Tax Audit of Transfer Pricing Cases Derived from Intangible Assets: A Study of Selected Tax Court Cases in Indonesia

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ATTESTATION OF AUTHORSHIP

“I hereby declare that this submission is my own work and that, to the best of my knowledge and belief, it contains no material previously published or written by another person (except where explicitly defined in the acknowledgements), nor material which to a substantial extent has been submitted for the award of any other degree or diploma of a university or other institution of higher learning.”

Abdul Haris Muhammadi

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ETHICS APPROVAL

The Application for Ethics Approval by AUTEC (EA1) was submitted on 31 January 2013. On 25 February 2013 a letter concerning *Ethics Application: 13/18 Tax audit of transfer pricing cases derived from intangible assets: A case study in Indonesia* from Dr Rosemary Godbold, Executive Secretary of the Auckland University of Technology Ethics Committee, was received. The letter outlined that the AUTEC approved the ethics application subject to four conditions.

An amendment to the EA1 was made and resubmitted to the AUTEC Team on 3 March 2013. On the following day, 4 March 2013, Dr Godbold sent a letter regarding *Ethics Application: 13/18 Tax audit of transfer pricing cases derived from intangible assets: A case study in Indonesia* advising that the ethics application had been approved for three years until 4 March 2016.

ABSTRACT

In the absence of market forces, transactions between affiliated companies can lead to distortion of the amount of tax that should be paid to government. The OECD introduced the 'arm's length' principle, which uses comparable transactions to overcome that problem. However, identification of comparable transactions, especially for intangible assets, is very challenging. The objective of this research is to investigate how Indonesian tax auditors cope with transfer pricing cases derived from intangible property. Qualitative methodology was deemed most appropriate and a case study approach was adopted. The methods used were document analysis and interviews. A combination of thematic analysis and document analysis was then employed to analyse the data.

This study finds difficulties faced by Indonesian tax auditors during the audit of transfer pricing cases derived from intangible property include: a lack of transparency in bookkeeping; limited taxpayer cooperation in providing data and documents; current regulations; and problems related to organisation and human resources. The study also finds that Indonesian tax auditors and tax officials cope with transfer pricing cases derived from intangible assets by using legal bases, e.g. Article 18 paragraph 3 of the Income Tax Law and domestic regulations, contracts entered into among affiliated enterprises, and OECD transfer pricing guidelines as references; and by role specialisation: i.e. tax auditors, heads of district tax offices, the head office of the Directorate General of Taxes, and account representatives all have distinct roles.

The study suggests that Indonesian tax auditors perform the following tasks: conduct in-depth analysis of taxpayers being audited, seek evidence of the existence of intangible property owned by taxpayers, classify intangibles, look for evidence of benefits received by taxpayers from intangible property, find comparables for intangible asset transactions, find 'arm's length' prices for intangible asset transactions, verify transfers of intangible property, verify the entitlements of intangible property. Further, the study also finds that the head of the district tax office acts as leader and inspiration for tax auditors in performing audits, and as quality assurance for audit work. Moreover, the study finds that the role the head office of the Directorate General of Taxes commences when the Directorate of Tax Audits and Collections, and the Directorate of Tax Regulations II, coordinate with each other in providing assistance to the tax auditors who carry out transfer pricing audits, and in interpreting transfer pricing rules and regulations. The Directorate of Tax Audits and Collections also coordinates with the Directorate of Tax Objections and Appeals in reviewing decisions of tax courts what are unfavourable to the Directorate General of Taxes. Finally, the study discovers that the account representatives provide support to the tax auditors handling transfer pricing cases in providing data and in-depth analysis on transfer pricing cases, before taxpayers are officially audited by tax auditors.

LIST OF ABBREVIATIONS

EY	Ernst & Young
CPM	Comparable Profit Method
CUP	Comparable Uncontrolled Price
CUT	Comparable Uncontrolled Transaction
DGT	Directorate General of Taxes
IAS	International Accounting Standard
IP	Intangible Property
IRC	Internal Revenue Code
IRD	Inland Revenue Department
IRS	Internal Revenue Service
ITA	Indonesian Tax Authority
MAP	Mutual Agreement Procedure
MNE	Multinational Enterprises
OECD	Organisation for Economic Co-operation and Development
TP	Transfer Pricing
TPO	Transfer Pricing Officer

CHAPTER ONE – INTRODUCTION

This chapter provides brief overviews of the Indonesian tax regime for transfer pricing and of intangible transaction disputes in Indonesia. The purpose of the research and the research questions are outlined, and an overview of chapters is presented.

1.1 Overview of the Indonesian Tax Regime on Transfer Pricing

In the last decades, Indonesia has attracted overseas investors interested in the country's abundant natural resources, lower cost of production and potential market, with its population of approximately 240 million. Foreign investors, as parent companies, have set up entities in Indonesia in the form of branches or subsidiaries. In general, from 2008 to 2012, foreign direct investment inflows to Indonesia increased significantly from US$4.9 billion (2008) to US$19.9 billion (2012) (OECD, 2013)[1].

Navarro and Mukanov (2012) claim that transfer pricing transactions taking place in Indonesia between a parent company and its branch, or subsidiary, increased significantly due to the remarkable growth in foreign direct investment, which started from the mid-1960s and occurred in many forms. An Indonesian entity might take natural resources from Indonesia and sell them to its branch or subsidiary in other countries. Another variant might involve an Indonesian entity acting as a contract manufacturer: purchasing raw material from its overseas-related parties, producing goods based on the order of its head office or other related parties located overseas, and sending the finished goods to other countries on behalf of its affiliated enterprises. In another variant, a parent company, for example a car manufacturer, electronic-devices manufacturer or software producer, might provide assistance with know-how, management and technical skill for the Indonesian entity, in return for which the parent company would receive a significant amount of compensation in the form of royalties, technical, 'and/or' management fees.

Borkowski (2001) and Li (2005a) claim that, following the increase in foreign direct investment, the conflicts between multinational companies and tax authorities in both host and home countries amplify, as the multinational enterprises try to reallocate their income from higher to lower tax jurisdictions in order to minimise their total tax burden and maximise profit. Moreover, a considerable fiscal problem emerges, since intra-group transfers offer multinational enterprises a substantial chance to decrease taxes, lower the corporate tax base, and discriminate against domestic corporations (Benshalom, 2013). Responding to the actions taken by multinational enterprises, Li (2005a) finds that tax authorities enforce their legislative and regulatory tools on multinational transfer pricing practices. Therefore, the likelihood that multinational enterprises will be audited, is increased.

[1] OECD: Organisation for Economic Co-operation and Development

The fairness of the price being decided upon could be an issue, since it is settled among related parties, and market forces do not influence affiliated transactions significantly (OECD, 2010a). For this reason, the 'arm's length' principle[2] is often considered to be inapplicable to transactions between Indonesian enterprises and their foreign-related parties, since one party has significant influence over the others. It is assumed that prices can be set, owing to the absence of market forces, so that the amount of taxes payable to the government could be distorted.

According to the Indonesian Income Tax Law, Indonesia adopts a self-assessment system[3] so that taxpayers are granted the right to define, calculate, and pay their own taxes, and a tax audit might take place for refund claims only, or for special circumstances such as transfer pricing, merger, or acquisitions. When initial analysis conducted by account representatives indicates transfer pricing, tax auditors play a significant role. Tax auditors are responsible for ensuring that the government receives the appropriate amount of revenue resulting from transfer pricing transactions, and are granted rights by the tax laws and regulations, to carry out rigorous examination and investigation of taxpayers. For this reason, they make appropriate adjustments to related-party transactions after a series of tax audits have been performed.

Transfer pricing provisions are stipulated in Article 18 of the new Indonesian Income Tax Law which took effect from 1 January 2009. These provisions require taxpayers conducting affiliated transactions to adopt the 'arm's length' principle. In order to apply the 'arm's length' principle, taxpayers are obliged to undertake comparability analysis, determine comparable transactions, and provide transfer pricing documentation (EY, 2011). Article 18 paragraph (3) of Income Tax Law Number 17 Year 2000 provides an authority to the Director General of Taxes to adjust and redistribute income and expenses of related parties when calculating taxable income so that transactions between affiliated parties are treated as those of independent parties. The term "*related taxpayer*" is explained further in the Article 18 paragraph (4) of Income Tax Law number 17 Year 2000 as follows:

a. A taxpayer who owns directly or indirectly at least 25% of the equity of other taxpayers; a relationship between a taxpayer through ownership of at least 25% of the equity of two or more taxpayers, as well as a relationship between two or more taxpayers concerned;
b. A taxpayer who controls other taxpayers; or two or more taxpayers directly or indirectly under the same control;
c. A family relationship either through blood or through marriage within one degree of direct or indirect lineage.

Usually, during the audit process, taxpayers and tax auditors have an opportunity to discuss the audit findings. A potential dispute occurs when they fail to reach a consensus regarding the amount of tax payable. In most transfer pricing cases, tax audits end up in disputes in which taxpayers have the right to submit objections to the relevant regional district tax office or to the

[2] The 'arm's length' principle: the principle that treats related party transactions as being similar to those conducted by independent parties.
[3] Self-assessment system: system that allows taxpayers to define, calculate, and pay their own taxes. This differs significantly from the official assessment system, in which tax auditors have significant roles in determining the amount of taxes that taxpayers need to pay.

Directorate of Tax Objections and Appeals. If taxpayers are still not satisfied with the tax office's decision on their objections, they have the right to submit an appeal to the tax court which is an independent party of Directorate General of Taxes.

At the same time, taxpayers are also granted the right to request a Mutual Agreement Procedure (MAP) with the competent authority in the country of a related party having a tax treaty with Indonesia, as stipulated in Government Regulation Number 74/2011. Therefore, taxpayers are allowed to apply for an MAP simultaneously with any objection, or request for reduction, to an incorrect tax assessment made by the Indonesian Tax Authority, or with any appeal to the Indonesian Tax Court (KPMG, 2012).

Settlement of transfer pricing cases is very difficult, and considerable time is needed for each of the processes of objection and appeal. In addition, it might take many rounds of bilateral negotiations between the Competent Authority of Indonesia and her counterparts, during which significant resources are consumed.

1.2 Intangible Transaction Disputes in Indonesia

Navarro and Mukanov (2012) claim that the Indonesian Tax Authorities (ITA) give more attention to transfer pricing cases because there has been a significant increase in related party transactions, as many investors have set up businesses in Indonesia. They highlight that Indonesian transfer pricing regulations are stipulated in Article 18, paragraph (4), of the 1983 Income Tax Law. Moreover, in 2008, the Indonesian Parliament enacted regulations requiring taxpayers to maintain all documentation for related-party transactions. With respect to finding comparables for settling tax disputes involving intangibles, "common business practice[4]" was adopted by the Income Tax Law. With these resources available, the ITA started conducting aggressive transfer pricing audits from the beginning of 2009. Royalty and service transactions were the first target of these audits. Intangible transaction disputes between the ITA and taxpayers were increasing, because the audits resulted in considerable tax adjustments as the Indonesian companies involved in related party transactions were unprepared, and incapable of demonstrating the use of intangible property and services, as well as the benefits that they might enjoy from them. The audits changed transfer pricing practices in Indonesia, and forced international companies operating in the country to better administer their intra-group transactions.

Moreover, Navarro and Mukanov (2012) write that, in 2010, the ITA enacted the first comprehensive transfer pricing regulations, in which it adopted the 'arm's length' principle as a replacement for 'common business practice' principles. In general, this regulation follows the 2005 OECD Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations. With regard to documenting the utilisation of services, taxpayers were to provide related documentation to demonstrate that services had been rendered and that those services 'add value' to the recipients in economic or commercial terms. For royalty payments, the new

[4] Common business practice: benchmark derived from industry norms and practices

regulation defines and elaborates further on intangible properties such as patents, copyrights, trademarks, trade intangibles and marketing intangibles, so that taxpayers have a legal basis to characterise royalty transactions.

1.3 Purpose of the Research

Dealing with intangible transfer pricing cases is not an easy task for the Indonesian tax auditors owing to difficulties in searching comparable transactions under comparable circumstances. If tax auditors manage to make positive adjustments to the amount of tax to be paid to the Indonesian government, and if taxpayers agree to pay those additional taxes, there is no risk for the government. However, taxpayers have the right to submit objections if they are not satisfied with the adjustments. Moreover, if taxpayers are not satisfied with the decisions rendered on their objections, they can further appeal to the tax court. If taxpayers win the case, and if they had already paid the additional tax imposed on them by the ITA, the Government has an obligation to pay back that amount, plus interest of 2% per month, for a maximum of 24 months.

In parallel with the process of objections and appeals, taxpayers are also granted the right to request a mutual agreement procedure with the competent authority in the country of the related party if it has a tax treaty with Indonesia. Settling a dispute over transfer pricing at the international level is very difficult, and many rounds of bilateral negotiations might take place between competent authorities with the expenditure of significant resources.

At present, no study has been conducted in Indonesia to identify the difficulties faced by tax auditors during the audit process of transfer pricing cases from intangible assets. The objective of this study is to investigate how Indonesian tax auditors cope with those transfer pricing cases. The research will benefit the ITA in terms of providing a good understanding of how to handle transfer pricing cases so that the financial risk borne by the government can be minimised.

1.4 Research Questions

There are two research questions in this study: “What difficulties do Indonesian tax auditors face during the audit process of intangible transactions?” and “How do Indonesian tax auditors deal with transfer pricing cases derived from intangible assets?”

1.5 Overview of Chapters

The remainder of this dissertation is structured as follows: Chapter Two provides a literature review of the definition of transfer pricing and its related problems; the ‘arm’s length’ principle and comparables; intangible property; definition of intangible property; difficulties in dealing with transactions of intangible property; the identification, creation, and ownership of intangibles; the ownership of intangible property: the US, Canada and the OECD; identifying arrangements made for the transfer of intangible property; transfer pricing methods for intangible assets; burden of proof; transfer pricing methods for intangibles: the US experience; intangible transaction disputes in the United States and India. Chapter Three describes methodology, methods, method of data analysis, trustworthiness, ethics approval and Directorate General of

Taxes approval. Chapter Four discusses the main findings: namely, difficulties faced by Indonesian tax auditors during audit process of transfer pricing cases derived from intangible property, and ways Indonesian tax auditors and tax officials handle transfer pricing cases derived from intangible property. Chapter Five provides an overview of the study, conclusion, practical contributions, limitations, and future research.

CHAPTER TWO - LITERATURE REVIEW

2.1 Introduction

This section provides a brief overview of the definition of transfer pricing and its related problems; and the 'arm's length' principle and comparables. The concept of intangible property is elaborated further by exploring the definition of intangible property; difficulties in dealing with transactions of intangible property; the identification, creation, and ownership of intangibles. Further, discussion is extended to the ownership of intangible property: the US, Canada and the OECD; transfer pricing methods for intangible assets; burden of proof; transfer pricing methods for intangibles: the US experience; intangible transaction disputes in the United States and India, and conclusion.

2.2 Definition of Transfer Pricing and Its Related Problems

Eccles (1986) explains that transfer pricing first appeared in the nineteenth century when some companies started multi-segmented businesses in which managers had to define prices of transactions that had taken place between segments within the firm in order to reveal individual segment performance and to maximise overall profitability. Further, transfer pricing could be referred to as a set of regulations intended to deal with intra group transactions (Falcao, 2010). Also, transfer pricing could be viewed as an international instrument of tax strategy and management used by multinational enterprises for the purpose of maximising their profit and minimising their tax liabilities in the countries where they operate one or more subsidiaries, divisions, or affiliates (Borkowski, 2010). Further, transfer prices could be defined as the prices settled between associate enterprises in return for physical goods and intangible property transferred or services rendered from one entity to its associate (OECD, 2010a).

