

## Analysis of PSM after implementation of CbCR policy in Indonesia

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### ABSTRACT

The Country-by-Country Reporting (CbCR) policy requires that multinational enterprises report financial information of all of their business group members globally. The presence of the information within such policy framework should be reviewed as to whether it will be useful for the Profit Split Method (PSM) implementation. This research used a qualitative approach with data collection techniques including indepth interview. The results indicate that in the future, the PSM will grow in urgency with the development of multinational enterprises and the Anti-BEPS (Base Erosion and Profit Shifting) project. However, the PSM implementation in Indonesia at the present time is still rare due to particular difficulties encountered by both taxpayers and tax authorities. CbCR data alone is not sufficient to be used as a basis for the PSM implementation. Nevertheless, CbCR can still be used by taxpayers as a basis for the PSM implementation in collaboration with other data and information.

### Introduction

Out of numerous tax avoidance schemes, transfer pricing manipulation is the most prominent, the most dominant and the most used tax avoidance channel (Heckemeyer & Overesch, 2017). Moreover, as main carriers of economic globalization, MNEs organise business globally and have the ability to use various schemes that involve affiliating parties. Through these schemes, MNEs are enabled to make decisions internally on unit prices of goods and services sold. Thus, the prices set can earn multinational enterprises 'tax benefit'.

In order to prevent increased erosion of state revenue out of tax avoidance practiced by MNEs, especially through the utilization of affiliate transactions, countries around the world make provisions on transfer pricing. The transfer pricing provisions currently prevailing mostly refer to the guidelines published by the Organization for Economic Cooperation and Development (OECD). The OECD in its published transfer pricing guidelines recommends the use of the arm's length principle (ALP) in determining affiliate transaction value reasonableness. As an approach widely accepted by multiple countries, the ALP still bears some weaknesses, either in the conceptual or practical aspect. Such approach will give MNEs artificial tax incentives to transfer their profits to low-tax countries (Kato & Okoshi, 2018).

Some parties, in the preceding time, recommended the use of an alternative approach, namely the Global Formulary Apportionment/GFA (Avi-Yonah et al., 2011; Buettner et al., 2021; Clausing & Yonah, 2007; Piccioto, 2012). However, the implementation of GFA has provoked a debate as well. The OECD (2017) exhibits an explicit rejection of that non-ALP approach. The ALP approach actually includes the Profit Split Method (PSM) which is perceived to share similarity with the GFA. The implementation of the PSM requires data from every entity of MNE groups globally. However, data has all this time posed the primary impediment to the PSM implementation.

As cited from Tax Justice Network's page (2012), a CbCR is compatible in theory with the unitary taxation and formulary apportionment systems as it provides an accounting bases for such approaches. However, the OECD in Paragraph 25 of BEPS Final Report Action Plan 13 asserts that CbC Report information should not be used by tax authorities to make an adjustment to transfer pricing based on the GFA approach (OECD, 2015). Similarly, the provisions under Article 10 Paragraph (6) of the Regulation of the Minister of Finance Number 213/PMK/03/2016 set out that such information should only be used for tax avoidance risk assessment purposes.

The country-by-country reporting requirement increases tax transparency (Dutt et al., 2019). The information contained in CbC Reports can, in fact, be used as a basis for the PSM implementation to provide solutions for the limitation and weaknesses of the transfer pricing method. Furthermore, the PSM is basically the right transfer pricing method after Base Erosion and Profit Shifting (BEPS) project. In relation to the aforementioned, this research seeks to understand comprehensively the implementation of the PSM as a transfer pricing method, especially after the implementation of CbCR policies, which were adopted from the Regulation of the Minister of Finance No. 213/PMK.03/2016 jo. PER-29/PJ/2017. Some problems underlying this research are as follows: First, how urgent is the implementation of the PSM amidst MNE and Anti-BEPS project development?

Second, how is the PSM implemented as a transfer pricing method in Indonesia? Third, how sufficient is the CBC Report data to be used as a basis for the PSM implementation in Indonesia?

Indonesia itself adopted and implemented the CbCR policy through the Minister of Finance Regulation Number 213/PMK.03/2016 concerning the Types of Documents and/or Additional Information that must be Stored by Taxpayers who Make Transactions with Parties with Special Relations. These provisions are promulgated and come into force on December 30, 2016. The next step, Indonesia has also participated in signing the Multilateral Competent Authority Agreement on The Exchange of Country-by-Country Reports (CbC-MCAA) on January 26, 2017 (OECD, 2017). This shows Indonesia's commitment as an inclusive framework member country to implement minimum standards that must be implemented from the Anti-BEPS Project. This study attempts to fill the research gap by analyzing the PSM after implementation of CbCR policy in Indonesia. Specifically, this study examines PSM more macro with a broader perspective and is associated with the existence of CbCR policies applied in Indonesia, not based on case studies of a particular transaction.

## Literature Review

### Theory

There are various reasons why MNEs are widely used as vehicles in carrying out business operations globally. Hennart (2005) through a transaction cost theory approach states that there are two fundamental reasons why companies need to expand abroad and establish MNEs. The first reason is structural market imperfection related to pecuniary externalities where each competitor drops each other through various forms of competition including price competition. Competition is considered to be able to reduce company profits. Therefore, the company is considering merging and trying to make products at the lowest possible cost. So that MNEs are used as vehicles to organize companies that join each other. The second reason is natural market imperfection. Hennart describes the decision tree with respect to market search and search for inputs (raw materials). The market can be obtained by companies through exports or by producing abroad. The materials can be obtained domestically or obtained from abroad. The choice to produce or obtain raw materials from abroad requires integration or affiliation with overseas parties. In this regard, MNEs are used to organize these international interdependencies.

