cross-section random	0.2197

Source: output evIEWS 8.0 (2018)

The test result in table 3 shows that p-value > 0.05 or 0.2197 > 0.05. So the random effect model is better used than the fixed effect model.

**4.2.3. Lagrange Multiplier Test**

**Table 4 Lagrange Multiplier Test Result**

	p- value
Breusch-Pagan	0.0000

Source: output evIEWS 8.0 (2018)

The test result in table 4 shows that p-value < 0.05 atau 0.0000 < 0.05. So the random effect model is better used than the common effect model.

**4.3. Panel Data Regression Analysis**

**Table 5 Panel Data Regression Result With *Random Effect Model***

Variable	Coefficient	t-Statistic	Prob.
C	-0.743040	-2.109842	0.0367
TAX	0.316021	2.502137	0.0135
TNC	0.117590	1.291167	0.1989
BONUS	0.045304	2.652683	0.0089
SIZE	2.979335	2.705686	0.0077
R <sup>2</sup>	0.125578		
<b>F-statistic</b>	4.846935		
<b>Prob(F-statistic)</b>	0.001104		

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Sumber: Output Eviews 8.0 (2018)

Based on the result of panel data regression on table 5, model regression of this study is:

$$\text{TP} = -0,743 + 0,316 \text{ TAX} + 0,117 \text{ TNC} + 0,045 \text{ BONUS} + 2,979 \text{ SIZE} + \varepsilon$$

Based on table 5 shows that a significance of F statistic is 0.001104, which means less than 0.05 or 5%, it concluded regression model is feasible to use so that it can test the significance of individual parameters or statistical tests t.

On table 5 shows that determination coefficient (*R-squared*) for panel data regressions model are 0.125578 which means that 12.55% of the varians of transfer pricing can be explained by independent variable. While the other 87.45% (100%- 12.55%) explained by other variables not included in research model.

The regression coefficient of tax shows a positive direction of 0.316 and a significance value of 0.0135 which means less than 0.05 (0.0135 <0.05) so that H1 is accepted. It can be concluded that the tax partially has a significant positive effect on transfer pricing on manufacturing companies listed on the Indonesia Stock Exchange in the period of 2013 to 2017. The results of this study are consistent with the results of several previous studies Tiwa et al., (2017), Hartati et al., (2014), and Noviasatika, F et al., (2016), which shows that tax has a positive effect on transfer pricing. However, this research is not in line with research by Marfuah & Azizah (2014), because in this study based on testing the hypothesis the tax actually has a significant negative effect on transfer pricing decisions.

The research is in accordance with the theory which states that the tax motivation in transfer pricing for multinational companies is carried out by transferring income to the country with the lowest or minimum tax burden where the country has a company group or division of the company that operates. This is supported by cases that have been raised by Klassen & Mescall (2014), found that there was a shift in income by multinational companies in response to the level of tax change in Canada, Europe and the United States. Multinational companies shift revenues from Canada to the United States, while a reduction in tax rates in Europe shifts revenues from the US to Europe.

This is also evidence that the application of transfer pricing is still a way of tax avoidance by multinational companies and puts an effective tax rate to measure it. The results of this

study also prove that arm's length price which should be the controller in the transfer pricing activity is still not fully utilized. This weakness needs to be a concern for the Director General of Taxation, which in this case has the authority to determine the price of transactions between related parties through an Advance Pricing Agreement (APA).

The regression coefficient tunneling incentive shows a positive direction of 0.117 and a significance 0.1989 which means more than 0.05 ( $0.1989 > 0.05$ ) so that H2 rejected. . It can be concluded that tunneling incentive doesn't have effect on transfer pricing on manufacturing companies listed on the Indonesia Stock Exchange in the period of 2013 to 2017. The results of this study are consistent with research by (Damayanti, Marwati, & Widayanti, 2017) that shows tunneling incentive doesn't have effect on transfer pricing. It identifies that foreign shareholders do not exercise their control rights for order management to do transfer pricing or it can also mean that the presence or absence of foreign shareholders, the company will continue to transfer pricing. This result is contrary to the logic of the preparation of hypotheses which show that tunneling incentive has a positive effect on companies to transfer pricing.