The OECD (2010a) explains that one company becomes the associate of another company if it takes part directly or indirectly in another company's "management, control, or capital" or if the same people play a part in the "management, control, or capital" in both companies, directly or indirectly. Other tax jurisdictions describe the meaning of related parties differently. In terms of the US, regulations under Code Sec. 482, define control as follows (Levey & Wrappe, 2010):

> Controlled includes any kind of control, direct or indirect, whether legally enforceable or not, and however exercisable or exercised, including control resulting from the actions of two or more taxpayers acting in concert or with a common goal or purpose. It is the reality of control that is decisive, not its form or the mode of its exercise. A presumption of control arises if income or deductions have been arbitrarily shifted. (p. 7)

Moreover, New Zealand adopts common ownership when 50 percent or more of shareholders are owned by an entity, while Australia does not specify a specific percentage of ownership. Instead Australia uses a relationship test to determine whether a transaction satisfies the 'arm's length' condition or not (Li, 2005a).

Transfer pricing creates problems for both multinational enterprises and tax administrations. From a multinational enterprises point of view, burden and compliance costs might increase as each tax administration applies its own transfer pricing rules and regulations. On the other hand, tax administrations also find difficulty at the policy level when related tax administrations need to negotiate the taxing rights that arise in their jurisdictions in order to avoid double taxation, which would have a negative impact on cross-border transactions of goods, services and capital. In addition, at a practical level, tax administrations also discover problems in collecting data from outside their own jurisdictions (OECD, 2010a).

Tax administrations around the world have identified that transfer pricing produces significant issues that need to be addressed, as they struggle to maintain tax revenue derived from multinational enterprises conducting business in their countries (Pinto, 2012). Supporting this idea, Levey and Wrappe (2010) argue that transfer pricing has become an international tax issue because multinational enterprises operate globally, and each tax authority must ensure that taxpayers pay taxes on accurately calculated taxable income.

Vidal (2009) explains that, by definition, multinational enterprises generate income in more than one country. To allocate those incomes, two methods are recognised: the separate accounting approach, and the formula apportionment approach. The separate accounting approach assumes that multinational enterprises can be differentiated further into separate entities: namely, parent, subsidiaries or branches, so that each entity is required to conduct transactions in accordance with the 'arm's length' principle. On the other hand, the formula apportionment approach presumes that jurisdictions can reach an agreement on a formula designed to determine the appropriate tax base.

As the OECD uses a separate accounting approach, comparison is required in order to determine a fair 'arm's length' price (Vidal, 2009). The OECD prefers the separate accounting approach, rather than the formula apportionment approach. They claim that global formulary apportionment is difficult to implement, because reaching an agreement among jurisdictions where multinational enterprises are running businesses is extremely difficult and time consuming when substantial international coordination and consensus on predetermined formulae is required. Further, they point out that the possibility of countries accepting a single universal formula is uncertain (OECD, 2010a).

2.3 'Arm's length' Principle and Comparables

The OECD points out that when independent parties conduct a transaction, market forces will define the conditions of both commercial and financial relations, such as the price and condition of goods and services being transferred. On the other hand, when associated enterprises are involved in transactions with each other, external market forces might not influence those transactions. Thus, concerns that prices and profits might be set up to favour associated enterprises and, as a result, tax revenue of host countries could be distorted (OECD, 2010a)

arise. For those reasons, the OECD (2010b) introduced application of the 'arm's length' principle, which refers to Article 9 of the OECD Model Tax Convention as follows:

> [Where] conditions are made or imposed between the two [associated] enterprises in their commercial or financial relations which differ from those which would be made between independent enterprises, then any profit which would, but for those conditions, have accrued to one of the enterprises, but, by reason of those conditions, have not so accrued, may be included in the profits of that enterprise and taxed accordingly. (pp. 27-28)

In line with that idea, Pinto (2012) points out that the 'arm's length' principle is the fundamental principle for transfer pricing rules and regulations in most countries. Further, he points out that the international transfer pricing guidelines have been developed by the OECD in order to promote common global transfer pricing policies. The OECD guideline offers alternatives and methods that could be utilised to calculate suitable prices for the cross-border transactions of goods and services conducted among associated enterprises. In addition, Borkowski (2001) points out that OECD transfer pricing guidelines are voluntary and could be used by countries as the foundation of their own transfer pricing regulations, or as the starting point from which their regulations are developed. However, in practice, the application of these guidelines differs from one country to another because of variations in traditions, politics, economic and legal systems (Pinto, 2012).

On the other hand, Falcao (2010) points out that indeed the OECD has the responsibility to harmonise international tax regulations. However, as the OECD is mainly comprised of developed countries, these guidelines might not apply to the political and economic frameworks of developing countries. Further, she highlights that developing countries adopt the 'arm's length' principle since it is widely accepted and they have little economic force or ability to adopt a different methodology. Moreover, she claims that while the OECD Transfer Pricing Guidelines suggest methodologies for multinational enterprises to achieve 'arm's length' pricing they provide only general guidance on the issue.

The 'arm's length' principle might offer equal tax treatment between multinational enterprises and independent enterprises as it removes any tax advantages or disadvantages and, as a result, it may have a positive impact on international trade and investment. Further, the OECD argues that in the absence of market forces and the 'arm's length' principle, both the tax liabilities of multinational enterprises and the tax revenue of countries where multinational enterprises operate could be manipulated to the benefit of the multinational companies. In order to minimise such distortions, OECD member countries have agreed to make necessary adjustments for tax purposes (OECD, 2010a).

Further, with regard to potential adjustments, under the substance over form principle, tax authorities are authorised to ignore a scheme or an arrangement that is judged to be fictitious or made only to decrease or avoid tax (Maucour & Benard, 2008).

The fundamental goal of the 'arm's length' principle is to ensure that arrangements undertaken between affiliated enterprises are at least similar to those conducted by independent enterprises in a perfectly competitive environment. The final outcome of the 'arm's length' principle is to obtain a price, which is an objective measure that is derived from subjective tools such as assumptions and adjustments. Even though the level of subjectivity is quite high in the determination of a price, if a taxpayer follows specific rules and regulations, this price might be accepted by the tax authorities. When conditions between affiliated enterprises differ from those of independent enterprises, tax authorities are granted power to adjust profits earned by those affiliated enterprises, based on Article 9 (2) OECD Model Tax Convention (Pogorelova, 2009).

Levey and Wrappe (2010) explain that Code Sec. 82 of the Internal Revenue Code grants authority to the Internal Revenue Service (IRS) to reallocate income, deductions or tax attributes among the members of affiliated enterprises in order to prevent tax avoidance, and to reveal income among related entities and treat a controlled taxpayer as equivalent to an uncontrolled taxpayer as follows:

> In any case of two or more organizations, trades, or businesses (whether or not incorporated, whether or not organized in the United States, and whether or not affiliated) owned or controlled directly or indirectly by the same interest, the Secretary may distribute, or apportion, or allocate gross income, deductions, credits, or allowances between or among such organizations, trades, businesses, if he determines that such distribution, apportionment, or allocation is necessary in order to prevent evasion of taxes or clearly to reflect the income of any such organizations, trades, or businesses. In the case of any transfer (or license) of intangible property (within the meaning of Code Sec. 936 (h) (3) (B)), the income with respect to such transfer or license shall be commensurate with the income attributable to the intangible (p.6).

The 'arm's length' principle's application is usually derived from a comparison between the circumstances of associated transactions and those of independent enterprises. These conditions need to be sufficiently comparable, which means that if there are any differences in the conditions, appropriate adjustment could be undertaken to remove the influence of the differences. The OECD highlights five key factors in determining comparability including features of goods or services, a functional study, contractual conditions, the economic situation, and the business plan. The OECD introduces "comparable uncontrolled transactions" in Chapter 3, Section A.4 of the Transfer Pricing Guidelines, which refer to the transactions undertaken by two independent parties comparable to related party transactions being audited by the tax auditors. This could be in the form of internal comparables (transactions between affiliated parties and independent parties) or external comparables (transactions between independent parties) (OECD, 2010a).

Falcao (2010) claims that one method to determine whether transactions undertaken by affiliated enterprises are in accordance with the 'arm's length' principle is by the use of comparables. Such comparables can be found in many ways such as (i) comparables such as benchmarks might be issued by the tax authorities (ii) an entity might provide comparables for goods; or (iii) an entity might present a list of comparable transactions made under the same circumstances, with the same type of goods or services being transferred, and the same profit

margin. However, as multinational enterprises make profit due to their uniqueness and market imperfections, their essential comparables probably “do not” and “cannot” exist (Vidal, 2009).

The OECD (2010a) claims that the concept of the ‘arm’s length’ principle is sound in theory as it provides the best estimate of market forces in the transactions between associated enterprises. It usually generates an appropriate allocation of income among members of associated enterprises that is accepted by tax administrations. However, at the practical level, the ‘arm’s length’ principle might be difficult to apply.

In addition, Falcao (2010) claims that finding appropriate comparable transactions under comparable circumstances is very demanding, especially in developing countries, as they do not have enough ability to produce goods and services that would supply the data required to develop comparable benchmarks. They might import benchmarks from developed countries such as the United States, United Kingdom or Belgium, but application problems will arise due to the differences in affiliated transactions between developing and developed countries in terms of supply and demand, market, and business conditions. Furthermore, she claims that those problems become more prominent when developing countries try to deal with related party transactions involving electronic commerce or the commercialization of intangibles.

2.4 Intangible Property

One of the main factors contributing to the revenue of modern multinational enterprises is the development of intangible property. Competitive advantage in the international market can only be maintained by the utilisation of valuable intangible assets. Also, to enter new markets the multinationals rely significantly on intangible property. Moreover, even for existing markets where multinational enterprises have already achieved success, intangible property could be used to differentiate their exclusive premium products from cheap locally manufactured products (Przysuski, Lalapet, & Swaneveld, 2004a). Further, in today’s economy, the combination of intellectual property and branding play a significant role in influencing the success of multinational enterprises. Therefore, intangible property accompanies a majority of cross-border transactions among associated enterprises (Przysuski et al., 2004a).

Visconti (2012) argues that the tax treatment of transfer pricing of intangibles has become one of the most important international tax concerns, as the possibility of cross-border rearrangement aiming to shift profits to other jurisdictions might result in a significant decrease in the tax base in the country where the intangible property was developed.

2.4.1 Definition of Intangible Property

The OECD (2010a) defines intangible property as the right to use industrial property (e.g. patents, trademarks, trade names, designs and models). It also encompasses literary and artistic property rights and intellectual property rights (e.g. know-how and trade secrets). Commercial intangibles consist of marketing intangibles and trade intangibles. Marketing intangibles are special kinds of commercial intangible which include trademarks and trade

names which assist the commercial exploitation of a product or service; customer lists; distribution channels; and unique names, symbols or pictures which hold significant promotional value. Commercial intangibles other than marketing intangibles are classified as trade intangibles. Trade intangibles are developed through intensive research and development activities which have high risk and expensive costs, and the developer tries to recover those costs and gain a return through sales of its products, service contracts, or license agreements.

The Internal Revenue Service (IRS) claims that investment in these intangibles results from advertising, marketing and promotion expenditures ("AMP"). Code Section 482 regulations apply when the owner of property "transfers" their rights to a controlled party. This term "transfer" refers to the 1968 regulations in which a defined transfer will be deemed to occur when the respective intangible is "sold, assigned, loaned, or otherwise made available in any manner" (Levey & Wrappe, 2010).

Intangibles in the United States context are defined in the US Treasury Regulations under Internal Revenue Code (IRC) Section 482 as assets having significant value, and can be classified further into six major groups namely technology (patents, inventions, formulas, processes, designs, patterns, and know-how); literary (copyrights, literary compositions, musical compositions, and artistic compositions); sales (trademarks, trade names, and brands); business organisations (franchises, licenses, and contracts); operations (methods, programs, systems, procedures, campaigns, surveys, studies, forecasts, estimates, customer lists, and technical data), and other similar items (Przysuski et al., 2004a). On the other hand, the Canadian Customs and Revenue Agency's (CCRA's) Information Circular (IC) 87-2R basically follows the OECD Guidelines for defining intangible property and the application of transfer pricing rules as regulated in Section 247 of the Income Tax Act (Przysuski et al., 2004a).

2.4.2 Difficulties in Dealing with Transactions of Intangible Property

Borkowski (2001) highlights that the 'arm's length' principle has been adopted as an international standard for settling transfer pricing cases regarding intangible property between multinational enterprises and their subsidiaries. However, it is demanding to apply the principle for intangible property because of the complicated nature of determining comparable 'arm's length' prices.

The OECD (2010a) states that the application of the 'arm's length' principle to controlled transactions of intangible property among related parties can be complicated because it is difficult to identify comparables for intangible property due to its unique nature, and to determine its value at the time of transaction. In line with this idea, Visconti (2012) claims it is demanding to apply the 'arm's length' principle to intangibles since those intangibles, such as trademark and patents, always exhibit exceptional features.

The OECD (2010a) suggests that in the application of the 'arm's length' principle, the following factors need to be considered in determining comparability between controlled and uncontrolled

transactions involving intangible property. These factors include: the prospective advantages derived from the intangible property; any restrictions on the geographic area which will be covered by the intangible rights; export barriers on goods produced as a result of any rights transferred; the exclusive or non-exclusive features attached to any rights transferred; the initial investment; the initial expenses and development work necessary for the market; sub-licensing possibilities; the network coverage of license distribution; and the potential for the licensee to take part in further development of the intangible property owned by the licensor.

As the OECD recommends that the usefulness of the intangible property should be accounted for in the determination of comparability, Visconti (2012) argues that the "usefulness of intangible assets" is a function of "estimated future usefulness of the intangible property", which refers to extra revenue or cash flow in economic terms. This concept might be understood and examined by taking into account the functional analysis of potential sellers as well as buyers, the prediction of the future benefit of the intangible for sale, and the price as a result of market equilibrium between supply and demand.

Moreover, the OECD suggests that in order to apply the 'arm's length' principle to controlled intangible transactions, the expected benefit from the intangible property, which can be derived from the net present value (NPV), should be taken into account. Responding to his recommendation, Visconti (2012) points out that the NPV does not aid in estimating cash flow accurately, especially when this method has to deal with unpredictable events or flexibility options, as with patents. Furthermore, he argues that discounted cash flow (DCF) might be suitable for the application of the 'arm's length' principle, but it also is difficult to apply since this method is essentially based on doubtful projections, especially with regard to time frames. If an audit is conducted some years later, then the projection will be rendered useless.

Further, Oestreicher (2011) points out that the requirement in the OECD Transfer Pricing Guidelines, paragraph 6.14, states that the views of both the transferor and the transferee of intangibles need to be taken into consideration in determining comparability. From the transferor's perspective, the 'arm's length' price would scrutinise the price at which a comparable independent company would like to transfer the property, whereas from the transferee's viewpoint, they would normally pay those fees if the benefit expected from the use of intangibles was deemed to be satisfactory after consideration of all other options available. Oestreicher claims that this standard looks for a scope of agreement (price), and is contrary to the 'arm's length' principle which concentrates on functions, assets and risks of all parties associated with the transactions, rather than the question of whether or not the transferor or transferee agrees to pay a certain price. Furthermore, Visconti (2012) points out that a double 'arm's length' takes place in effect, as the agreement will refer to the both transferor and transferee when they finally settle on a price.

In dealing with the difficulty in finding comparables due to the lack of comparable data supplied by independent parties, the Inland Revenue Department (IRD) of New Zealand has adopted a

practical and flexible way that permits taxpayers to set up an optional safe harbour for intra-group services to decrease their cost of compliance (Li, 2005a).