Gonnet and Fris (2007) suggest four techniques for applying the analysis of contributions in PSM. First, Capital Investment Approach. Measurements of relative contributions are made based on the capital invested in intangible assets by each affiliate party. This approach is based on the economic relationship between capital investment, including investment in intangible assets and operating profit as a basis for determining the proportion of profit sharing. Second, Compensation Approach. Measurement of contributions is made based on labor costs. Labor costs that can include salaries, allowances and bonuses are then capitalized to describe the amount of time needed to make an intangible asset. The use of labor cost data is based on the assumption that these costs represent the economic value of the company created by employees (labor). Third, the Bargaining Theory Approach. Bargaining theory built from game theory can be a powerful tool for measuring the contribution of an entity, because it allows evaluation of the roles and contributions of each actor who collaborates in creating benefits and added value. Fourth, the Survey Approach. This approach can be applied to certain conditions where it is not possible to identify internal or external data to be used as a basis for analysis of contributions. This approach identifies the opinions of relevant industry experts, both from internal and external companies. The opinion is then converted into quantitative data so that it can be used for numerical assessment.

### Multinational Enterprises (MNEs)

MNEs in the Black Law Dictionary (Garner, 2004) are defined as a company that operates in two or more countries, thus allowing companies to transfer funds and products according to price and demand conditions, and consider risks such as changes in exchange rates or political instability. Theoretically, MNEs are entities that are integrated with each other. Eden (1998) classifies MNEs into two categories, specifically MNEs that have horizontal integration and MNEs that have vertical integration. Horizontal integration occurs when the compilation of two or more related companies from MNEs produces the same products or combines certain products in the evolution of the same supply chain. Vertical integration emerged in different stages in the supply chain carried out by different companies but still with intrafirm transfers. Li and Paisey (2005) added another type of MNEs organizing, namely conglomerates, where subsidiaries are not naturally related because business activities are carried out differently. In general, there are no inter-subsidiary transactions, direct transactions are conducted with the holding company as a service provider and internal funding.

### Transfer Pricing

In a neutral definition, Horngren et al. (2015) defines transfer pricing as the price charged by sub-units (departments or divisions) for products or services distributed to sub-units within the same organization. The transfer price

becomes revenue for the selling sub-unit and becomes a cost for the buying sub-unit, thereby affecting the operating income of each sub-unit. Therefore, transfer pricing can be used to evaluate the performance of sub-units and provide motivation for managers.

In the context of taxation, transfer pricing often refers to terms that are negatively connoted. Setiawan (2013) states that the negative connotation which is actually an abuse of transfer pricing is a transfer of income from a company in a country with a higher tax rate to other companies in one group in a country with lower tax rates so as to reduce the total tax burden on the group of companies. Eden (Darussalam & Septriadi, 2008) termed what is referred to as "transfer pricing manipulation" as an activity to increase costs or lower bills aimed at reducing the amount of tax liability.

### **Approaches in Transfer Pricing Analysis**

The Arm's Length Principle (ALP) is a prevailing approach in transfer pricing analysis as recommended by the OECD and adopted in various transfer pricing regulations in various countries around the world. ALP is built on the premise that the commercial and financial conditions of transactions carried out between independent parties are generally determined by market forces. Whereas when affiliates trade with each other, the commercial and financial conditions that are formed may not be directly affected by external market forces (OECD, 2017). Therefore, independent transactions that represent market power are considered as arm's length transactions and are used as a reference in evaluating transactions between affiliated parties (Kristiaji & Sejati, 2013).

### **Global Formulary Apportionment (GFA)**

Hellerstein (2005) defines formulary apportionment as a method for determining the profits of a company or group of affiliated companies attributed to the country by referring to a formula that describes the proportion of profit sharing from companies or affiliated companies based on factors / factors that reflect (considered to reflect) the main earning activities in the country. Weiner (1999) states that, although formulary appreciation is often referred to as unitary taxation, the two terms are not the same. Appropriation refers to the process of using a formula to allocate a certain portion of the total income of a company and its branches operating in several locations. While unitary taxation is a process of combining the functionally integrated operations of several affiliated entities in a group of companies that operate as a single economic enterprise into a single unit for taxation purposes.

### **Profit Split Method (PSM)**

PSM is a transfer pricing method that aims to eliminate the profit effect of special conditions which appear in affiliated transactions by determining the distribution of profits to the parties involved in the transaction on a valid economic basis. Unlike the other transfer pricing methods, PSM can be applied to complex transfer pricing cases (Sejati & Tobing, 2013).

The application of PSM begins with determining profit to be split and then dividing the profit based on a valid economic basis. There are two methods of profit sharing according to the OECD, namely contribution analysis and residual analysis. The contribution analysis splits the combined profit based on a reasonable estimate as profit sharing is carried out by an independent party for comparable transactions. If comparable data is not available, the division is based on the relative value of each function performed by each affiliated company

Residual analysis divides combined income through two stages. In the first stage, each affiliated company receives a reasonable allocation (initial remuneration) for contributions that are not unique (routine contributions) through the application of one of the traditional methods (CUP, RPM, or C+) or TNMM. Furthermore, the remaining profits are distributed based on a certain allocation basis that takes into account the facts and conditions of the transaction. The remaining residual income reflects the profit generated by non-routine contributions which are generally in the form of intangible assets of high value (Sejati & Tobing, 2013).

### **Research Method**

This research employed a qualitative approach with inductive flow of thinking, departing from a social phenomenon of the PSM implementation in transfer pricing analyses in Indonesia. This research sought to build understanding concerning CbCR policies and sufficiency of CbCR data to be used as a basis for the implementation of the PSM as a transfer pricing method. Understanding allowing for information interpretation was built through interactive relationships with research sources. In addition, this research also took into consideration the complexity of perspectives of different individuals with different focuses and contexts.