The results of this study are consistent with research by (Dewi & Jati, 2014), The results of this study state that institutional ownership does not affect tax avoidance which is suspected because institutional owners only think to maximize their welfare so that whatever decisions made by management provided which is profitable they will support the decision, including the decision to transfer pricing. In institutional ownership there is foreign ownership where in that study foreign ownership used by institutions.

The regression coefficient bonus mechanism shows a positive direction of 0.045 and a significance 0.0089 which means less than 0.05 ( $0.0089 < 0.05$ ) so that H3 accepted. It can be concluded that the bonus mechanism partially has a significant positive effect on transfer pricing on manufacturing companies listed on the Indonesia Stock Exchange in the period of 2013 to 2017.

The results of this study are consistent with research by Hartati et al., (2014), that shows bonus mechanism has a positive effect on transfer pricing. But this study not consistent with research by Saraswati & Sujana (2017), that shows the result from regression is bonus mechanism doesn't have effect on transfer pricing.

The amount of the Bonus Mechanism seen from the Net Profit Trend Index will affect the Transfer Pricing decision. Because in giving bonuses to directors, company owners will certainly see the performance of the directors in managing their companies. In this case as an assessment, the owner of the company will see the company profits. For this reason, the directors will try their best to increase the company's profits, including by transfer pricing. This research is also in accordance with the positive accounting theory, the bonus plan hypothesis, which says companies with the bonus plans, managers will tend to choose the best accounting methods that can report future period earnings to the present, including transfer pricing method. The bigger profit received by the company, company owner considers that the board of directors has carried out their duties well so that the image of the board of directors will be better, thus the owner of the company will give bonuses to the directors. For this reason, management can increase the company's profits by transfer pricing.

The regression coefficient firm size shows a positive direction of 2.979 and a significance 0.0077 which means less than 0.05 ( $0.0077 < 0.05$ ) so that H4 is accepted. It can be concluded that the firm size partially has a significant positive effect on transfer pricing on manufacturing companies listed on the Indonesia Stock Exchange in the period of 2013 to 2017.

Firm size can be defined as an effort to measure the size of the company. In general, research in Indonesia uses total assets as a proxy of firm size. Companies that have large total assets show that the company has reached maturity stage where in this stage the company's cash flow is positive and is considered to have good prospects in longer period. Large companies that have more big profits to engage in tax avoidance transactions. In some cases large companies tend to have high tax payment problems, therefore some companies do various ways to make tax payments low, one of them by transfer pricing. The results of this study are consistent with research by Marisa (2017), that shows the firm size has a positive effect on transfer pricing. However this study is not consistent with research by Refgia (2017), that shows the firm size has a negative effect on transfer pricing.

## **5. Conclusion**

Variable tax has a significant positive effect on transfer pricing on manufacturing companies listed on the Indonesia Stock Exchange in 2013-2017. Tax motivation is one

reason manufacturing companies do transfer pricing by conducting transactions to affiliated companies that are outside the national boundary. Variable bonus mechanism has a significant positive effect on transfer pricing on manufacturing companies listed on the Indonesia Stock Exchange in 2013 - 2017. Bonuses are distributed on the basis of directors' performance which is measured by the current year's net profit divided by the previous net income. The bigger of bonus received by management, it makes the possibility of transfer pricing bigger. Variable firm size has a significant positive effect on transfer pricing on manufacturing companies listed on the Indonesia Stock Exchange in 2013-2017. Relatively larger companies are more interested in transfer pricing compared to smaller companies. However, Variabele tunneling incentive has no effect on transfer pricing on manufacturing companies listed on the Indonesia Stock Exchange in 2013-2017. This means that majority shareholding in the company does not affect decision making for transfer pricing.

This study has some limitations, among others: The selection of indicators is only based on the availability of information available at the annual report, but sometimes the information presented in the annual report is too minimal so that in seeking information there is still subjectivity in determining the value needed. The R-Square value in this study is still relatively small, which is 0.125578 or 12.55%, which shows that variables tax, tunneling incentives, bonus mechanisms, and firm size are only able to influence the transfer pricing transaction of 12.55%, meaning that there are still many variables other than research that can influence transfer pricing.

For further research it is recommended to enlarge the research sample not only limited to manufacturing companies, but also to companies that run in the mining, plantation, financial, and other sectors. Also further research can add another dependent variable so that the R square value in statistical tests can increase even greater than this study.

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