Pinto (2012) emphasises that transfer pricing for intangible property is one of the most difficult issues, not only for tax administrations around the world but also for multinational enterprises running business in those respective countries. It is difficult to define intangible property due to its nature and characteristics. Moreover, Pinto highlights that when transfer of intangible property takes place between associated enterprises, valuation issues arise, as it is very difficult to find comparable prices because intangible property is frequently self-developed by the associated enterprises, exclusive to the group, and not transferred to independent parties. Supporting these opinions, Borkowski (2001) points out that lack of comparables for intangible transactions results in difficulty in valuing intangible property which is usually unique in nature.

In line with those ideas, Visconti (2012) claims that valuation is one of the central issues surrounding intangible property. Intangible assets are predominantly difficult to assess as they have immaterial features and no active markets. It is complicated to conduct valuation of intangible assets, such as patents and trademarks, because of their intrinsic, abstract nature and also because different multinational enterprises apply different valuation methods. The valuation issues worsen for non-tradeable intangibles such as know-how, trade secrets and goodwill, since they have no or limited marketability, higher asymmetric information, and less legal boundaries. Moreover, Visconti points out that it is becoming increasingly difficult from an accounting point of view. The International Accounting Standard (IAS) 38 stated that intangible assets have no active market, so that it is demanding to assess their fair value.

In addition, Wittendorff (2010, as cited in Visconti, 2012) claims that patents and trademarks have high value because of their exclusiveness and uniqueness. Thus, it is very demanding to find comparable conditions and to value these assets using ‘arm’s length’ principles accordingly. Moreover, the OECD (2010a) claims that special attention is necessary for intangible property, since its transactions are difficult to assess for tax purposes.

With regard to comparability, Visconti (2012) points out that the application of the “comparable uncontrolled transaction” principle introduced by the OECD might create further problems with intangible property, since transactions of intangible property are usually negotiated within international groups. Well-known trademarks or patents usually belong to big companies under international groups, so it seems complicated and often meaningless when their transactions are compared to those of smaller and uncontrolled negotiations. Further, he points out that there is a contradiction in the OECD Transfer Pricing Guidelines section 6.8, in which it is stated that a “patent” provides an “exclusive” right for a certain period of time to utilise a particular innovation, while “trademark” is a “unique” name, symbol, or picture that allows the owner or licensee to recognise an exceptional product or services. He raises a rhetorical question: “How can exclusivity or uniqueness be fit for comparable uncontrolled transactions if its semantic meaning seems the opposite?”

Furthermore, Visconti (2012) argues that the features of intangibles are difficult to segregate and may overlap so that the difference between types of intangibles is intrinsically flexible in nature. Thus, they might be used as a tool in searching for valuable synergies and constructing potential for profitable tax planning by moving or combining categories of intangible properties.

Another complexity is presented when entities within a multinational group develop intangibles as a joint effort, then use those intangibles regardless of their involvement in the initial development. These facts make the task of separating and allocating the relative involvement of each group member within a multinational group a burdensome and inaccurate exercise (Przysuski et al., 2004a).

Furthermore, it is extremely difficult to determine the accurate value of intangibles because they are frequently embedded in physical assets. Investigating the economic characteristics of intangible assets would be useful in order to differentiate them from physical, human, and financial assets and to recognise them within multinational enterprise groups (Przysuski et al., 2004a). Multinational enterprises attempt to develop valuable intangible property through the combination of innovative processes, organisational practices, and human resources. However, there is no guarantee that this will result in the intended intangible property (Przysuski et al., 2004a). In line with this idea, the OECD (2010a) mentions that not all research and development activities will end up with valuable trade intangibles and not all marketing efforts will generate marketing intangibles.

2.4.3 Identification, Creation, and Ownership of Intangible Property

Przysuski, Lalapet and Swaneveld (2004a) argue that the identification, creation, and ownership of intangibles are three essential issues that will influence their valuation in a transfer pricing context. Identification of intangibles is critical since their value in companies is not taken accurately into account by contemporary accounting methodologies. Most intangible properties which exist and are generated on an on-going basis by multinational enterprises, are neglected in their balance sheets. The balance sheets include only the book value of tangible assets currently owned. As a result of the acquisition of intangible assets, only goodwill appears in the balance sheets.

Further, Przysuski, Lalapet and Swaneveld (2004a) point out that the process of developing intangibles is often associated with their value. It is essential to scrutinise the type of process that generates an intangible when investigating intangible property for transfer pricing, in order to determine precisely the value that intangible contributed to the total value of a multinational enterprise.

The third issue relates to the ownership of intangible property, which has significant influence on the entitlement to income produced by its utilisation. Ownership will also influence transfer pricing consequences and the associated tax accordingly.

In investigating related party transactions, the determination of ownership of intangible assets is one of the most important aspects. There are two main ownership principles in transfer pricing: legal and economic ownership. Under the legal ownership principle, once a parent company retains legal ownership of certain intangibles then its subsidiary might not be able to create its "own local marketing" intangibles that differ from the one possessed by the parent company. On the other hand, the economic ownership principle assumes that the owner of the intangible is the one that contributes most in its creation in terms of economic costs and associated risks. Economic ownership usually takes place as licensing or leasing, such that all benefits and risks of the intangible are moved to the licensee or lessee while the legal ownership is kept by the licensor or lessor. Thus, the licensee or lessee is the economic owner of the intangible asset being licensed or leased. Economic ownership may be present, even though the actual transfer price is not paid. The test of economic ownership is principally based on the relative contribution of each party in the affiliated multinational enterprises (MNE) group, and the amount of benefit gained from the intangible property. Economic ownership represents the view that income from intangible property belongs to the entity which bears the economic costs and risks in the development of the intangible (Przysuski, Lalapet, & Swaneveld, 2004b).

Visconti (2012) argues that patents are more demanding to compare because they are inherently unique, as this is one of the requirements of a patent. On the other hand, since trademarks are not necessarily unique, finding comparability for them is less challenging. With regards to patents, OECD (2010a) recommends that the analysis conducted for comparability purposes should consider the following: the characteristics of patents (for a product or process); extent and length of protection provided by the patent laws of the respective countries; the duration for which patents will maintain their economic value; the production' process in which the intangible property is used; and the value of the process contributing to the final products. Product and environmental liability need to be considered in a FAR analysis (functions conducted, asset utilised and risks faced) for intangible property. Responding to those suggestions, Visconti (2012) argues that estimating the actual useful life of a patent beyond its expiry date is always challenging due to the difficulty in forecasting competitiveness of inventions or the market's evolution.

Przysuski, Lalapet and Swaneveld (2004a) claim that although conducting the valuation of a unique brand name or trade mark is not demanding, when combined with the extra value of marketing intangibles, the process becomes more complicated. Complexity increases when trade intangibles are valued based on research and development and associated technological enhancements, because these activities might not result in the successful creation of intangible property. Further, they point out that many taxpayers, transfer pricing practitioners, and tax authorities assume that intangible properties associated with day-to-day functions of a firm might not be valuable, since similar functions are conducted by others in the same industry. In contrast to those arguments, they claim that intangibles may be valuable even when they are developed from an enterprise's daily activities, as long as they are utilised in order to preserve the enterprise's market share in a constantly changing market environment.

When the distributor of a branded product bears significant marketing expenses without having any ownership interest in the trademark and/or trade name of the distributed product, the OECD Transfer Pricing Guidelines suggest functional analysis needs to be conducted in order to attribute an additional return to that distributor. If it is proven that a distributor bears extraordinary marketing expenses compared to those spent by an independent distributor having similar rights, then the distributor under examination might receive an extra return through a decreased purchase price or a reduced royalty rate (Przysuski et al., 2004b).

2.4.4 Ownership of Intangible Property: The US, Canada and the OECD

It is important to determine the owner of intangibles, as that owner will be entitled to compensation for any transfer or licence from their intangible assets. If the intangible assets are registered under the US Patent and Trademark office, they are classified as “legally protected” so that their owners will be treated as the “owner” for Code Sec. 482 purposes. On the other hand, the intangible’s developer will be deemed to be the “owner” for Code Sec. 482 purposes for intangibles that are not legally protected. The developer is the party bearing the biggest expense of intangible development. Other parties contributing to the development or improvement of intangibles will be treated as associates in that they have the right to receive an ‘arm’s length’ reward from the owner of the intangibles. The allocation of rewards follows regulations governing services. Compensation might be provided in terms of loans, services, or the use of tangible or intangible property, but routine expenditures are excluded. It is possible to divide the ownership of intangibles so that the owners of each of the subdivided intangible property will be treated as an owner of intangible property for Code Sec.482 purposes (Levey & Wrappe, 2010).

The US holds the view that the legal owner of intangibles is the one entitled to the income generated from that intangible property. Therefore, relative economic contributions from other group members are not taken into consideration once the legal owner is established. However, when intangible assets are not legally protected, the “developer-assister principle” will apply, in which the developer will be treated as the legal owner while the participating members in the development of the intangible will be treated as assisters (Przysuski et al., 2004b). The United States applies the “largest portion test”, in which the entity that bears the largest shares of the development cost of the intangibles is treated as the owner of the intangibles. Thus, when two or more associated enterprises take part in the development of intangible property and no prior agreement is set up for cost-sharing, the IRS would allow only one entity: the one who bears the most significant cost of development, as the “developer” and “owner” of intangible assets and, as a consequence, that entity will be entitled to the income generated from the intangible assets (Przysuski et al., 2004a).

A sole owner of intangibles might not be necessary in Canada, since Canadian Tax Authorities allow the income from intangible assets to be distributed among the entities based on their contribution to the development of the intangibles, according to the ‘economic ownership principle’. Canadian Tax Authorities, following the OECD Transfer Pricing Guidelines, use this

principle when intangible properties used within Canada do not officially have legal protection in the form of intellectual property (Przysuski et al., 2004a). Canada adopts the economic ownership principle when comprehensive analysis is required to discern costs and risks incurred by an entity during the development of intangible property. Therefore, tax authorities might attribute income proportionate to those costs incurred and risks borne, in spite of the fact that the intangible assets are legally owned by another group member (Przysuski et al., 2004b).

The OECD Transfer Pricing Guidelines emphasise business rights, which are essentially intangible properties connected with commercial activities. The OECD states explicitly that intangible properties might have significant value and bear significant risk, even though their values are not captured in the balance sheet of the company. In the transfer pricing context, the implicit value of intangibles and their associated commercial risk are key factors considered in every intangible transaction (Przysuski et al., 2004a).

2.4.5 Identifying Arrangement Made for the Transfer of Intangible Property

Determining whether a full or partial transfer has taken place from the designated owner to another member of the controlled group is essential (Przysuski et al., 2004a). The OECD (2010a) points out that the transfer of intangible property may take place in the form of the total sale of the intangible, or royalty payments under a licensing agreement. Royalties are usually paid on a regular basis depending on the licensee's output or sales.

According to Robbins and Stobaugh (1973, as cited in Li, 2005b), the parent company might establish a high transfer price on goods delivered to its subsidiaries in response to limitations on the transfer of royalty or management fees from their subsidiaries imposed by the tax authorities in countries where the multinational enterprise operates.

The reward for the utilisation of intangible property might already be incorporated in the price of goods if, for example, one entity sells unfinished products to another, and at the same time the selling entity shares its experience of processing unfinished into finished goods. Further investigations need to be conducted based on facts and circumstances, in order to test whether or not the rewards for intangibles are already covered by the price of the goods. If so, then any extra payments for royalties should not be allowed by the tax administration of the buyer's country (OECD, 2010a).

Further, sometimes a "package price" might represent the transfer price for both goods and intangible property. If this is the case, and is supported by facts and circumstances, any payment in addition to the royalty as compensation for intangible assets, such as providing technical expertise, might not need to be paid. Segregation of the package price is needed in countries where withholding tax is imposed on royalties.

Further, the OECD (2010a) explains that a bundle or package contract sometimes takes place where intangible property contracts include patents, trademarks, trade secrets and know-how in

one package. The packages should be broken down into their individual components so that the 'arm's length' nature of the transfer of intangibles can be verified. Further, the following need to be taken into account: the value of the service (technical assistance, training for employees) that might accompany the transfer of intangible property in bundling contracts, and the advantages provided by the licensee to the licensor in terms of enhancement of the product or process. However, Visconti (2012) explains that when sold or licensed in package or bundle contracts, the valuation of intangible properties becomes more complicated and challenging.

Moreover, the OECD (2010a) highlights that know-how and service contracts might be treated differently from one country to another in regard to withholding tax. If compensation for those contracts is viewed as a service fee, those payments are not subject to tax in the paying country unless the receiving party conducts business or carries out activities in that country through a permanent establishment, and the fee is attributable to that permanent establishment. On the other hand, in some jurisdictions when those contracts are treated as royalty payments in compensation for the use of intangible assets, those payments are subject to withholding tax.

2.4.6 Transfer Pricing Methods for Intangible Assets

The OECD (2010a) argues that, in the sale or license of intangible property, the Comparable Uncontrolled Price (CUP) method could be applied where an owner of intangible property has transferred or licensed comparable intangible property to both independent and affiliated enterprises under comparable conditions. The CUP method compares the price settled for the goods transferred or services rendered in a controlled transaction, to those in a comparable uncontrolled transaction under comparable conditions. If a difference exists between those prices, it might be a sign that the controlled transaction does not adhere to the 'arm's length' principle and, as a result, the price of the controlled transaction might be replaced by that of an uncontrolled one. However, to find similar transactions with no material differences affecting the price of independent parties might be difficult, as minor differences in property would materially influence the price regardless of the similarity of the business being conducted. To find appropriate comparables, the influence of broader business functions on the price would be considered more important than merely product comparability. The CUP method works best when both independent enterprise and associated enterprises sell the same product. The amount settled by independent parties or the range of pricing for intangible transactions from the same industry could serve as a guide. Offers received by independent parties, or authentic bids obtained by competing licensees, might be considered in this regard.

The OECD explains that the resale price method could be applied in cases in which affiliated enterprises enter sub-license agreements with independent enterprises. The resale price margins might be predominantly influenced by internal comparables when the reseller sells the products to both associated enterprises and independent enterprises. In addition, external comparables – the resale price margin of other independent enterprises from comparable uncontrolled transactions – would provide guidance. Fewer adjustments are usually needed in regard to product differences compared to the CUP method, since minor product differences do

not have a material impact on the profit margin. However, if valuable or exclusive intangibles are involved in the compared transaction, the similarity of the products needs to be considered to obtain a valid comparison. If an external comparable is used, the reliability of the resale price method might be questioned where the way of conducting business between associated enterprises and independent enterprises differs significantly. The resale price method relies significantly on the comparability of functions conducted, assets utilised, and risks assumed. The amount of resale price margin would be influenced by the extent of reseller activities. If the reseller performs as a forwarding agent only, the resale price margin might be minimised, whereas if the reseller conducts substantial activities in addition to an agent's function, their resale price margin could be significant. The resale price method works best for marketing operations where the reseller does not add substantial value to the product and the time between when the product is purchased and sold is short (OECD, 2010a).

If the chain of distribution is involved in the transaction, tax administrations need to check both the resale price bought from the intermediary company and the price the intermediary company will pay to its supplier. Also, tax administrations need to investigate the real function of the intermediary. When a reseller has the exclusive right to sell a product, the resale margin might increase significantly. Exclusive rights could benefit both the supplier and reseller, as the reseller may conduct extra work to sell the supplier's product and, in turn, the supplier might grant the reseller a monopoly that could result in significant increase in sales without any extra supplier effort. The CUP and resale price methods might be applied to the sale of goods with integrated intangible property (OECD, 2010a).

The OECD (2010a) recommends that if an intangible transaction includes marketing intangibles (e.g. trademarks), a comparability analysis should take into account "value added" provided by the marketing intangible, by considering consumers' degree of acceptance, the role of the geographical area, position in the market, share volume, and other relevant factors. In the case of trade intangibles, value is allocated to them and the significance of current research and development should be considered in the comparability analysis.