Data was collected using qualitative interview, e-mail correspondence, and qualitative document techniques. The qualitative interview technique was used against sixteen sources consisting of executives as policy-makers, associated parties and transfer pricing practitioners as well as academicians. Meanwhile, the qualitative document technique was used against OECD's official documents in relation to public commentary on the PSM

guidelines revision draft. Data analysis was conducted manually using the successive approximation strategy with some iterations to gather new data, especially to see the sufficiency of the CbC Report information for supporting the PSM implementation in Indonesia.

**Table 1.** List of the Selected Informants

No.	Informant's Institution	Informant's Position	Code
1	DGT's International Taxation Directorate	International Tax Senior Analyst	SIC1
2	DGT's International Taxation Directorate	Transfer Pricing Senior Analyst	SIC2
3	Directorate of Inspection and Billing of the Republic of Indonesia, DGT	Transfer Pricing Section Executor and Other Special Transactions	SIC3
4	Deloitte Tax Solutions	Transfer Pricing and International Tax Partner	SIC4
5	DDTC	Senior Manager of International Tax and Transfer Pricing	SIC5
6	MUC Consulting Group	Manager of Transfer Pricing and International Tax	SIC6
7	OECD CTPA (Centre for Tax Policy and Administration)	Senior Transfer Pricing Advisor	SIC7
8	NERA Economic Consulting	Affiliated Consultant	SIC8
9	BDO Indonesia	Transfer Pricing Leader	SIC9
10	Copenhagen Economic	Senior Economist	SIC10

## Results and Discussion

### The PSM Urgency Amidst MNE and Anti-BEPS Project Development

#### a) The PSM urgency in the context of MNEs business development

The needs for The PSM application are projected to constantly rise, especially with the fact that MNEs businesses are increasingly integrated and with the launch of Anti-BEPS Project by the OECD. In the past few years, there is an escalation of the PSM acceptance and usage, both by TP practitioners and tax authorities. There are two things influencing this: regulatory changes and business changes. The regulatory aspect is related to the changing perspective on the transfer pricing method selection in the OECD TPG from a hierarchical system to the most appropriate method. PSM is predicted to be a solution to overcome such complex transfer pricing issues.

*“From a regulatory perspective, the new OECD Transfer Pricing Guidelines changed the consideration of the PSM, from being a last resort method to one of the five described methods to be used in order to determine the arm’s length (AL) value of the intercompany transactions. At the same time, the OECD TP Guidelines softened the former hierarchy in the method selection, from the “CUP-preferred” to the “most appropriate” method approach. From a business perspective, the overall production and value creation process adopted by multinational enterprises (MNEs) changed from a pure sequential input-output approach, where each phase of the value chain was covered and managed by single group companies, to a multi-layer approach, where more group companies work in parallel on the same value chain phase in an integrated fashion. In addition, the need to control critical strategic phases of the value chain led MNE Groups to insource the latter, determining a lack of comparable uncontrolled transactions. These factors, among others, increased the difficulty for the MNE Groups to evaluate and price the contributions of the various group companies on a stand-alone basis, making use of the CUP or other one-sided methods. As a consequence, the PSM surged as a viable solution to solve complicated TP issues.” (Correspondence via e-mail with SIC10 a Senior Economist — Copenhagen Economic on 15 May 2018).*

In terms of business development, the process of value creation undertaken by MNEs today has also changed, from inclining to be managed by one sole company to be multi-layer-natured with involvement of a greater number of companies operating in parallel and integration. Informant SIC10 describes that the need for controlling strategic phases in value creation leads MNEs to make the multi-layered value creation process to take place internally. This has challenged MNE groups to conduct evaluation in isolation based on the CUP method or one-sided methods.

One of the conditions under which the PSM becomes the most appropriate method for analysing affiliate transaction reasonableness is when the business operations conducted by MNEs have a high degree of integration. Based on the classification of MNEs integration types proposed by Eden (1998) as well as Li and Paisey (2005), most MNEs operating in Indonesia combine vertical integration and horizontal integration. On the one hand, MNEs strive to create an internal market by acquiring a supply chain, but on the other hand, they also own other business lines. Informant SIC9 states that MNEs’ inclination to vertical integration will be suitable with the PSM application. However, this obviously must also be based on the most appropriate comparability analysis and method selection analysis.

#### b) The PSM urgency in the context of anti-BEPS project development

*BEPS Action Plan Item 1: Digital Economy*

The ALP implementation in the context of digital economy with all its digital products and services has been increasingly difficult as MNEs use a global value chain with a high degree of integration. In this case, the separation on a legal basis of MNE affiliates is considered less relevant from the economic perspective in digital economy businesses. For this reason, the OECD advocates the importance of value chain analysis and the PSM application to assure that profits in the digital business model are appropriate with value creation (Olbert & Spengel, 2017). Digital businesses, which are characterized as a business that is dependent on intangibles, integrated value chains, and unique structures, render the PSM the standard transfer pricing method for digital business (Olbert & Spengel, 2017)

*"... the industrial sector whose characteristics fulfil it is the digital economy industry sector, huh? Where they are related to each other, this IP cannot be developed by just one place, but this is indeed in each region there is a contribution of each. Actually, it's not right if we apply a method that is only one side. We must use methods that are several sides, divided according to each contribution. It is the industrial sector that fulfils the reasonableness analysis using the profit split method." (In-depth interview with SIC6 as Manager of Transfer Pricing and International Tax — MUC Consulting Group on March 23, 2018 at 14.15).*

#### *BEPS Action Plan Item 8: Intangibles*

In the context of determination of intangibles transaction reasonableness, difficulties to collect independent comparable data often arise. This is especially true when the contributed intangibles are unique and of value (Kroppen et al., 2012). Basically, the five transfer pricing methods have equal opportunities to be used in transfer pricing analyses involving intangibles or rights in intangibles. However, Paragraph 6.145 of the OECD TPG states that the most feasible transfer pricing methods to be used are the CUP and the PSM (OECD, 2017).

One-sided methods such as the RPM and the TNMM are not reliable in general when used directly to assess intangibles. The use of cost-plus- (C+) based methods is not recommended and should be avoided as correlations between cost plus and intangible values or transfer prices are rarely found after intangibles are developed (Paragraph 6.142). Nevertheless, under some conditions, the RPM and the TNMM can be used in the context of indirect assessment. That is, it is used with a mechanism of value setting for some functions that use one-sided methods, and later residual values on intangibles are obtained (OECD, 2017). This is what is called PSM with a residual analysis approach.

*"Yes, in practice we are CUP, in practice. But I actually agree with the OECD that split profits are right for intangible assessment. Because, actually it is not the intangible value that we will see, but from its contribution. This will affect the assessment of the intangible later." (In-depth interview with SIC6 as Manager of Transfer Pricing and International Tax — MUC Consulting Group on March 23, 2018 at 14.15).*

*"The point is in Indonesia there are many intangible properties. It's likely that the profit split. For many companies that have an intangible property in Indonesia. If there is a lot of IPR (Intellectual Property Rights), that is the possibility of PSM. The PSM depends on IP too." (In-depth interview with SIC9 as Transfer Pricing Leader — BDO Indonesia on May 17, 2018 at 09.20).*

#### *BEPS Action Plan Item 10: PSM Guidelines Revision*

The BEPS Action Plan Item 20 mandates clarification on the implementation of transfer pricing methods, especially the PSM in the context of global value chain (OECD, 2015). To figure out any problem arising in the PSM implementation, the OECD released discussion drafts containing a number of questions based on the scenarios developed by Working Party 6. The drafts were later published, and they received responses from stakeholders in the form of public commentary. To the present day, the OECD has published drafts of discussion on the PSM three times, namely on 16 December 2014, on 4 July 2016 and, most recently, on 22 June 2017.

Some specific questions were posed by the OECD in the 2017 Draft (OECD, 2017), namely those related to conditions under which the PSM becomes the most appropriate method, the use of anticipated profits and actual profits, profit sharing factors and additional scenarios in which the PSM becomes the most appropriate method. In the development, there are 45 institutions giving public commentary. Informant SIC7 as the Senior Transfer Pricing Advisor of the OECD confirms that the PSM guidelines revision are expected to be completed in the near future without too many changes from the discussion draft published in 2017.

*"The main reason that ALP is seen as vulnerable or even objectionable can be found in the complexity of business operations – this demands serious economic analysis (VCA) as the starting point for dealing with TP in the specific situation of each individual MNE or, where relevant, of each line of business within this MNE. Economic analysis to this extent goes further than most professional service providers can or are prepared to achieve. In my perspective, applying VCA and using PSM as (one of) the method(s) are the pillars for successfully operating and defending TP systems as the most appropriate reflections of the arm's length principle (ALP)." (Electronic correspondence with SIC8 as Affiliated Consultant — NERA Economic Consulting on May 21, 2018).*

*"We expect the revised guidance on the Profit Split method will be finalised very soon. We do not anticipate significant changes in the final guidance compared to the discussion draft published in mid-2017, however the examples have been substantially revised following the public consultation process that we undertook in the last part of 2017." (Electronic correspondence with SIC7 as Senior Transfer Pricing Advisor — OECD CTPA on April 13, 2018).*

## The PSM Implementation in Indonesia

### a) The PSM implementation by taxpayers in transfer pricing document conception

On the taxpayer side, the PSM is rarely used in transfer pricing analyses as contained in local documents. Informant SIC6 explains that such rare usage is caused by the difficulty to collect partnering transaction affiliates data. Every entity involved in a transaction basically has a separate legal status. Although as a member of an MNE group an entity shares the same goals and resources with other members, it still has its own interest. Thus, it is often difficult to access internal data even of affiliates in the same business group.

*"Because each entity has its own interests, and this is supported by the OECD, and it is stated that we must position each entity as separate entities. With such existence, each of them has an interest right, with such data will be difficult to be more open. Thus, the implementation of profit split itself will be difficult." (In-depth interview with SIC6 as Manager of Transfer Pricing and International Tax — MUC Consulting Group on March 23, 2018 at 14.15).*

Furthermore, difficulties to determine consolidated profits also arise in the PSM implementation. The (OECD, 2013) states that the relevant profits to be split in the PSM implementation are the profits of affiliates that have relevance with a specific transaction subject to the PSM implementation. In other words, if a taxpayer earns profits from a different transaction, the profits are not considered as relevant profits, and thus, must be separated from the profits to be split. In practice, enterprises seldom do such segmentation.

*"... for outside entities, it's likely they don't make segmentation for activities that are from Indonesia only. Because what can be combined is all income associated with activities in Indonesia. We will not be combined the income of overseas entities from other overseas parties. Thus, it has to be segmented. In practice, they never make segmentation. Thus, we can't attract all of their profits. It must be segmented for sales to Indonesia only." (In-depth interview with SIC2 as Transfer Pricing Senior Analyst — DGT's International Taxation Directorate on April 26 2018 at 08.00).*

Meanwhile, Informant SIC4 shares his perspective that the rarity of the PSM implementation is caused more by little interest of taxpayers in it. This is especially true because the OECD has limited the PSM implementation only to certain conditions that are complex. According to him, the PSM can actually be used for all kinds of transactions and is not limited to only complex conditions. Besides, the difficulty to identify factors influencing profits to be used as splitting factors still poses a problem.

*"PSM itself is a concept to share profits, so we can use it for every transaction that is not complicated - we can only use PSM. Yes, so ... more precisely because it doesn't want to be like that. Rather, because OECD itself has limited the use of PSM, it is only suitable if two parties create intangible assets. Even though it really doesn't need to be... Besides identifying factors that affect revenue and income. This factor will later become the basis for allocation in PSM. That's the difficulty." (In-depth interview with SIC4 as the Transfer Pricing and International Tax Partner — Deloitte Tax Solutions on May 9, 2018 at 21.00).*

Informant SIC1 expresses another reason why this method is rarely used. This is related to taxpayers' worry about the PSM implementation that is considered to allocate a greater amount of profits. A greater allocation will cause the amount of profits subject to tax considered reasonable to swell. Thus, the value of tax payable will be greater, too. Characterized as always striving to maximize global after-tax profits, MNEs definitely will try to avoid a great deal of taxable profits.