The profit split method could be applied to highly valuable intangible property, since it is very complicated to find comparable transactions under comparable conditions for this kind of situation. Traditional methods and the transactional net margin method are difficult to apply.. The profit split method will identify the profit or loss needed to be split among the associated enterprises from the controlled transactions. Then, the identified profit will be shared among the associated enterprises in accordance with the 'arm's length' condition using an economically valid basis. This method is best for highly-integrated operations in which one-sided methods would not be able to cope. It is also the most appropriate method to be applied to the transaction when both affiliated parties have "unique" and "valuable" contributions, such as intangible property since, in this case, independent parties might hope to share the profit, based on their respective contributions to the controlled transactions. If comparable data is available, it will be used to support the division of profits and to assess the contribution of each related

party to the controlled transactions. In determining whether the conditions of an intangible property transfer are in accordance with the 'arm's length' principle, the amount, characteristics, and occurrence of the cost incurred in developing and preserving the intangible property need to be investigated further, as a tool to determine comparability or possible relative value contributed by each party, especially when the profit split method is used (OECD, 2010a).

2.4.7 Burden of Proof

Different jurisdictions have different rules with regards to burden of proof. In the United States, burden of proof lies with the taxpayers, as the deficiency determinations issued by the IRS under Code Sec. 482 are assumed to be correct so that taxpayers must prove that the IRS acted in "an arbitrary and unreasonable manner" (Levey & Wrappe, 2010). In New Zealand, burden of proof lies with the commissioner of the Inland Revenue Department, which must demonstrate that the transfer price applied by the tax payer is not an 'arm's length' consideration. On the other hand, onus of proof is on taxpayers in Australia, since the Australian Taxation Office requires taxpayers to show that their prices are in accordance with the 'arm's length' principle (Li, 2005a).

2.4.8 Transfer Pricing Methods for Intangibles: The US Experience

The comparable uncontrolled transaction (CUT) method examines whether the amount paid in an intangible transaction between affiliated enterprises is in accordance with the 'arm's length' condition, compared to those of comparable independent transactions. The CUT method will offer the most straightforward and trustworthy approach provided the intangible being transferred is the "same" for both the controlled and independent transactions. It can still be used when there are minor differences between the intangibles as long as an appropriate adjustment is made. Thus, the intangibles being compared between controlled and uncontrolled transactions must be similar "products or processes" and in the same "industry or market." The following factors need to be considered in evaluating comparability of transactions conducted by controlled and uncontrolled parties: conditions of transfer; intangible phases of development; rights to renew and improvement; distinctiveness of intangible property; length of the licence; any potential risks related to economic and product liability; any collateral or in-progress business relationship; and any services rendered by either transferor or transferee (Levey & Wrappe, 2010).

The comparable profit method (CPM) examines whether the amount paid in an intangible transaction between affiliated enterprises is in accordance with the 'arm's length' principle against objective measures of profitability resulting from uncontrolled taxpayers that conduct comparable business under comparable circumstances. Operating profit of related enterprises is compared to the inter-quartile range calculated from comparable companies. If the operating profit falls within the inter-quartile range, it is deemed to be in accordance with the 'arm's length' principle (Levey & Wrappe, 2010).

The profit split method compares the distribution of joint operating profits or losses in controlled transactions to the relative value of each affiliated enterprise's contribution to that joint profit or loss. The allocation should be similar to that of uncontrolled transactions conducted by independent enterprises with similar functions (Levey & Wrappe, 2010).

2.4.9 Intangible Transactions Disputes in the United States and India

Intangible asset disputes between taxpayers and tax administrations are nothing new. Gujarathi (2007) points out that 11 September 2006 was an important day for international taxation as the largest historical dispute over marketing intangibles was settled between the Internal Revenue Service (IRS) and GlaxoSmithKline Plc. (GSK) in the amount of US$3.4 billion. GSK claimed that the value of drugs sold in the United States was derived from research and development undertaken in the United Kingdom. Thus, GSK argued that it was justified that British parents charged high prices for drugs sold in the US. On the other hand, the IRS argued that GSK US paid too much to its British parent and ignored the importance of marketing efforts conducted by GSK US, so that it reduced GSK US profit and less tax was paid in the US accordingly. The IRS pointed out that GSK US developed marketing intangible assets in the US that were "distinct" and "separate" from its British parent. The IRS claimed that royalties paid by GSK US to GSK UK were excessive since GSK overvalued research and development in the UK and underestimated the value of advertising and other marketing efforts in the US.

Another interesting case is the IRS examination of the DHL-DHL International (DHLI) case with regard to the owner of non-US rights of DHL's trademark (Levy, Shapiro, Cunningham, Lemein, & Garafalo, 2002). The IRS issued a deficiency notice[5] for the amount of US$270 million (of which US$ 75 million was for penalties), and adjusted the purchase price of the trademark, because DHL never charged royalties for use of the DHL trademark, plus service fees up to 1990 to DHLI. Even though the tax court reduced the deficiency notice made by the IRS to the amount of US$60 million, it rejected the claim that DHLI was the owner of the trademark because it had invested significantly in the development of the trademark in the previous ten years. In contrast, the Ninth Circuit decided to write off the deficiency notice by reason that DHLI had developed the non-US trademark and spent more than US$340 million in the previous ten years to promote that trademark outside the US. Here the 1968 regulation is applied in which the developer of the intangible is the economic owner for tax purposes.

Another intangible dispute took place between the Indian Tax Authority and Maruti Suzuki India Ltd. Levey and Arthur (2010) describes the case as follows. A Japanese company, Suzuki Motor Corporation (Suzuki) had ownership of over 50% in shares of Maruti Suzuki India Ltd (Maruti), an Indian company. Maruti signed a license agreement with Suzuki which granted Maruti the right to use the brand on its product in India, and technical know-how in order to develop the product of Suzuki to be incorporated with the product of Maruti. In return, Maruti had to pay a lump sum royalty and a regularly-paid royalty based on the free-on-board value of

[5] The additional amount of taxes shall be paid to the Government.

certain components incorporated in the product Maruti manufactured with the technology owned by Suzuki.

Further, the Indian Tax Authority, in this case the Transfer Pricing Officer (TPO), made a positive adjustment by claiming that Maruti should not pay royalties to Suzuki at all, and actually it was Maruti that was entitled to compensation for the use of Suzuki's brand on Maruti's products. The first reason was that the TPO claimed the use of Suzuki's brand on Maruti's product effectively constituted the sale of the Maruti brand to Suzuki, since the Maruti brand is more popular in India than the Suzuki' brand. The TPO argued that the use of Suzuki's brand in collaboration with Maruti's brand allowed Suzuki to penetrate the Indian market. Thus, the TPO calculated the "deemed sale" of the Maruti brand to Suzuki based on Maruti' s expenditure on advertising, marketing, and distribution that made it become the number one car company in India, plus 8% mark-up for a total sale of INR 4,420 crores (approximately US$1 billion). In addition the TPO argued that Maruti should receive half of the royalty payment under the license agreement for the use of Maruti's brand on the co-branded trademark "Maruti Suzuki". The total adjustment made by the TPO was approximately INR2 billion (approximately US$47 million).The High Court of India decided that there was no basis for claiming that the transfer of Maruti's brand to Suzuki took place, and the license agreement was valid as Maruti was justified in entering the agreement with Suzuki and in paying royalties to Suzuki for the use of the its trademark.

2.5 Conclusion

This chapter reviews some aspects of transfer pricing, including definition, problems caused by transfer pricing, 'arm's length' principle and comparables. Also, intangible property and its related topics were discussed further. The literature has underlined difficulties in finding comparable transactions especially for intangible transactions. The research tries to address these difficulties by investigating how Indonesian tax auditors handle transfer pricing cases derived from intangible properties.

CHAPTER THREE - METHODOLOGY AND METHODS

3.1 Introduction

This chapter provides an overview of methodological issues relating to the investigation undertaken for this dissertation. It is structured as follows: first it discusses why qualitative research and, in particular, a case study approach were adopted in the context of this investigation; followed by discussion of the methods and the method of data analysis used. Trustworthiness, ethics approval and Directorate General of Taxes (DGT) approval are explained subsequently.

3.2 Methodology

The objective of this research was to derive rich descriptions and explanations from the Indonesian Tax Authority regarding complicated tax adjustments that could have social consequences. A qualitative research approach was therefore undertaken. An interpretive paradigm was used, as the focus of the research was on how actors (Indonesian tax auditors) interpret accounting numbers, not as a representation of an objective reality, but as subjective products. Moreover, this paradigm provided an opportunity to discover how accounting interacts with its environment, and to offer a better perspective on how the Indonesian Tax Authority's actions on the cases under investigation may be justified (Moll, Major, & Hoque, 2006).

Adams, Hoque, and McNicholas (2006) claim the case study approach facilitates the unveiling and portraying of individual insight on the subject being examined. Yin (2003, as cited in Adams et al., 2006) claims the case study is a preferred research strategy for "how" and "why" research questions. Also, it works best for conditions in which researchers have no ability to control the investigated subject, and the research has real life contexts. Further, Yin explains that this approach allows researchers to experience and to learn the process from first-hand actors. Moreover, case studies provide a comprehensive analysis of certain issues followed by an intensive investigation of their backgrounds (Bryman & Bell, 2011).

3.3 Methods

Documentation and interviews were used to collect the data. Yin (1994) argues that documentation plays a significant role in case studies in corroborating and augmenting evidence, as it can be used to check material mentioned in interviews and confirm information from other sources. The documents which were used are the Indonesian Tax Court's decisions on intangible disputes between the Indonesian Tax Authority, and the following taxpayers:

- PT. Ford Motor Indonesia (Put.30538/PP/M.V/15/2011 - *ITA vs. Ford Motor*)
- PT. L'Oreal Indonesia (Put.24631/PP/M.II/15/2010 - *ITA vs. L'Oreal*)
- PT. Halliburton Indonesia (Put.32485/PP/M.I/15/2011 - *ITA vs. Halliburton*)

Currently, there have been five cases settled by the Indonesian Tax Court for intangible disputes (Navarro & Mukanov, 2012). The three cases listed above were selected as samples

because they were settled from 2010 to 2011, so that they reflect the current standards of transfer pricing, whereas the other two cases were decided in 2002 and 2007 and referred to previous standards. Relevant quotations from the abovementioned tax court decisions have been translated by the researcher and will be presented with the results of the data analysis from the interviews.

As case studies deal with human affairs, interviews are an important source of evidence (Yin, 1994). A semi-structured interview which followed predetermined guidance (Appendix 1) was utilized to interview the tax auditors involved in the aforementioned cases. This semi-structured approach was selected as it was expected to fulfil the research objective and to allow flexibility to respond to participants' replies and follow-up on emerging issues (Bryman & Bell, 2011). In addition, for corroboratory purposes, an open-ended interview *(*Appendix 2*)* was conducted with the persons in charge at the Directorate of Tax Audits and the Directorate of Tax Regulations II. The open-ended method was applied for these interviews because these people are policy makers and the questions which they would be asked were related to their insight on transfer pricing regulations and management (Bryman & Bell, 2011). There were 13 respondents interviewed, and their profiles are as follows:

Table 3.1
Respondents' Academic Background

Academic Background	Number of Participants	Percentage of Total
Non degree university	1	7.69%
Bachelor degree	3	23.08%
Master Degree	8	61.54%
Doctoral Degree	1	7.69%
Total	13	100.00%

Table 3.2
Respondents' Years of Service in the Directorate General of Taxes (DGT)

Years of Service in the DGT	Number of Participants	Percentage of Total
10-15 years	2	15.38%
16-20 years	2	15.38%
21-25 years	9	69.24%
Total	13	100.00%

Table 3.3
Respondents' Current Position Held

Current Position Held	Number	Percentage
Structural Echelon II	2	15.38%
Structural Echelon III	1	7.69%
Structural Echelon IV	4	30.77%
Structural Staff (non-echelon)	2	15.38%
Functional (Auditors)	4	30.77%
Total	13	100.00%

The prospective respondents were provided with a "Participant Information Sheet" (Appendix 3) and were given five working days to consider whether to participate in the research. Among the prospective candidates, 13 respondents made themselves available to be interviewed, one prospective respondent declined the proposal to be interviewed due to health reasons, and two

prospective respondents could not be contacted further. Before commencing the interview, participants were provided with a “Consent Form” to be signed (Appendix 4).

By using multiple sources of evidence (documents and interviews), a triangulation process was achieved because ‘converging lines of inquiry’ emerged (Yin, 1994). Also, the multiple sources offered solutions to deal with ‘construct validity’ problems, since the evidence suggested many methods to cope with the same phenomenon (Yin, Bateman, & Moore, 1983 as cited in Yin, 1994). Therefore, the data’s richness increased, and the findings were more “convincing” and “accurate” following the corroboratory principle.

3.4 Method of Data Analysis

The interviews were conducted in Bahasa Indonesia, the official Indonesian language, and were recorded with the consent of participants. Transcription of the interview results was done by a professional transcriber. The transcription and data analysis were conducted in Bahasa Indonesia. Interviews lasted for a half an hour to one hour. Interviews were semi-structured except for the two respondents who hold positions as directors (echelon II); in this case open-ended interviews were used. The outcome of the interviews was transcribed by a professional transcriber and a confidentiality agreement was signed by the transcriber accordingly (Appendix 5). The interviews produced 1,753 quotations including questions or further clarification from the researcher with a breakdown as follows:

Table 3.4
Number of Quotations

Respondent	Number of Quotation
Respondent 1	427
Respondents 2 & 3	168
Respondent 4	55
Respondent 5	111
Respondent 6	177
Respondent 7	43
Respondent 8	158
Respondents 9 & 10	374
Respondent 11	100
Respondent 12	53
Respondent 13	87
Total	1,753

For respondent validation purpose, the transcriptions were sent by the researcher to the participants to receive their approval of the interviews. After the transcriptions were validated by the respondents, data analysis was conducted in Bahasa Indonesia. Myers (2009) argues that findings gathered during the data collection process need to be managed in a convenient structure so that the most significant aspect of the data will be revealed. Further, he claims the aforesaid process does not simply reduce the amount of data, but the entire set of data and core points are aligned with the researchers’ insights and interpretations. Among the available qualitative data analysis methods such as grounded theory and computer-assisted software, thematic analysis (Braun & Clarke, 2006) was chosen since the features of the data consist of subjective judgements. As key points needed to address the research questions will be revealed during the interview process, thematic analysis was an effective tool to summarize the

data's key characteristics, identify similarities and differences across the data set, and generate unexpected insights. Furthermore, Boyatzis (1998, as cited in Braun & Clarke, 2006) argues that thematic analysis could go further by inferring features of the findings. Thus, main themes could be identified convincingly.