*"... especially if the Taxpayer is clear, because later they have to pay or have a higher profit. If you are a taxpayer, you want to use TNMM, the only benefit is that it is small." (In-depth interview with SIC1 as International Tax Senior Analyst — DGT's International Taxation Directorate on March 13, 2018 at 14.20).*

However, it is important to note that the rarity of the PSM implementation is not due to the absence of MNE group members meeting the indicators of the PSM implementation. When looking into the conditions of MNEs in Indonesia, many of the enterprises actually have met the criteria to use the PSM in their transfer pricing policy. Today's trend is, virtually all enterprises implement the PSM. This is especially true with some market countries' arguments on fair share.

*"... but make no mistake, Indonesia is still sparse, but we already have a case in the court that came out and has won over the profit split, and it already exists. Thus, in my opinion, we are not left behind, instead, we are more advanced, a little indeed, but it does not mean lagging behind. Because globally there are very few, in Asia there*

*are countries that have never implemented a profit split.” (In-depth interview with SIC1 as International Tax Senior Analyst — DGT’s International Taxation Directorate on March 13, 2018 at 14.20).*

Informant SIC2 also mentioned that there had been cases where Taxpayers used PSM and then corrected by DGT using other methods. This is because the PSM is applied by taxpayers based on profit-loss consolidation globally. Even the MNEs’ group position at that time was a loss, so Indonesia also suffered a loss. In fact, from the FAR analysis conducted by the DGT, in fact the Taxpayers did not suffer a single loss. Although PSM gives equal treatment to the position of profit and loss, Informant SIC2 states that not only do taxpayers use PSM when they lose. Whereas if profit, use TNMM or other methods.

*“... there are cases in the trial, the WP absorbs PSM, but globally. All MNEs in the world, not only transactions in Indonesia with one country, but all, global profits are split. That is not GFA split profit. Yes, indeed at the OECD TPG does not say that PSM can only be applied to two parties, can it be more than that. Yes, but if it is like that, basically using a console, if it is compromised, Indonesia will suffer losses, even if it is seen in terms of function, assets and risks, Indonesia does not lose. Thus, we have to bear the loss right, when the loss is divided by the loss. When profit doesn’t use profit split.” (In-depth interview with SIC2 as Transfer Pricing Senior Analyst — DGT’s International Taxation Directorate on April 26, 2018 at 08.00).*

## **b) PSM implementation and audit**

In the context of audit, there have been some transfer pricing disputes, in which taxpayers’ methods were corrected, and tax authorities used the PSM. However, some cases tend to deviate from the guidelines published by the OECD. The PER-32 and the PER-22 only provide simple examples. In fact, the PSM implementation takes some crucial steps, for example the determination of consolidated profits and factors to be used as a basis for profits apportionment needing careful consideration.

Informant SIC2 states that the PSM implementation in the context of DJP (the Direktorat General of Taxes) audit in essence will face significant challenges. To achieve transfer pricing outcomes that are fair and reliable, auditors must understand the nature of transactions and each party’s contributions to the transactions. Likewise, to determine consolidated profits and splitting factors, it is necessary to have comprehensive financial data, either from taxpayers or from affiliating parties overseas. Thus, such factors will result in profit sharing that objectively reflect contribution of each party.

*“... but it can’t be applied on inspection. It is impossible, the obstacles are huge when we apply to the examination. Because, to be able to absorb the profit split, we have to know the combined profit right. That means we have to have the data there the income follows the cost. Then it can enter combined profit. If we can’t get it, it seems like we can’t apply the profit split fairly. Because if the data doesn’t exist, then we are composing, we are deemed, it is not fair also for the Taxpayer ... To some extent, it can be right, but mostly not, afraid of that. If the data is full, that means if it’s correct, comprehensive, then the splitting factor can be objective, the contributonal percentage can be objective. If it is possible, usually at the MAP or APA level at the authority level, sitting together, the data is all there, then we can only apply profit split.” (In-depth interview with SIC2 as Transfer Pricing Senior Analyst — DGT’s International Taxation Directorate on April 26, 2018 at 08.00).*

Informant SIC3 describes some difficulties to encounter in the transfer pricing auditing, especially by those who will implement the PSM as their analysis method. The difficulties are related to data availability, taxpayers’ willingness to cooperate and auditing resources’ capability. Informant SIC3 agrees that the data required to produce fair and reliable analysis outputs is not always available. Problems also occur in the reliability and completeness of the data provided by taxpayers. Some information can only be made available by taxpayers, but they (for one reason or another) are unable to provide the data needed because the head office did not allow them to hand over the data or they did not find any relevant data from the head office.

*“... it needs data that is very ... complete. Reliability of data, then complete data itself from WP. Thus, you have to open it for the examiner to be able to calculate it right ... It used to be possible for EOI, only what is called EOI, if we are waiting, it can hinder the time of inspection. Can it last long or not. Like if people ask, they can answer or not. We can’t force people to answer quickly ... Thus, when the examiner asks for EOI, it doesn’t stop the inspection time. The check continues without waiting for EOI results. In the past, maybe the weapon was EOI, but it wasn’t automatic ... If at least there is at least CbCR or AEOI ... Thus, it can be used for re-examination if EOI data arrives after the inspection is complete, and the EOI data that comes is material, it can be opened again.” (In-depth Interview Results with SIC3 Transfer Pricing Section Executor and Other Special Transactions— Directorate of Inspection and Billing of the DGT RI on May 21, 2018 at 13.33).*

In the inspection process, taxpayers are certainly required to be cooperative, especially in providing data and/or information needed by tax auditors. Informant SIC3 states that there is some information that can only be obtained from taxpayers. Whereas the Taxpayer himself, for one reason or another, may not be able to provide the necessary data. For example, because the head office does not allow taxpayers to provide data or

because taxpayers do not obtain the relevant data at all from the head office. This was conveyed in the following interview excerpt:

*"Cooperation of taxpayers, of course. In essence, what is known by the WP must be given to the examiner ... To know the function of the children or only the parent, and the examiner has no access to that information other than the WP itself. And that's one of the openness constraints of WP ... And sometimes it's not just because the WP is not cooperative, it could be that he really doesn't have access to it. Like, for example, the WP said 'I am not given the same centre, I can't give it anyway.' Thus, it's not because he doesn't want to give, but because he is not given the central permission to give." (In-depth Interview with SIC3 as Transfer Pricing Section Executor and Other Special Transactions — Directorate of Inspection and Billing of the Republic of Indonesia DGT on May 21, 2018 at 13.33).*

Moreover, there is inequality in the capabilities of DJP officers, especially auditors, with regard to transfer pricing. Some auditors have a strong understanding on the transfer pricing concept so they are able to generate reliable and accurate auditing results. However, some others have no understanding on the very same matters at all.

### c) The PSM implementation in MAP and APA processes

The PSM is ideally implemented in the MAP or APA process, in which each jurisdiction sits together at a negotiation table. This is because when the PSM is implemented one-sidedly in the auditing context but the jurisdiction in which the transaction partner is domiciled disagrees with the transfer price changes so it refuses to make any corresponding adjustment, any correction to the transfer price will instead lead to double taxation. Moreover, in the MAP and APA contexts, the two parties represented by their states will expose their data, so the difficulty to collect data from foreign affiliates will be tackled.

*"In practice, even if we use profit split, it is in the context of APA. Because if Indonesia determines its own splitting factor, it is not necessarily the opposite country of the transaction also agrees. So inevitably in practice, we use that also in the context of APA. We may first debate the APA about justice. 'Wow, Indonesia feels more of its portion, the country says its arguments are technical.' But in the end what? negotiation. How about the profit split? So, it is unrealistic to use profit split which will cause double taxation if you don't sit together with the countries involved." (In-depth interview with SIC5 as Senior Manager of International Tax and Transfer Pricing — DDTC on February 14, 2018 at 17:35).*

Still, MAP and APA practices in Indonesia are pervasive. According to the MAP statistics gathered by DJP in 2016, the number of MAP cases early of the year reached 62, where 19 of which were transfer pricing cases. Until the end of the year, 32 cases were settled, and the remaining 30 were left unsettled, including 14 remaining unsettled transfer pricing cases. In other words, DJP only managed to settle 5 transfer pricing cases throughout the year. Indonesia itself did not release a special report that outlined the application of APA and MAP transfer pricing in detail by covering the methods used. Informant SIC1 explained that at this time there was no reason to make this matter urgent.

*"Indonesia has never disclosed ... if the method is APA, it doesn't seem like that. Because the information is opened, we don't know what the benefits are. After all, we can't use it too, for example, this taxpayer case cannot be used for other taxpayers." (In-depth interview with SIC1 as International Tax Senior Analyst — DGT's International Taxation Directorate on March 13, 2018 at 14.20).*

Although there were no detailed methods released, Informant SIC2 explained that Indonesia had tried several times using PSM. However, the debate to agree on some crucial parts of PSM (such as dividing factors) of profit is not easy. So that countries will think practically and find it easier to use TNMM. In addition, many countries are still not familiar with the application of PSM. However, Informant SIC2 is optimistic that after the release of the final draft of the OECD Community Participation Guidelines, more and more countries will be open to applying the method in the MAP and APA processes.

*"Yes, we already tried a few times. But, the debate about using PSM is not easy. Because those countries will think practically, it's better to use TNMM, aggregate base than we use profit split. To determine the splitting factor just isn't easy, you have to specify the percentage, between Indonesia and other countries. If that (final PSM guideline) has come out, perhaps countries will be more open to using profit split. Because, finally the interest is to divide profits, to share profits to be taxed." (In-depth interview with SIC2 as Transfer Pricing Senior Analyst — DGT's International Taxation Directorate on April 26, 2018 at 08.00).*

### Sufficiency of CbC Report Data as a Basis for the PSM Implementation

The year 2018 will be the first year in which tax authorities of countries joining the BEPS Inclusive Framework gain information relating to business group revenue, profits, tax and some other attributes of large MNEs operating in their countries. This has been unprecedented, so it can open a considerable opportunity for tax authorities to understand the MNEs' business structure in an unprecedented manner (OECD, 2017). The information must be



packaged according to the policy framework of CbCR that must be delivered by Partner Entities in respective country of domicile. Under certain conditions, CbC Reports can also be delivered by the Constituent Entities of a business group.

CbC Reports must be delivered in the form of digital copies with the XML (Extensible Markup Language) extension. CbC Report XML files can be delivered through DJP's online portal (DJP's Press Broadcast, 13 April 2018). After receiving the CbC Reports from taxpayers, tax authorities will upload the reports to an electronic platform provided by the OECD called the common transmission system (CTS). Then, the CbC Reports are exchanged with the tax authorities of another jurisdiction in which MNE group members are domiciled with the status of either a resident in such jurisdiction or a Permanent Establishment (OECD, 2017).

CbC Report exchange is done under the provisions of international agreements, including the Convention on Mutual Administrative Assistance in Tax Matter (CMAA), the Bilateral Tax Agreement (BTA) which contains provisions on information exchange based on Article 26 of the OECD Model Convention, the Tax Information Exchange Agreement (TIEA) which contains automatic information exchange and the Qualifying Competent Authority Agreement (QCAA) which contains operational details of CbC Report exchange (OECD, 2017). The CbC Reports received by DJP are subsequently managed for risk analysis purposes in order to gain profiles of taxpayers with a high level of tax avoidance risk. The management is conducted through a cooperation between the Directorate of International Taxation, Directorate of Tax Potential, Compliance and Revenue and the Directorate of Audit and Collection.