Data analysis was conducted as follows:

a. Familiarisation with the data

   Repetitive and dynamic readings were conducted to recognise the content's "breadth and depth" (Braun & Clarke, 2006).

b. Generation of initial codes

   Boyatzis (1998, as cited in Braun & Clarke, 2006) defines codes as the most fundamental element of data that can be measured consistently with regard to a phenomenon. At the end of the reading process of each quotation, initial codes were produced. This generated 863 initial codes along with initial code references. The "initial code" and "initial code reference" are determined as follows: the most essential message from a quotation was extracted and an initial code reference was given using the participant's code with a sequence number. Sometimes, one long quotation produced more than one initial code but other times, it might not produce an initial code at all when essential messages were not found (Appendix 6).

c. Identification of themes

   A theme will capture an essential part of the data which will answer research questions and match with the "patterned" meaning of the data set (Braun & Clarke, 2006). This process was guided by the two research questions: namely, "What difficulties do Indonesia tax auditors face during the audit process of intangible transactions? (RQ-1)" and "How do Indonesian tax auditors deal with transfer pricing cases derived from intangible assets? (RQ-2)". This process resulted in 42 potential themes (Appendix 7), such as the role of Article 18 paragraph (3) of the Income Tax Law and domestic regulations; looking for "entitlement" of intangible property; and problems with the database.

d. Review of themes

   Themes were reconsidered at the level of 'coded data' on which a repeat reading of the data extracted from each theme was conducted, to ensure its coherent construction. If it was found to be coherent, an individual theme's validity and the thematic map's accuracy were checked against the whole data set. Otherwise, a new theme would have been proposed (Braun & Clarke, 2006). In this step, 42 potential themes were classified and grouped into thematic maps. This stage produced 13, along with their sub-themes (Appendix 8). For example: the thematic map for "difficulties arise from current regulations" has three sub-themes: namely, work load; limited time for completion of audits, especially for tax refunds; and transfer pricing regulations are too loose.

e. Definition and naming of themes

   The essential nature of the themes was identified by reviewing the "data extract" of each theme and managing those themes in logical and consistent constructs, accompanied by narrative-interpretive analysis (Braun & Clarke, 2006). At this stage, after reviewing quotations in the transcriptions and referring to the above-mentioned research questions,

four themes along with their sub-themes were produced in order to address research question one, five themes along with their sub-themes were produced in order to address research question two, and four themes: namely, the Mutual Agreement Procedure and Advanced Pricing Agreement; withholding tax, value added tax and double taxation issues; shifting profit issues; and others were excluded because they did not relate directly to the research questions (Appendix 9). For example, the theme "difficulties arising from taxpayers" has two sub-themes: problems with transparency of taxpayers' bookkeeping; and lack of taxpayer cooperation in providing data and documents.

At this step, relevant quotations were translated into English, and were classified based on themes along with quotation numbers from each participant, so that it would be easier to trace issues to the original transcripts later on (Appendix 10).

The results of the thematic analysis were combined with relevant quotations from the abovementioned documents of the Indonesian Tax Court's decisions on intangible disputes between the Indonesian Tax Authority and the following taxpayers: PT. Ford Motor Indonesia, PT. L'Oreal Indonesia, and PT. Halliburton Indonesia, which have been translated by the researcher (Appendix 11). The results of the data analysis are presented in English.

3.5 Trustworthiness

As realities have multiple interpretations and are socially constructed (Guba & Lincoln, 1994), the acceptability of research' results depends on the credibility or trustworthiness of what has been done by the researcher to arrive at the findings (Bryman & Bell, 2011). Further, Bryman and Bell argue that trustworthiness can be achieved by the implementation of good conduct in research and respondent validation. An audit trail was developed to achieve good practices in research by providing citations from relevant documents and interviews along with thematic maps, tables, and figures which represent codes, themes, and concepts that emerged during data analysis. Respondent validation of all their transcripts was conducted. The following table describes the date transcripts were sent to the respondents for validation, their date of reply, and the corresponding responses.

Table 3.5
Respondent Validation

Respondent	*Date Transcript Sent*	*Date of Response*	*Notes*
Respondent 1	23 April 2013	29 April 2013	Agree
Respondent 2	24 April 2013	6 May 2013	Agree
Respondent 3	24 April 2013	25 April 2013	Agree, notes and correction
Respondent 4	23 April 2013	1 May 2013	Agree, notes and correction
Respondent 5	23 April 2013	4 May 2013	Agree
Respondent 6	24 April 2013	1 May 2013	Agree
Respondent 7	24 April 2013	2 May 2013	Agree
Respondent 8	26 April 2013	30 April 2013	Agree, notes and correction
Respondent 9	27 April 2013	2 May 2013	Agree, notes and correction
Respondent 10	27 April 2013	29 April 2013	Agree
Respondent 11	25 April 2013	6 May 2013	Agree
Respondent 12	25 April 2013	1 May 2013	Agree
Respondent 13	25 April 2013	22 June 2013	Agree

All respondents provided their responses. Four respondents replied with notes and corrections, and these inputs were taken into account in the transcripts, while nine respondents wholly agreed with the transcript of their interviews.

The original copies of recordings and transcriptions will be stored for six years at an AUT designated premise on a USB flash drive. Other documents such as confidentiality agreements, consent forms, the Application for Ethics Approval by AUTEC (EA 1), relevant letters for ethics approval, the Directorate General of Taxes approval, and respondent validated transcripts will also be stored for six years in an AUT designated premise.

3.6 Ethics Approval

Ethical clearance was needed, since human subjects were involved in the study (Hoque, 2006). The Application for Ethics Approval by AUTEC (EA1) was submitted on 31 January 2013. On 25 February 2013 a letter concerning *Ethics Application: 13/18 Tax audit of transfer pricing cases derived from intangible assets: A case study in Indonesia* from Dr Rosemary Godbold, Executive Secretary of the Auckland University of Technology Ethics Committee, was received. The letter outlined AUTEC approval of the ethics application subject to four conditions (Appendix 12). An amendment to the EA1 was made and resubmitted to the AUTEC Team on 3 March 2013. On the following day, 4 March 2013, Dr Godbold sent a letter advising that the ethics application had been approved for three years until 4 March 2016 (Appendix 13*).*

The key principles of ethics (informed-voluntary consent, respect for privacy' rights and confidentiality, risk minimisation, truthfulness, social-cultural sensitivity, research adequacy, and avoidance of conflict of interest) and relevant principles (respect for participants' vulnerability and property) were followed. To do so, respondents were given a "participant information sheet" to obtain their "voluntary consent". They were given five working days to consider whether they would participate in the survey or not. Those who agreed to take part in the research signed a written consent form. In addition, respondents were informed that they had the right to withdraw from the research process before the completion of data collection. Moreover, confidentiality and anonymity were maintained in dealing with possible associated risks and vulnerability of participants. The outcome of interviews was treated professionally and honestly (Auckland University of Technology Ethics Committee (AUTEC), 2009).

3.7 Directorate General of Taxes Approval

Following the approval of the application for Ethics Approval by the AUTEC (EA1), the permission to conduct research from the Director of Counselling, Services, and Public Relations was obtained. Two letters of permission were granted by the Directorate General of Taxes, the Ministry of Finance of the Republic of Indonesia: S-330/PJ.09/2013 dated 25 March 2013 (Appendix 14) that allows researchers to conduct research in the Foreign Investment Three District Tax Office, the Directorate of Tax Audits and Collections, and the Directorate of Tax Regulation II and S-527/PJ.09/2013 dated 10 April 2013 (Appendix 15) that allows researcher to conduct research in the Oil and Gas District Tax Office.

Data collection commenced after Form EA1 had been approved and the permission to conduct research from the Director of Counselling, Service, and Public Relations was obtained.

3.8 Conclusion

This chapter described how the research study was conducted and how the data was gathered and analysed so that the findings were more convincing and accurate, following the corroboratory principle.

CHAPTER FOUR - RESULTS AND DISCUSSIONS

4.1 Introduction

This section presents the findings of the study. Two main groups of findings are discussed, namely, difficulties faced by the Indonesian tax auditors during audits of transfer pricing cases derived from intangible property; and approaches used by Indonesian tax auditors and officials in dealing with transfer pricing cases derived from intangible assets. The section ends with conclusions that summarize the findings of the study.

The relevant documents from the Indonesian Tax Court's decisions on intangible disputes between the Indonesian Tax Authority (ITA) and the taxpayers, namely, PT. Ford Motor Indonesia, PT. L'Oreal Indonesia, and PT. Halliburton Indonesia, are combined with the outcome of thematic analysis from the interviews.

Thematic analysis was used to analyse 1753 quotations from interviews with 13 respondents. From the thematic analysis 13 themes emerged that addressed the research questions. With regard to research question one: "What difficulties do Indonesian tax auditors face during the audit process of intangible transactions?" four themes were identified: difficulties with regard to technical matters of tax audits; difficulties arising from taxpayers; difficulties arising from current regulations; and problems related to organisation of the Directorate General of Taxes and human resources. For research question two: "How do Indonesian tax auditors deal with transfer pricing cases derived from intangible assets?", five themes were identified from thematic analysis: the legal bases used for referencing audits of transfer pricing cases; the role of tax auditors; the role of the head of the district tax office; the role of the head office of the Directorate General of Taxes; and the role of the account representatives. Four themes were excluded because they did not relate directly to the research questions.

4.2 Difficulties Faced by the Indonesian Tax Auditors during Audit of Transfer Pricing Cases Derived from Intangible Property

There are four themes that emerged from thematic analysis inductively: difficulties with regard to technical matters of tax audits (eight sub-themes), difficulties arising from taxpayers (two sub-themes), difficulties arising from current regulations (two sub-themes), and problems related to organisation and human resources (three sub-themes).

Theme 1: Difficulties with Regard to Technical Matters of Tax Audits

4.2.1 Difficulties with Regard to Technical Matters of Tax Audits

From the thematic analysis conducted on results of interviews, it was found that interviewees alluded to eight different kinds of difficulties in relation to technical matters of tax audits, namely: determining the existence of intangible property; differentiation and classification of intangible property; finding appropriate comparables for intangible property transactions; determining the transfer of intangible property; determining the benefits of intangible property; determining the

fair value of intangible property; determining the entitlement to intangible property; and difficulties in relation to infrastructure (databases, budgets, internet availability). Each interviewee had an opinion regarding difficulties they faced during the audit process and the relative importance of these difficulties, so that findings were presented based on the results from the interviews with no order of importance.

4.2.1.1 Determining the existence of intangible property

Due to the characteristic of intangible property, i.e. it cannot be seen physically, the first relevant problem faced by tax auditors is to determine whether an intangible transaction has occurred. This problem becomes more complicated when an intangible transaction takes place among affiliated parties. Another issue, is determining the existence of intangible property from both the legal and economic points of view. Seven respondents shared the view that determining the existence of intangible transactions was among the first problems in dealing with this kind of transaction (Appendix 10). One respondent emphasized that determining the existence of intangibles was the first task to be completed by tax auditors and another respondent claimed that it was the most difficult task.

> "The first thing that needs to be proved is the existence of intangible property, something that is intangible must be proved, whether it exists or not" (R4).

> "Yes, to prove the existence of intangibles is the most difficult task" (R6).

In addition, since these intangible transactions were conducted among related parties such that one party could influence another, one respondent had suspicions that transactions that do not exist could be deemed to exist.

> "Moreover, those transactions are conducted between affiliated parties, because they are not independent, but inter-affiliate, then something that does not exist, could be deemed to exist" (R4).

Further, another respondent claimed that the existence of intangible property should be proved in legal and economic terms. However, other respondents did not have the same views on the legal aspects of intangible transactions.

> "The first one, it should be obvious that the intangible asset - it does exist, in the sense of legal and economic terms". (R5)

> "The problem is, in the past, people [tax auditors] would like to bring existence [of intangible property] into the legal. [However], where is the proof? In fact, the existence of transfer pricing is not always supported legally and is not always included on the balance sheet" (R9).

These findings are in accordance with the opinion of experts discussed in the abovementioned literature review. The difficulty in defining intangible property is caused by its character and distinctive nature (Pinto, 2012). Moreover, Przysuski, Lalapet and Swaneveld (2004a) claim that the identification of intangible property is critical, since its contributing value in the company is not taken into consideration by contemporary accounting methodologies.

4.2.1.2 Differentiation and classification of intangible property

Two respondents mentioned problems in defining, differentiating and classifying intangible asset transactions.

> "The second obstacle occurs when we would like to classify the types of intangible property. So, sometimes a bit similar when they claim something as an intangible property but it is actually a service" (R6).

> "First, we have to check, under which category the certain payment will fall - royalties or services? If it is classified as a royalty, then we have to scrutinise the components of the royalties" (R8).

Since the characteristics of services and intangible property are quite similar, tax auditors have difficulty defining intangible property transactions, differentiating between intangible property and services, and classifying types of intangible property. This problem is in line with Visconti's (2012) claim that since the characteristics of intangibles are difficult to isolate and may overlap, tax auditors might have difficulty in differentiating one type of intangible property from another as well as in differentiating between intangibles and services.

4.2.1.3 Finding appropriate comparables for intangible property transactions

Four respondents mentioned that finding comparables is a problem for tax auditors during the audits of intangible transactions (Appendix 10). One respondent explained why this is so difficult:

> "Indeed, intangibles are very difficult. Why are they so difficult? First, intangible property is abstract, so it is difficult to conduct assessments or measurements. Second, in the matter of transfer pricing, intangible assets should have a unique value, and a unique value will have unique characteristics, so finding its comparison is very difficult [and] contradictory, and that is the main difficulty..." (R4).

The important features of intangibles are abstract and unique which makes it quite demanding for tax auditors to find comparables for intangible transactions. This difficulty is amplified since intangible transactions are carried out between related parties with contractual terms and economic conditions rarely similar to those in independent relationships. This result of the research is supported by experts. Vidal (2009) claims that finding comparables for intra-group transactions undertaken by multinational enterprises is challenging because multinational enterprises generate profit due to their uniqueness as well as market imperfections. Moreover, Pinto (2012) highlights that since intangible property is often self-developed by these associated enterprises, it is frequently exclusive to the groups and is not transferable to independent parties, so finding its comparable is quite difficult. In addition, certain types of intangible property, such as patents and trademarks, are claimed by Wittendorff (2010, as cited in Visconti, 2012) to have high value because of their exclusiveness and uniqueness, so it is common to experience difficulty in finding their comparables. Further, Visconti (2012) points out that there is a contradiction in the OECD transfer pricing guidelines, since the guidelines define a "patent" as "exclusive" and a "trademark" as "unique," so finding comparables to fit the exclusivity or uniqueness of an intangible is quite difficult.

4.2.1.4 Verifying the transfer of intangible property

One respondent mentioned the difficulty of verifying the transfer of intangible property:

> "The second difficulty relates to the transfer of intangible property. The payment of intangible property will be justified once such intangible property is transferred from the licensor to the licensee...to prove the transfer of intangible property is not easy because unlike goods, which have physical features, intangible property is not visible..."(R4).

Verifying the transfer of intangible property from the parent, owner, or developer of the intangible property to a subsidiary or licensee is one of the requirements that needs to be fulfilled. However, doing so is challenging for tax auditors because it is different from the transfer of tangible property, which is quite easily verified. Proof of the transfer of intangible assets is difficult to obtain because those assets cannot be seen physically. This finding is supported by Przysuski, Lalapet and Swaneveld (2004a) who claim that verifying the transfer of intangible property, whether fully or partially, from the designated owner to its affiliate is essential (Przysuski et al., 2004a).

4.2.1.5 Determining the benefits of intangible property

One respondent indicated that another problem faced by tax auditors during the audit of intangible transactions is proving benefit enjoyed by the party paying for the intangible property. Proving that the payment for intangible transactions from taxpayers to their associates overseas has advantages to taxpayers is one of the requirements before that payment is treated as a deductible expense for tax purposes. When tax auditors could not find evidence that the payment of intangible property delivered an added value to the company, tax auditors would conduct positive adjustment.

> "The second one [problem] is [proving] the benefit; the company will have an additional benefit of using the intangible property" (R5).

4.2.1.6 Determining the fair value of intangible property

Six respondents mentioned that determining the 'arm's length' value of intangibles is also a difficult problem faced by tax auditors (Appendix 10). One respondent shares his view as follows and other respondents had similar concerns.

> "The third difficulty is to prove how much is the real value" (R4).

Determining the value of intangible property is quite challenging for tax auditors due to its abstract features and the difficulty in finding comparables. The difficulty in finding the 'arm's length' value of intangible property has drawn the attention of many scholars. Pinto (2012) argues that valuation is a major issue in the examination of transfer pricing due to the difficulty in finding appropriate comparables. Further, Visconti (2012) claims that valuation is one of the central issues in intangible property because it has immaterial features which are abstract, and no active markets exist for this kind of property. In addition, he argues that this difficulty in valuation results from different methods adopted by multinational enterprises when assessing the value of intangible property. Moreover, the complexity in the valuation of intangible property exists because it is frequently embedded with other physical assets when transferred to company affiliates (Przysuski et al., 2004a).