The BEPS Action Plan Item 13 as contained under Chapter V of the OECD TPG stipulates three principles required for the procurement and utilization of CbC Reports: confidentiality, consistency and appropriate use (OECD, 2017). Tax authorities are obliged to maintain CbC Reports confidentiality in several ways, including limiting information usage, determining which parties are allowed to access information, guaranteeing that the information is inaccessible to public, among others. They are also required to use standard templates as contained in Annex III Chapter V of the OECD TPG and are not allowed to require any information other than that contained in those templates. Finally, CbC Reports are only used for estimating transfer pricing risks and other BEPS risks. In no way are tax authorities allowed to use the information to make adjustments to taxpayers' income based on allocation formula from CbC Report data.

Although it is true that CbC Reports provide financial information describing gross revenues of all MNE group members, and that other information such as the capital amount, the number of employees and total assets, which, if seen from the PSM concept as delivered by the OECD, can be used as splitting factors, after reviews of various literature were conducted, reinforced by the perspectives of this research sources, we found some problems or difficulties that may arise if the financial data and information contained in the CbC Reports are directly used for conducting transfer pricing analyses using the PSM. The problems are classified into two categories, namely juridical-aspect-related problems and practical-aspect-related problems.

#### **a) Juridical-Aspect-Related Problems**

Juridical-aspect-related problems in this context refer to problems arising from inconsistency with prevailing CbCR-related regulations, especially regarding the principles of appropriate procurement and use. Currently, the domestic legal framework that contains provisions on the usage of CbC Report information is Article 10 paragraph (6) of the PMK-213/2016, which covers the principle of appropriate use, emphasizing that CbC Reports can only be used to analyse high-level transfer pricing risks, to analyse other BEPS-related risks or, if appropriate, to analyse statistics. Thus, the data cannot be used as a basis for correction, especially if the correction is done based on the GFA.

Indonesia will face a sanction if it is caught having violated the principle of appropriate use in the form of prohibition of receiving CbC Reports from other jurisdictions while still being obliged to share the CbC Reports provided by domestic taxpayers with other jurisdictions. The OECD has developed a scheme to make sure that CbC Reports are used appropriately. This scheme includes the following: making the principle of appropriate use as a requirement for receiving and using CbC Reports; fostering commitment to revelation of violation of the principle of appropriate use; fostering commitment to promptly acknowledge any form of adjustments made by other competent authorities; and granting power to competent authorities to temporarily defer CbC Report exchange if non-compliance of a partnering competent authority is found (OECD, 2017).

#### **b) Practical-Aspect-Related Problems**

CbC Report Data Alone is Insufficient for Illustrating Value Creation and Conducting Functional Analyses of MNEs' Businesses

CbC Reports basically list information on the location of MNEs group income, tax and MNEs' business activities organised per jurisdiction. The reports also cover business activities of every constituent entity in a business group. However, the main business activities listed in the CbC Form 2 will not directly provide a picture on the

value creation of each entity because how important an activity conducted by each entity is and how much the activity contributes to the business group's profit generation cannot be identified.

#### CbC Report Data is Aggregate Data and Does Not Reflect Transaction after Transaction

Transfer pricing methods essentially are based on transactions and are not aggregately based on whole entities. This also applies to the PSM. Affiliate transactions that are suitable to be used as a subject of the PSM implementation must be identified from the beginning. Not all gross revenue, asset, capital, and number of employees' values listed in CbC Reports are necessarily related to the transactions that become subjects to the PSM implementation. The values listed in CbC Reports are not necessarily related to affiliate transaction either. The values may also include transactions with third parties supposed to be predetermined.

#### CbC Report Data Exchange Only Includes the CbC Form 1 and the CbC Form 2

The CbC Reports to be exchanged between jurisdictions are only inclusive of the CbC Form 1 and the CbC Form 2. The CbC Form 3 that lists additional information and explanation is excluded, and so is the CbCR worksheet. The values of gross revenue, asset, capital and others contained in the CbC Form 1 are consolidated values of one country, so the value of each entity in a country will not be identifiable if there are more than one entity in that country.

#### Potential Inconsistency/Mismatch of the Accounting Principle Used in CbC Reports

CbC Reports cover gross revenue data. The PSM guidelines give two options of splittable profits: gross profits and operating profits. Either profits chosen must apply uniform accounting principles and standards. If the accounting principles and standards applied are not consistent, the PSM implementation will be biased, especially when consolidating and apportioning profits to each affiliating party. Meanwhile, the CbCR Implementation Guidelines under Annex 3 Chapter 5 of the OECD TPG state that adjustment is unnecessary if a difference in the application of accounting principles by different MNEs group members within different jurisdictions exists (OECD, 2017).

*"Because of that, in applying profit split we must ensure that the data used are data related to the transaction, then the accounting principles used must also be consistent, between party 1 and party 2. This must be consistent, otherwise it will be biased. When we combine and share it." (In-depth interview with SIC6 as Manager of Transfer Pricing and International Tax — MUC Consulting Group on March 23, 2018 at 14.15).*

#### Polemic of the Use of the Information on the Number of Employees as a Splitting Factor

One of information pieces contained in CbC Reports is the information of the number of employees. The information on the number of employees was initially perceived to have the potential to be used as a splitting factor. However, given the development of the PSM guidelines discussion draft, the use of the information on the number of employees still causes a polemic in the sense that there is an absence of unanimous consensus of commentators on the urgency, advantages and disadvantages of the use of this factor. Informant SIC1 also argues that the use of employee quantity as a splitting factor will lead to bias as quality and contribution vary between employees.