4.2.1.7 Determining the entitlement of intangible property

Finding the true owner of intangible property could be a problem for tax auditors as explained by one respondent:

> "The fourth one is the entitlement of intangible property - which [entity] is truly entitled to the intangible property. By logic, the one that is entitled to the intangible property is the one who created it, who developed it, but in fact, because it is an affiliated transaction, intangible property will move from the country in which it was developed to a new country, for example, the most common one is from the United States to Ireland. Those things are not easy due to cross-border transactions." (R4).

Defining the party who owns intangible property can create problems for tax auditors since the real owner of intangible property sometimes moves from one jurisdiction to another lower-tax jurisdiction, and the schemes of cross border transactions become more sophisticated and complicated so that tax auditors have problems dealing with intangible property transfers. The abovementioned finding is in accordance with the concern of some scholars. The determination of ownership of intangible assets for either economic or legal purposes is claimed to be one of the most demanding aspects of the examination of intra-group transactions (Przysuski et al., 2004b). In addition, Przysuski, Lalapet and Swaneveld (2004a) argue that entitlement to intangible property is one of the main issues needing to be addressed in the valuation of intangible property, since the ownership will define who is entitled to the income generated from that property. Further, the ownership will also influence transfer pricing and associated taxes.

4.2.1.8 Difficulties in relation to infrastructure (databases, budgets, Internet)

Tax auditors in Indonesia experience infrastructure problems typical of developing countries. One respondent mentioned that the Internet connection is very limited and has low speeds. Five respondents said that Indonesia only has recently developed a transfer pricing database, and it can be accessed only in the headquarters of the Directorate General of Taxes. Further, two respondents said their district tax offices or regional offices could not use this database due to budget restrictions and accountability issues (Appendix 10). One of them shared his opinion as follows:

> "the problems are obvious, the first one is at the district tax office level, they do not have database [access] because of budget constraints and budget accountability" (R6).

In summary, with regard to technical matters of tax audits, tax auditors experienced eight difficulties with intangible property: determining the existence; differentiating and classifying; finding appropriate comparables; determining the transfer; determining the benefits; determining the fair value; determining the entitlement; and difficulties in relation to infrastructure (databases, budgets, internet availability).

Theme 2: Difficulties Arising from Taxpayers

4.2.2 Difficulties Arising from Taxpayers

Based on the thematic analysis of interview responses, two concerns with taxpayers emerged: problems with the transparency of taxpayers' bookkeeping; and lack of cooperation in providing data and documents.

4.2.2.1 Problem with transparency of taxpayers' bookkeeping

As reported by one respondent, tax auditors often face a problem understanding taxpayers' bookkeeping, because taxpayers create sophisticated techniques that obscure transactions undertaken. This is exacerbated when taxpayers refuse to open the relevant codes unless approval from headquarters is obtained.

> "Indeed, it [XCo] has a closed bookkeeping and accounting system; they have so many codes and no descriptions. A chart of accounts exists, but there is no description; we didn't know what the codes on these accounts were for. When we requested to open the codes they said that permission from its headquarters must be obtained." (R1).

4.2.2.2 Lack of taxpayers' cooperation in providing data and documents

Another problem is encountered by tax auditors when taxpayers do not provide the data required so that further investigation of certain issues is curtailed. If data or documents needed for the audit process are not available from uncooperative taxpayers, problems will be created for tax auditors. Tax auditors might request assistance from tax treaty partners[6] overseas through an information-exchange mechanism, but that would take time and there would be no guarantee that it would succeed. Another problem would arise where taxpayers were non-listed companies, since these were unlikely to be transparent.

> "The biggest obstacle is the availability of data provided by the taxpayer." (R6).

> "Could we ask for the data from [other] jurisdictions in the US or Europe? Maybe we could do it through exchange of information, but it might take a long time, and there would be no guarantee that it would succeed." (R3).

> "Sometimes, it is difficult to obtain financial statements of the parent company if they are not transparent. If it were a non-listed company, it would also be very difficult" (R2).

To sum up, tax auditors faced problems arising from taxpayers with regard to the transparency of their bookkeeping and a lack of cooperation in providing data and documents.

Theme 3: Difficulties Arising from Current Regulations

4.2.3 Difficulties Arising from Current Regulations

Thematic analysis has identified two issues with regards to current regulations: namely workload pressures and limited time for the completion of audits, especially for tax refund audits; and transfer pricing regulations being too loose and lacking detail.

[6] Country or jurisdiction with which Indonesia has already signed a tax treaty.

4.2.3.1 Workload and limited time for completion of audits, especially for tax refund audits

Six respondents mentioned that large workloads due to routine audits for tax refunds put an excessive burden on tax auditors so that less time could be dedicated for transfer pricing cases (Appendix 10). It is stated in the Indonesian regulations that every tax refund claim submitted by taxpayers shall be audited so, as a result, tax auditors are greatly burdened. The time limit for completion of this kind of audit is one year starting from the day the tax return is submitted. The burden on tax auditors is even greater when transfer pricing cases take place along with refund claims.

> "The second one is a limitation of time. Tax audits for intangibles are complicated because it is impossible to conduct an in-depth analysis in only one or two days, and rigorous reseach and much evidence are needed. Time is restricted, because for example, if the case falls under the requirements for a tax refund claim audit, then it is very difficult to cover transfer pricing audits properly" (R5).

> "But the main reason is actually because of workload. One audit team could get 100 assignment letters. So, they do not have any chance to manage transfer pricing." (R9).

4.2.3.2 Transfer pricing regulations are too loose and lack detail

Two respondents claim that current regulations dealing with transfer pricing are too loose and not detailed enough, making it very difficult to prove that transactions conducted by related parties are not in accordance with 'arm's length' conditions.

> "Then the third one [problem] is our regulations; they are too loose to provide justification for royalty payments. So, we look at PER 32, which states that all royalty payments are reasonable regardless of whether or not they are of a significant amount. Thus, our regulations are too loose compared with section 1482, which is very rigid" (R5).

> "Unfortunately, our domestic rules are not detailed enough, and we would like to make these clearer" (R6).

One respondent mentioned that the transfer pricing regulation is relatively new so that improvement is needed.

> "Then in our own regulations audit transfer pricing and transfer pricing are still relatively new and need improvement, and the legal basis is still based on regulations of the Directorate General of Taxes. We would like to upgrade to the level of Finance Minister Regulation" (R12).

Since Indonesian transfer pricing rules and regulations are quite new, problems for tax auditors arise because they cannot address every case and, additionally, they do not have enough detailed written guidance to deal with transfer pricing cases.

In short, tax auditors experienced problems with current regulations in terms of limited time for the completion of audits, especially for tax refund audits, and transfer pricing regulations that are too loose and lack detail.

Theme 4: Problems Related to Organisation and Human Resources

4.2.4 Problems Related to Organisation and Human Resources

As a result of the thematic analysis, three problems were identified with regards to organisation and human resources: namely, rotation system; organisational structures for handling transfer pricing cases; and the level of knowledge of tax auditors.

4.2.4.1 Rotation system

Different interests between the Directorate of Tax Audits and Collections and the Human Resource Division lead to conflict in the rotation of tax auditors. Human Resource Division policy is that the rotation system should be nationally based, so that every tax auditor should move from one district tax office to another within the territory of the Republic of Indonesia, while Directorate of Tax Audits and Collections would like to make exceptions for those tax auditors whose expertise is in transfer pricing, because they are most needed in certain regional tax offices, such as the Special Regional Office and the Regional Office for Large Taxpayers. Two respondents highlighted the problems related to the rotation system (Appendix 10). One of them expressed this idea as follows:

> "Sometimes there are conflicts, the interests of the Directorate of Tax Audits and Collections are different from those of the Human Resource Division. Actually, the Director of Tax Audits and Collections is already aware that rotation for auditors must be nationwide for turn purposes but the skilled persons should get exceptions" (R1).

In order to handle transfer pricing cases properly, experienced tax auditors are required. However, with the current rotation system, the most knowledgeable tax auditors may not always be working on the most difficult cases. It can take a long time to train new tax auditors to handle transfer pricing cases, and this puts the audit team and organisation as a whole at a disadvantage.

4.2.4.2 Organisational structure for handling transfer pricing cases

Two respondents mentioned the organisational structure for transfer pricing in their interview responses (Appendix 9). One respondent explained as follows:

> "Then, the second problem, is that we do not have the human resources that specifically address transfer pricing audits in the field. The third problem, is our organisational structure for handling transfer pricing audits is not specific and is only in the Level 4 echelon. It is too small, isn't it?" (R12).

The Directorate General of Taxes does not have any tax auditors especially dedicated to handling transfer pricing cases, and they are only of echelon-4 status in the organisational structure. Thus, as the number of transfer pricing cases has recently increased, without any changes to current organisational structure, burdens on tax auditors and the Directorate General of Taxes will increase significantly.

4.2.4.3 Level of knowledge of tax auditors

As transfer pricing cases in Indonesia are quite new and the cases take place only in certain regional tax offices, the general competency level of tax auditors is quite low. There are further

complications when inexperienced tax auditors are rotated to units handling transfer pricing cases. Six respondents mentioned the low level of knowledge by tax auditors (Appendix 10). One of them shared his views below:

> "The main difficulty is the lack of understanding by tax auditors regarding concepts of fairness ('arm's length') of intangibles." (R5).

One respondent further explained the reason for this problem:

> "The rotation system replaces tax auditors with new ones. That creates issues for us [the Directorate of Tax Audits and Collections]. We have to educate the auditors from the beginning with basic skills" (R9).

In summary, tax auditors have problems with regards to organisation and human resources: rotation systems do not reflect the need for tax auditors; organisational structures are not appropriate for handling transfer pricing cases, and tax auditors have a low level of appropriate knowledge.

4.3 Ways Indonesian Tax Auditors and Officials Deal with Transfer Pricing Cases Derived from Intangible Assets

Five themes were identified from thematic analysis: the legal bases used as references in the audits of transfer pricing cases (with three sub-themes), the role of tax auditors (with eight sub-themes), the role of the head of the district tax office (with two sub-themes), the role of the head office of the Directorate General of Taxes (with three sub-themes), and the role of account representatives.

Theme 5: Legal Bases Used as References in Audits of Transfer Pricing Cases

4.3.1 Legal Bases Used as References in Audits of Transfer Pricing Cases

Three sub-themes were identified in relation to the references used by tax auditors during the audit of intangible transactions: namely, Article 18 paragraph (3) of the Indonesian Income Tax Law and domestic regulations; legal documents, contracts, or agreements entered into among affiliated enterprises; and the OECD Transfer Pricing Guidelines.

4.3.1.1 Article 18 paragraph 3 of the Income Tax Law and domestic regulations

Tax auditors use Article 18 paragraph (3) of the Income Tax Law as a legal basis and starting point to conduct analyses and evaluations of related party transactions. This Article provides an entry point for tax auditors to conduct further investigations once a related party is deemed to exist. Eight respondents mentioned this in their interviews (Appendix 10).

> "Related-party relationships are defined in Article 18 paragraph 3 of the Income Tax Law, so with the authority of this article we decide that certain related-party transactions need to be explored more. In principal, Article 18 paragraph 3 provides the key and entry gate. If a related-party relationship exists, then it must be examined further" (R1).

> "Yes, it is right [Article 18 paragraph (3)] is the starting point. It must be determined that a related-party relationship exists and then we look for the level of reasonableness" (R8).

One respondent elaborated further in addition to the Article 18 paragraph (3) as a legal basis by including domestic rules and regulations:

> "First, use Article 18 paragraph (3), then try to find domestic rules [such as] KEP-01 1993, PER 43, or PER 32" (R5).

In order to use Article 18 paragraph (3) of the Income Tax Law, tax auditors try to verify related-party relationships between parents and subsidiaries as shown in the Indonesian Tax Court's decision on intangible disputes between the Indonesian Tax Authority and PT. L'Oreal Indonesia. L'Oreal S. A. France was proved to be a related party to PT. L'Oreal Indonesia since 99% of shares of PT. L'Oreal Indonesia was owned by L'Oreal S. A. France. The other two court cases also shared similar stories (Appendix 11).

> "These non-'arm's length' conditions took place because L'Oreal S. A. France and PT. L'Oreal Indonesia were related parties in which 99% of shares of PT. L'Oreal Indonesia were owned by L'Oreal S. A. France and 1 % of shares is owned by Holdial SNC, France."

The related-party relationship is determined in order to implement Article 18 Paragraph (3) of the Income Tax Law. This is in line with the US definition of "control" under Code Section 482 (Levey & Wrappe, 2010). It is also quite similar to that of New Zealand, which grants common ownership based on a share of 50 percent or more (Li, 2005a).

Once a related-party relationship is proved to exist, tax auditors will use Article 18 paragraph (3) of the Income Tax Law as a legal basis to make a positive adjustment on transfer pricing cases as shown in the abovementioned cases. The following quotation was taken from the Indonesian Tax Court's decision on intangible disputes between the Indonesian Tax Authority and PT. L'Oreal Indonesia. Similar findings were also found in the other two aforesaid cases (Appendix 11).

> "Thus, based on Article 18 Paragraph (3) of the Income Tax Law number 17 year 2000 the tax auditors should make positive adjustments to royalty payments and reclassify those payments as dividend payments (profit sharing)".

After proving the existence of related party transactions, tax auditors conduct further investigations into these transactions. Once tax auditors have enough evidence and reach a conclusion that intangible property transactions are not in accordance with the 'arm's length' principle, they use Article 18 of the Income Tax Law as a legal basis to make positive adjustments to these affiliated transactions. The legal basis used by Indonesian tax auditors is in line with the opinions of experts. Pogorelova (2009) argues that tax authorities are granted the right to make a positive adjustment, if transactions undertaken by a member of the associated enterprises are different from those conducted by independent parties with reference to Article 9 (2) of the OECD Model Tax Convention. Further, as Levey and Wrappe (2010) point out in Code Section 482, the Secretary of the Internal Revenue Service is granted the authority to conduct necessary actions such as distributing, apportioning or allocating gross income, deductions, credits, or allowances which belong to associate enterprises, in the interests of preventing tax evasion.

4.3.1.2 Legal documents, contracts, or agreements entered into among affiliated enterprises

Five respondents believe that contracts between associated enterprises would be respected as legal documents, but affirmed that these contracts would be compared to the facts of the taxpayers' transactions (Appendix 10). Two respondents elaborated further on their treatment of contracts between affiliated enterprises stating that they conducted direct investigation into the plant (factory) in order to see the productions process and to gather factual conditions which were then compared with those stated in the agreement. Tax auditors adopted the 'substance over form' principle whereby economic substance was granted more importance than the legal forms.

> "Legal documents are used as a starting point to determine 'who does what' but judgment should be based on factual conditions.Tax auditors visit the plant and look at production processes. Are the factual conditions in accordance with the agreement? Often, factual conditions do not adhere to legal conditions" (R4).

> "Yes, usually we still pay attention to the contract but we have to look at the facts. We respect the legal documents, but the substance must be seen" (R6).

In line with the previous ideas, one respondent emphasised that contracts alone would not prove the existence of intangible transactions:

> "However, the contract does not necessarily prove the existence of intangible property." (R5).

One respondent (R1) shared his experiences (Appendix 10) when scrutinizing and comparing contracts with the real-life situation of taxpayers. He explained that as the DGT adopts the 'substance over form' principle, any legal document concluded between affiliated enterprises will be followed by tax auditors as long as its substance makes sense to the businesses of the taxpayers and has reasonable value. When he conducted the audit on L'Oreal Indonesia, his team scrutinized the contract between L'Oreal Indonesia and L'Oreal SA France. His audit team found that in the agreement it is stated that L'Oreal SA France is entitled to a proportion of the net sales of the licensed products at two rates: 5% for the right to use the technology and 1% for the right to use the licensed trademark because L'Oreal SA granted an exclusive right to L'Oreal Indonesia to use its technology and licensed trademarks, and to distribute and sell its licensed products in Indonesia. Referring to the agreement, his team claimed that the technology was related to the composition or production process so that he concluded that the use of technology and the licensed trademark was subject to the production of licensed products by L'Oreal Indonesia. However, on examination in 2005 there was found to be no production of licensed products. Therefore, tax auditors came to the conclusion that royalties charged by L'Oreal France were not reasonable, and had resulted from the related-party relationship between L'Oreal Indonesia and L'Oreal France.

These experiences were confirmed by the Indonesian Tax Court's decisions on intangible disputes between the Indonesian Tax Authority and PT. L'Oreal Indonesia (Appendix 11) as follows:

- The tax auditors made positive adjustments to the whole royalty payment in the amount of IDR13,888,591,263.00 according to the "license agreement" between L'Oreal SA and PT.

L'Oreal Indonesia. It was stated in the licence agreement that L'Oreal grants to the licensee the exclusive right to use the "technology" and the "licensed trademarks" and to distribute and sell the licensed products in the territory and the right to market the licensed products, including the exclusive right to exploit the licensed patents. In return, PT. L'Oreal Indonesia shall pay royalties to L'Oreal S.A. France based on the proportion of the net sales of the licensed products as follows 5% for the use of technology and 1% for the use of licensed trademarks.

- The term 'technology' referred to all the valuable information developed by L'Oreal SA France with regard to the composition and/or process of the production of licensed products. The term 'licensed trademarks' mean the L'Oreal, Maybelline, Kerastase, Dralle and Redken trademarks as well as all other trademarks and any and all names, abbreviations, symbols and other distinctive signs including the designs, which are used at the present time or which will be used in the future, in combination or in association with one and/or another of the main abovementioned trademarks on L'Oreal initiatives, or any other trademarks that the parties will decide by common consent to exploit in accordance with this agreement.
- Tax auditors concluded that an invoice of payable royalties would occur only if PT. L'Oreal Indonesia had used 'technology' and 'licensed trademarks' owned by L'Oreal SA France. Referred to the meaning of the terms 'technology' and 'licensed trademark,' the tax auditors concluded that the use of 'technology' and 'licensed trademarks' would only take place if PT. L'Oreal Indonesia had produced licensed products owned by L'Oreal SA France.
- However, Tax auditors claimed that, based on audit results, it was found that during 2005, PT L'Oreal Indonesia did not produce 'licensed products' owned by L'Oreal SA France, so that royalties invoiced by L'Oreal SA France were not in accordance with the 'arm's length' condition. This non-'arms length' condition occurred because L'Oreal S.A. France and PT. L'Oreal Indonesia were related parties, with 99% of the shares of PT. L'Oreal Indonesia being owned by L'Oreal S.A. France. Thus, tax auditors made positive adjustments to the royalty payments and reclassified the payment into dividend payments (profit sharing). All of the royalty expenses in the amount of IDR13,888,591,263.00 reported by PT. L'Oreal Indonesia in its income tax return were adjusted by tax auditors to nil.

Thus, in the L'Oreal case, the tax auditors used the agreement concluded among affiliated enterprises as a starting point for further investigation. They scrutinized and conducted research into the contracts between associated enterprises and compared these with the real-life situation for the taxpayer. They found that L'Oreal Indonesia did not produce 'licensed products' owned by L'Oreal SA, France, i.e. royalty payments were unjustifiable since they were not associated with the production of licensed products.

On the other hand, three respondents believed that contracts between associated enterprises should be ignored, and put more emphasis on the economic substance, as contracts conducted among associated enterprises are easily set up to meet their needs and interests (Appendix 10).

> "Agreements between 'father' and 'child', not between independent parties, so, it could be set up" (R2).

> "Thus, the contract is not taken into account; instead from a transfer pricing point of view, it is existence, the economic benefits" (R11).

The Indonesian Tax Court's decision on intangible disputes between the Indonesian Tax Authority and PT. Ford Motor Indonesia (Appendix 11) is a good illustration of this view. It is stated in the contract that the grantors (parent company) appointed the PT. Ford Motor Indonesia (subsidiary) as an exclusive distributor of Volvo, Mazda and Ford products in the territory of the Republic of Indonesia, with the right to order, purchase, receive and resell the products to dealers and other customers as authorised by the grantors. In return, the company paid the grantors a distribution rights fee amounting to 9.5% of the net sales price for the applicable period. Tax auditors argued that the contract did not make sense and ignored it, making a positive adjustment subsequently to the distribution rights fee paid by PT. Ford Motor Indonesia to its principal.

Even though these transactions existed in legal terms, the tax auditors still examined the facts to investigate whether they were acceptable or not, and substance overrode the legal form. The 'substance over form' principle adopted by the tax auditors is in accordance with the opinion of Maocour and Benard (2008). They highlight that, by following the 'substance over form' principle, tax authorities are granted power to ignore an arrangement when it is deemed to be fictitious or intentionally set up for the purposes of decreasing or avoiding taxes.

4.3.1.3 OECD Transfer Pricing Guidelines

Tax auditors refer to the OECD Transfer Pricing Guidelines if they cannot find any references pertinent to their cases in domestic legislation and tax treaties. Two respondents shared their views on this issue (Appendix 10). One of them expressed his views as follows:

> "The OECD is the last reference when we can't find the relevant information in the domestic laws and treaties" (R1).

Further, four respondents mentioned that the OECD Transfer Pricing Guidelines are important references both for audits of transfer pricing, and for setting up regulations for transfer pricing (Appendix 10). Two of them shared their opinions as follows:

> "The OECD transfer pricing guidelines are a major reference in the audit of transfer pricing in Indonesia and a reference also when constructing regulations" (R6).

> "We adopt significantly from the OECD transfer pricing guidelines" (R7).

However, the OECD Transfer Pricing Guidelines cannot serve as a legal basis for positive adjustment. It can be used only as an argument in finding 'arm's length' transactions for intangible property.

> "Yes, but it is not allowed. So, the legal basis for making positive adjustments are still our laws and regulations. If only for an argument, that's OK. The argument of fairness could be obtained from anywhere but the legal basis for making positive adjustments is still Article 18 paragraph 3" (R9).

Thus, the OECD Transfer Pricing Guidelines are referred to by the Indonesian Tax Authority in auditing and constructing rules and regulations for transfer pricing cases. Tax auditors will refer to them as guidance in the absence of domestic legislation, but they cannot serve as a legal basis to conduct positive adjustments on transfer pricing cases derived from intangible property. The OECD Guidelines could serve as an argument in determining the fairness of certain transactions. These findings are confirmed by the scholars. Borkowski (2001) points out that certain countries might use the OECD Transfer Pricing Guidelines as a reference in developing their own transfer pricing regulations. In addition, the application of these transfer pricing guidelines vary from one country to another, owing to differences in traditions, politics, economics, and legal systems (Pinto, 2012).

In short, references utilized by tax auditors during the audit of intangible transactions were as follows: Article 18 paragraph (3) of the Indonesian Income Tax Law and domestic regulations; legal documents, contracts, or agreements entered into among affiliated enterprises; and the OECD Transfer Pricing Guidelines. The findings related to the legal bases used as references in audits of transfer pricing cases are supported by existing knowledge.

Theme 6: Role of Tax Auditors

4.3.2 Role of Tax Auditors

Eight themes emerged from thematic analysis of interview transcripts in relation to the roles of tax auditors: they conduct in-depth analysis of taxpayers undergoing audit; provide evidence of the existence of any intangible property owned by taxpayers; classify intangibles; identify evidence of benefits enjoyed or received by taxpayers from intangible property; find comparables for the transactions of intangible assets being audited; try to find 'arm's length' prices for the transactions of intangible assets; verify the transfer of intangible property; and verify entitlement for intangible property.

4.3.2.1 Tax auditors conduct in-depth analysis of taxpayers being audited

Tax auditors conduct comparability analysis using FAR (functions, assets, risks) analysis in order to define the need for specific intangible property transactions in certain industries. Tax auditors also consider the nature of business in industries in which taxpayers operate. If it is generally accepted that an intangible transaction is a necessity in operating the business of a taxpayer, then this typical payment is accepted as deductible expenses by tax auditors. However, for example, if a company only serves as a "contract manufacturer", then tax auditors might conclude that any payment related to royalties paid to its principal will be subject to positive adjustment. Also, if the principal argues that such royalty payments belong to other parties, the judgment of the auditors as to whether the payment for intangible transactions is deemed to be a deductible expense is still based on the functions performed by the subsidiary. If the subsidiary merely serves as a contract manufacturer then these payments will still be subject to positive adjustment. Two respondents mentioned this during interviews as follows:

> "A comparability analysis and FAR analysis of taxpayers should be completed because they relate to the analysis of the industry as well. So, the tax auditors

should look at it in more detail, in this industry, whether specific intangible property is needed or not" (R6).

"We see its FAR, and what is its function? Then, what is being charged? [if a company is only] a contract manufacturer but it is required to pay royalties on trademarks, that's obviously no longer relevant because its function [is only] as a service provider" (R9).

In addition, tax auditors do not stop at industry analysis level, if indeed such intangible transactions are necessary to run the business in certain industries, they go further by investigating economic benefit or value-added received by taxpayers from the payment of intangible transactions. If they pay royalties but always book a loss in their income statement, then tax auditors will be suspicious of this kind of transaction and will conduct positive adjustment subsequently, as indicated by the following respondent:

"Then, principle of economic benefits [needs to be taken into consideration]. If they pay royalties but suffer continous loss, then it should be questioned" (R6).

One respondent shared his experience of conducting rigorous financial statement analysis and trying to figure out key issues such as "How can a company with its main business in delivering services suffer a loss for such a long time?" In the normal course of business, a service company never suffers a loss for a considerable time, unless for genuine business reasons, such as market penetration, or the application of certain strategies. Tax auditors alleged that multinational enterprises intentionally made their affiliated company in Indonesia a 'loss centre', and shifted profit to other affiliated companies located in jurisdictions with lower taxes. As corporate income tax in Indonesia is paid only on profit, the Indonesia based-company paid no corporate income tax for a considerable time.

"We had been suspicious of XCo from the very beginning, and they didn't pay income tax for ten years due to continous loss. They would offer their price to the their clients with a 40% discount but they paid rent to their group at 100% of the rental expense. Is that logic? If the cost is paid to a third party it could be OK, it may be partly at risk of market penetration but if all of the transactions from the group, it becomes so weird, rental from the group, technical assistance from the group. What does it mean? purposely made to be loss" (R1).

One respondent mentioned that one in-depth analysis ended up with the critical question "How can a distributor company pay royalties for the goods they sell for their principal?" In a normal business, a distributor will receive commissions or bonuses based on their ability to sell products. Tax auditors found the taxpayer being audited was a subsidiary serving as distributor. In its normal business, it would book profit, but with expenses paid to its principal, so that the subsidiary suffered a considerable loss. Tax auditors conducted an analysis on cost of goods sold, which resulted in a very low gross profit (3%) while, if the expenses paid to its parent were added back, the company would have booked a significant profit.

"If someone becomes a car dealer, they would get a fee, wouldn't they? Expect a profit. They would sell enough cars to receive a certain amount of bonuses. However, in this case, why do we [distributors] have to pay [royalty to the principal]? This is a related-party relationship. Were the related-party relationship absent, is there anyone who would like pay [that royalty]? We try to calculate the costs of goods sold. The gross profit is only 3%, the bottom line is loss. If this [payment to its parent] was taken out, the company would show a profit. So, if the company is [in] a normal business with no frills, it is running well" (R3).

The efforts of tax auditors to scrutinize and investigate audit reports of taxpayers are found by the Indonesian Tax Court's decisions on intangible disputes between the Indonesian Tax Authority and PT. Ford Motor Indonesia (Appendix 11) as follows:

- Tax auditors conducted an analysis and concluded that payment of a distribution right fee in the amount of IDR111,618,916,000.00 to its parent was excessive causing loss to the subsidiary in Indonesia amounting to 8.89% of the net sales (according to the contract the amount should be 9.5%) and accounted for 60% of the general and administrative expenses. If the existing cost of goods sold was combined with the expenses paid to its affiliate overseas, such as distribution right fees, management fees, and global marketing fees, gross profit to maintain other general and administrative expenses accounted for only 3.46% or IDR43 billion of the net sales of IDR1.256 trillion.
- A distribution right fee was charged because PT Ford Motor Indonesia was granted an exclusive right by its principal to market car products with the trade names of Ford, Volvo and Mazda in the territory of Indonesia.
- Tax auditors made a positive adjustment to that distribution right fee expense vehicle (royalty payment) paid by PT. Ford Motor Indonesia to its affiliates namely Ford Motor Company; Ford Trading Company, LLC; and Volvo Car International AB because they were of the opinion that the distribution right fee caused harm to PT. Ford Motor Indonesia and was not an 'arm's length' condition. They claimed that PT Ford Motor Indonesia should get fees or revenues for the services being conducted in order to market the product (car) of its principal located overseas, not the other way around. In this case PT Ford Motor Indonesia paid a distribution right fee to its principal overseas. Similarly, other sole car distributors do not owe distribution right fees or other fees as compensation for the exclusive rights they receive from their principals.

Therefore, by conducting an in-depth analysis, which includes a comparability analysis, FAR analysis, and industry analysis, followed by rigorous financial statement analysis, tax auditors were able to handle transfer pricing cases derived from intangible transactions.

4.3.2.2 Tax auditors seek evidence of the existence of intangible property owned by taxpayers

In order to prove the existence of intangible property, tax auditors use many approaches. The first one is a practical approach in which they ask taxpayers to provide evidence to support the existence of intangible property, such as immigration evidence, performance reports, time sheets, tickets and other documentation. This evidence is needed in order to trace back the transactions claimed to exist by taxpayers. The following respondents shared their experiences:

> "If they [service provider] came here, there should be immigration evidence, time sheets. At least if there were services being performed, we could trace them back. Evidence from persons performing the services must exist"(R1).

> "Usually, we ask for some sort of reports, performance reports, and so on." (R3).

> "Sometimes, we ask for the ticket or proof of the person being here. What have they done? What kind of reports do they have?" (R2).

Where taxpayers claim that know-how or other intangible transactions are delivered by utilising technology, tax auditors require proof of correspondence such as emails or phone call records.

> "For know-how, at least correspondence should exist. Where was the correspondence? Phone calls? Email? They couldn't provide that evidence. How could services suddenly arise without any correspondence? The amount was significant and we made a positive adjustment to this" (R1).

In addition, tax auditors are also aware that sometimes expenses invoiced by headquarters are basically expense allocations without any sound basis. If it is merely allocation, without any rational and accountable calculation, tax auditors will conduct positive adjustment to this allocation as indicated by the following respondent:

> "Well, there was bill from P Co, its parent. Sometimes there was an expense which did not correspond with appropriate invoices. There should be expenses of the head office but shifted to Indonesia. Sometimes there are actually allocations, there might be allocations of parents' over head. It should be based on rational calculation and this should be accountable" (R1).

> "Indeed it [intangible transaction] should be rendered, not merely charged" (R5).

With regard to registered intangible property, such as brands and patents, tax auditors claim that proving their existence is relatively easy, since the tax auditors could ask taxpayers to provide the relevant registration documents from the Directorate of Intellectual Property Rights (in Indonesia) and other legal documents. Two respondents shared their views:

> "If the intangible property is the brand, to find the existence should be easy because we just need to physically see the brand, then check its registration with the Directorate of Intellectual Property Right here [in Indonesia]." (R4).