*"If you use the number of employees, here are a thousand employees, there are only ten, but there will determine the direction of company policy. Once the design fails, the company breaks down, they go bankrupt. Or vice versa, there is only administration, accounting, legal service, but here if nobody can do it, it's hard, right?" (In-depth interview with SIC1 as International Tax Senior Analyst — DGT's International Taxation Directorate on March 13, 2018 at 14.20).*

#### The Access to CbC Report Data is Limited

Not all DJP employees are able to directly access CbC Report raw data. The CbC Reports received by DJP either from taxpayers or from partnering jurisdictions will be managed by some directorates. After analysis, the results will be delivered to the auditing function of each KPP. With such limited access, DJP auditors will not be able to flexibly use CbC Report data as a basis of the PSM implementation. Auditors will only be able to take further compliance actions (if necessary) according to the recommendations of taxpayers' CbC Report analysis results.

*"Thus, this data, most likely it won't be accessible directly by the examiner, for example, it can't. Because we have to remember that we can get a CbCR agreement that is difficult, and to be able to participate in this agreement there are some things that we must fulfil, one of them is the appropriate use. If we violate the appropriate use, let alone breach, they will close everything, we cannot exchange again." (In-depth interview with SIC1 as International Tax Senior Analyst — DGT's International Taxation Directorate on March 13, 2018 at 14.20).*

#### Difference in the Timing of CbC Report Provision and Timing for Conducting Transfer Pricing Analyses

CbC Reports as stated under Article 2 paragraph (1) of the PER-29/PJ/2017 must be available no later than twelve months after the end of a tax year. In other words, the data contained in CbC Reports is actual data after transaction

and even after closing the book of the tax year in question (ex-post). Meanwhile, the PKKU implementation in transfer pricing analyses must be based on the data and information provided at the moment the transaction is made (ex-ante), as set out under Article 3 paragraph (1) of the PMK-213/2016. Thus, the difference in the timing of CbC Report provision on an ex-post basis and the timing for conducting transfer pricing analysis on an ex-ante basis will make it difficult to use CbC Report data as a basis for the PSM implementation.

*"... in PMK 213 it is required that the application of the fairness principle including the application of the method be carried out at the time of the transaction, in contrast to CbCR which is prepared twelve months after the end of the tax year. This is a time difference, where if we use CbCR data, this does not meet the conditions specified for the transaction. Thus, there is a risk of not fulfilling PMK 213 and may not be considered documentation." (In-depth interview with SIC6 as Manager of Transfer Pricing and International Tax — MUC Consulting Group on March 23, 2018 at 14.15).*

As an illustration, if Taxpayers will make transfer pricing documentation for 2018, it should be based on the 2018 Year budget or actual 2017 profit-loss. Whereas, CbC Report from the 2017 Tax Year, is only available at the end of 2018. It will be very difficult if it is solely based on the application of PSM for analysis of transfer pricing 2018 in the CbC Report document. Some of these difficulties reveal a challenge for both the tax authorities and Tax Payers when applying PSM based on CbC Report data. In addition, several difficulties related to technical aspects also indicate the importance of using data and other information as a companion to the CbC Report if it will be used in the application of PSM. In connection with this, Informant SIC5 expressed his opinion that CbCR data is only numeric data, which needs to be confirmed again through other documents. Moreover, if indirectly, the CbCR data is used as a prefix in applying PSM by the examiner.

*"... this is just a number, that number is indeed possible, people have many interpretations of that number. Now that's what is worrying because every number must have a story behind it. Before we judge the number, we should first look at the story. At least Taxpayers can explain first. Don't make adjustments based on the CbC Report only. That is very dangerous. As we see the financial statements, without asking for an opinion again, immediately interpret yourself. That is certainly a danger. This is just an excel, but there must be a story behind it. We don't want to have to listen first. That's why there are master files and local files too, so it's a single entity, so there must be a context first. Don't just judge from XML..." (In-depth interview with SIC5 as Senior Manager of International Tax and Transfer Pricing — DDTC on February 14, 2018 at 17:35).*

## Conclusion

The PSM as a transfer pricing method will be increasingly urgent in the future. This is due to the fact that MNEs' business development heads towards a model that is increasingly integrated and reliant on intangible property. Moreover, the BEPS Project which discusses digital economy and intangibles also develops towards the preference of PSM implementation in the arm's length analysis of affiliate transactions in relation to the two matters. The increase in PSM urgency in the future is also based on the needs for fair profits allocation between taxation jurisdictions.

Currently, the PSM implementation in Indonesia, both by taxpayers and tax authorities, is still considered rare. This is due to numerous difficulties. In the context of the PSM implementation by taxpayers, some difficulties faced during the conception of transfer pricing documentation are as follows: (a) Difficulties to collect comprehensive data and information from all parties involved in a transaction; (b) Difficulties to determine relevant consolidated profits to be split because enterprises rarely make segmentation per affiliate transaction; and (c) Lack of taxpayer interest in the PSM implementation.

Meanwhile, in the context of auditing, there have been some cases in which the PSM was not implemented in accordance with the prevailing guidelines, so the outputs produced are not objective. CbCR policies enable DJP to gather key financial data and information from MNE groups operating in Indonesia. However, CbC Report data alone is not sufficient to be used as a basis for the PSM implementation, especially by DJP, as juridically, it is not allowed by prevailing regulations. If DJP uses the data as a basis for correction, Indonesia will no longer be able to gain CbC Report data from partnering jurisdictions. In terms of the technical aspect, the data contained in CbC Report is not compatible to be used in the PSM implementation, unless it is used in combination with other data and information.

This study has at least two main limitations. First, this study analyzes PSM after implementation of CbCR policy in Indonesia only. Further studies can conduct comparative studies with other countries. Second, this study has not been able to involve informants from the tax payer's side. Further studies can also involve informants from the taxpayer's side to get another point of view from the implementation of PSM after implementation of CbCR policy.

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