> "If certain intangible property is patented, it would be easy [to prove its existence] because taxpayers provide evidence of their patents with legal documents." (R6).

However, for non-registered intangible property, extra efforts are needed to deal with the existence problem. To obtain proof of existence for non-registered intangible property, tax auditors put more emphasis on non-documentary evidence rather than legal documents, since legal documents sometimes differ from what is actually taking place in the business of taxpayers. Non-documentary evidence could be represented by factual evidence with economic value. Tax auditors go directly to the place where the intangible property is claimed to be used by the taxpayer, conduct observations and interviews of the person in charge of the intangible property and his supervisor, and have the official reports signed by both of them to address legal issues. If only machines are used to produce the goods, then the claim of any intangible involved in the production process should be denied. Two respondents claimed that non-documentary evidence is more important compared to documentary evidence (Appendix 10). One respondent shared his view as follows.

> "Basically [tax auditors are] looking for factual evidence that has economic value. So, [tax auditors] go to the production division, conduct an interview with the production division, directly observe that production process and ask which part of the production process uses IP [Intangible Property]? We ask for an explanation from the taxpayers and ask them to make an official report and produce testimony given by competent persons. Usually [we] ask for two, one from the production department and one from its chief, who is responsible for the statement made by the production division" (R4).

Some tax auditors argue that since the burden of proof lies with taxpayers to submit transfer pricing documentation, the role of tax auditors in proving the existence of intangible property is to criticize and evaluate those documents provided by taxpayers. When taxpayers fail to provide evidence of existence of their intangible assets, tax auditors will treat those intangible transactions as if they do not exist, and positive adjustment will be conducted on the whole amount of the transactions. Three respondents shared their experiences of this issue (Appendix 9). One of them shared his views as follows:

> "Taxpayers should provide this [proof of existence]. Taxpayers have the obligation to make transfer pricing documentations (TP Doc).Then, tax auditors will assess based on other sources, perhaps from other documents. If taxpayers were requested to supply documents but nothing happened, then finally all of intangible assets would be adjusted to nil" (R8).

Tax auditors' opinions on burden of proof are in line with the argument from experts. Levey and Wrappe (2010) explain that in the United States, the burden of proof lies with the taxpayers, as the deficiency determination issued by the IRS under Code Sec. 482 is assumed to be correct. Thus, taxpayers must prove that the IRS acted in "an arbitrary and unreasonable manner". The same thing happens in Australia: the onus of proof is on taxpayers, since the Australian Taxation Office requires taxpayers to show that their prices are in accordance with the 'arm's length' principle. However these practices differ in New Zealand, where the burden of proof lies with the Inland Revenue Department, which must demonstrate that the transfer price applied by the tax payer is not an 'arm's length' price(Li, 2005a).

In relation to high-technology and well-known products, two respondents suggested adopting a "broader and simpler" approach to proving the existence of intangible transactions. They recommended that tax auditors take 'for granted' high-technology products, since the existence of intangible transactions are obvious.

> "Actually, the case of 'existence' must be viewed in a broader and simpler context in a sense that when there is a product with high technology, for example mobile products. In this context, we cannot deny there is intangible property in the mobile phone technology. It applies to the brand as well. If the brand is very well known by the public, then it cannot be denied that there are marketing intangibles in that product" (R7).

> "For well-known products, there are no existence issues with those brands because indeed they exist" (R6).

The efforts of tax auditors in searching evidence for the existence of intangible transactions were observed in the Indonesian Tax Court's decisions on intangible disputes between the Indonesian Tax Authority and PT. Halliburton Indonesia (Appendix 10) as follows:

- Tax auditors conducted further investigations on invoices for the technical assistance fee with a total amount of US$3,324,791.62, and the royalty expense with a total amount of US$26,196.54. It was found that those expenses were invoices from Halliburton Energy Services Inc. for performing special projects.
- Based on an examination of the general ledger and respective invoices, it was found that the payments were made to Halliburton Energy Services Inc. The audit report refers to Halliburton Energy Services Inc. as a majority shareholder of PT. Halliburton Indonesia

(80%), so that a related-party relationship between the two companies exists. Tax auditors, using the authority of Article 18 paragraph (3) and paragraph (4) of the Income Tax Law, claimed that the validity of the transactions between the two above-mentioned companies was in question, and no real work was performed, so that positive adjustments were made to the technical assistance fee of US$3,324,791.62, and the royalty expense of US$26,196.54.

4.3.2.3 Tax auditors classify intangible property transactions

Once tax auditors ensure that transactions related to intangibles exist, the next step is to classify the intangible transaction. Intangible transactions might fall under the criteria of trade (commercial) intangibles if they relate to the production process, while if they were associated with methods of selling a product, transactions would be classified as marketing intangibles. With trade intangibles, tax auditors might find a patent or know-how that has different characteristics. Know-how, due to secrecy issues, has never been registered, so extra effort is needed by tax auditors to perform audits on know-how. One respondent explained the need to classify types of intangible property during interview.

> "We must first identify the type or types of intangible property. If we talk about a type of intangible property, then we should find out in advance which types of intangible property are trade and commercially intangible.Trade intangibles relate to the production of goods, while marketing intangibles relate to the how goods are sold. If it is related to a trade intangible, there are some types that must be analysed - whether it is know-how or a patent. If it is know-how, it will be hard to get a patent. Know-how tends not to be patented because it is confidential." (R6).

4.3.2.4 Tax auditors look for evidence of benefits received by taxpayers from intangible property

Three respondents were of the opinion that transactions of intangible property should bring advantages to taxpayers involved in such transactions. If no benefit is enjoyed by subsidiaries in Indonesia from intangible transactions with their parents, tax auditors would adjust this kind of expense (Appendix 10). Two respondents expressed their opinions as follows:

> "For distributors it is necessary to scrutinise the contract and the most important thing is whether the contracted items provided economic benefits to the user" (R4).

> "The technical assistance fee is classified as services. The main requirement is that it provides an advantage to the company" (R5).

Visconti (2012) claims that the "usefulness of intangible assets" refers to extra revenue or cash flow that the company might generate by using that intangible property. Thus, as long as an intangible will generate extra revenue for the company, the benefit of an intangible transaction is deemed to be delivered.

4.3.2.5 Tax auditors try to find comparables for intangible asset transactions

Tax auditors have many approaches to finding comparables for intangible transactions. The first one is that tax auditors try to find similar cases by conducting Internet research, as explained by one respondent.

> "Initially we're 'Googling', searching on the Internet, and browsing for any similar cases like this" (R1).

Moreover, when guidance did not yet exist during an audit, tax auditors interpreted solely from the legal bases: namely. Article 18 of the Income Tax Law and other domestic regulation. They compared the agreement with what took place in the business of the taxpayer. In L'Oreal's case, tax auditors concluded that, contrary to the intent of the agreement, what took place in L'Oreal Indonesia was not suitable for an application of royalty, as is illustrated by one respondent below:

> "At that time there was no guidance with regards to the FAR analysis. So, we purely interpreted regulations under Article 18, paragraph 3 and then KEP 01 year 1993. We continued to analyse the agreement between L'Oreal Indonesia and L'Oreal France and then we compared it with the business actions that took place. We conclude from the agreement, that what took place in [L'Oreal] Indonesia could not be applied to royalties" (R1).

In another approach, tax auditors try to find internal comparables, which are viewed as the best comparables when the parent licenses its intangible to both related and independent parties. However, finding internal comparables is very demanding owing to the secrecy issue. Multinational enterprises prefer to grant a license to their affiliates not to an independent party, so that they have full control over their intangible property. Intangible property is a secret, and the key of success in their business, as illustrated by the following respondent:

> "The OECD also prefers internal comparables [in which] a parent company grants a licence to another company, so that the licence is granted to the independent party and its affiliates. [However] I have not met this yet. Usually, for multinational enterprises, they are a bit reluctant to grant a licence to an independent party. Multinational enterprises feel more secure licensing to their affiliates in order to protect their secrets" (R9).

If internal comparables are not available, tax auditors will try to find external comparables. Tax auditors tried to find an external comparable for each type of intangible property, such as trademarks, patents, know-how, or trade secrets. If they are combined, the reliability of the comparable will be lower. However, since the typical contract for intangible transactions that took place in Indonesia was one contract for all types of intangible, finding external comparables was also demanding for the tax auditors. To deal with this issue, tax auditors adopt the 25% rule of thumb, in which royalty payments would be deemed to be in accordance with the 'arm's length' principle as long as they did not exceed 25% of the operating profits before royalties. Three respondents raised this isssue (Appendix 10). The following respondents shared their views:

> "We identify whether internal comparables can be used, if not, we use the external comparable [from our] database " (R5, R6).

> "To find external comparables, we need to differentiate what kind of intangible that taxpayer has? trademark, patent, know-how, or trade secrets? This needs to be determined, first because each one has its own protection. Therefore, we look for external comparisons for each type of intangible. They cannot be combined because it will lower the reliability of the comparative results later on. [However], so far, taxpayer' contracts are combined. One contract can include trademarks, patents, know-how, or services. That is what makes it difficult, and ultimately a practical soultion was found by the applicaton of the 25% rule or the rule of thumb. The royalty is paid for a maximum of 25% of the operating profits before royalties" (R5).

The experience shared by this respondent was supported by existing literature reviews. The OECD (2010a) claims that a bundle or package contract of intangible properties may include patents, trademarks, trade secrets and know-how in one package. The OECD recommends that the packages should be broken down to their individual components so that the 'arm's length' nature of the transfer of intangible can be verified. However, Visconti (2012) argues that when sold or licensed in package or bundle contracts, the valuation of intangible properties becomes more complicated and challenging. To handle this difficulty, Indonesian tax auditors adopt the 25% rule of thumb in which a royalty payment would be deemed to be in line with the 'arm's length' principle as long as it did not exceed 25% of the operating profits before royalties.

Further, three respondents utilized "secret comparables", meaning that the tax auditors used data of companies from the same industry, listed in the same district tax office in which the taxpayers are audited (Appendix 10). One respondent shared his experience.

> "At that time, my team was a specialist for Co. X, all group of Co. X went to my team. My team member compared Co. X with Co. X' affiliate" (R1)

However, three respondents did not agree with the use of secret comparables because the practice did not reflect fairness to the taxpayers, since the information was known only to the tax auditors, and taxpayers had no access to it (Appendix 10).

> "It [secret comparable] is not highly supported because in order to prove affiliate transactions both parties should have equal access to comparative information; if only one has the information it is not fair" (R4).

Moreover, two respondents argued that since the burden of proof lies with the taxpayers, the taxpayers should provide the necessary comparables, and then tax auditors would just need to scrutinise the comparables provided (Appendix 10).

> "The burden of proof is obvious. According to PER-32, the burden of proof lies with the taxpayer based on self-assessment. Firstly, the taxpayer needs to convince the auditor that its rate of royalty is at 'arm's length'. Then, the DGT will conduct a review and in-depth analysis" (R12).

As discussed in the section 4.3.2.2, tax auditors' opinions on burden of proof are in accordance with the argument from experts. Levey and Wrappe (2010) explain that in the United States, the burden of proof lies with the taxpayers. In Australia, the onus of proof is on taxpayers, whereas in New Zealand the burden of proof lies with the Inland Revenue Department (Li, 2005a).

Right now, the Directorate General of Taxes has a database of comparables, but the problem of finding comparables still arises, since finding a very similar transaction is not an easy task, as mentioned by five respondents (Appendix 10)

> "For comparables, we try to find them in the database software. [We use software] KT Mine. It's subscription. It's OSIRIS" (R6).

> "ORIANA and OSIRIS have comparable data in financial reports to the level of net profit, while Royalstat has comparable data for royalty rates. But, [to find a comparable] for the price of goods, it is difficult as well" (R3).

To conclude, the tax auditors have many approaches to finding comparables for intangible transactions: e.g. identifying similar transactions; comparing agreements and actions taken by taxpayers; using internal comparables when a company sells the same products to related

independent parties; using external comparables by comparing products and transactions of the company being audited with those of independent parties with similar characteristics under similar circumstances; using secret comparables when auditors use data from taxpayers listed in the same office as the taxpayer being audited. Also, some tax auditors claim that they can ask for comparables from taxpayers, as the burden of proof lies with them. Recently, the Directorate General of Taxes has created a database for comparables.

4.3.2.6 Tax auditors try to find 'arm's length' prices for intangible asset transactions

The tax auditors have different approaches to arrive at an 'arm's length' prices for Intangible Property (IP). For routine IP that is not unique, tax auditors use a Comparable Uncontrolled Transaction (CUT), while for the IP with unique value, the tax auditors will use the Profit Split Method. Other tax auditors use the CUT method, which is transaction-to-transaction based, along with the TNMM (Transactional Net Margin Method), which uses an aggregate approach (company-based at the level of net operating margin). TNMM serves as a second opinion to strengthen the CUT Method. Four respondents shared their opinions regarding the method being used to find 'arm's length' values for intangible transactions (Appendix 10).

> "IP [Intangible Property] can be grouped into two categories. First, there is routine IP whose value is not unique. Licences usually use a routine IP. Usually we use the CUT [comparable uncontrolled transaction] method to look for other licensees from independent parties for the same industry. We look at how much their royalty rate is. Second, there is IP with a unique value; the commonly used method is the profit split method" (R4).

> "When tax auditors can confirm that intangible property exists, the next step is to determine the fair value. The method being used is the comparable uncontrolled transaction.Then in addition to the CUT method, we also try to search for the aggregate basis. This [CUT] has a transaction-to-transaction [basis]. We try to find a comparison from the company's point of view, so we use the TNMM. What's the Profit Level Indicator [PLI] of their performance? We use the aggregate basis at the level of the net operating margin*"* (R6).

The experience from Indonesian tax auditors in utilizing transfer pricing methods for intangible transactions is parallel with the recommendations from the OECD, especially for the profit split method. The OECD (2010a) recommends transfer pricing methods for intangible transactions as follows: for the sale or license of intangible property, the Comparable Uncontrolled Price (CUP) method could be applied in the case of an owner of intangible property when comparable transferred or licensed intangible property has been sold to both independent and affiliated enterprises under comparable conditions. The resale price method could be applied in cases where affiliated enterprises enter sub-license agreements with independent enterprises. The profit split method could be applied to highly valuable intangible property, since it is very complicated to find comparable transactions under comparable conditions for this kind of situation. Traditional methods and the transactional net margin method are difficult to apply to this type of case.

4.3.2.7 Tax auditors try to verify a transfer of intangible property

Two respondents mentioned the need to prove a transfer of intangible property (Appendix 10). One of them argued as follows:

> "The same thing applies to 'transfer' as well, so we ask for proof. For example, to produce paint, the producer must use a certain formula. We have to look for evidence of the delivery of the formula either via email or through people who explain the technology to the user" (R4).

To ensure that the transfer of intangibles has taken place, the tax auditors look for evidence of the delivery of IP either via email or through people conducting the transaction. Without this kind of evidence, tax auditors will make positive adjustments to intangible property transactions. Supporting to this idea, Levey and Wrappe (2010) explain that the Internal Revenue Service (IRS) will be able to apply Code Section 482 regulations when the owner of property "transfers" rights to a controlled party, and the transfer of intangible property will be deemed to occur when a respective intangible is "sold, assigned, loaned, or otherwise made available in any manner".

4.3.2.8 Tax auditors try to verify the entitlement to intangible property

The tax auditors try to find the party that is entitled to the benefit of the IP by scrutinising the documents of the IP developer, such as financial reports, reports on IP development, a list of employees working for that IP, and asset lists. Tax auditors claimed that the developer of IP should have the expertise and capital to develop that IP. If, indeed, subsidiaries in Indonesia have contributed significantly to research and development of the IP for manufacturing industries, or in the marketing of intangibles for distributors, both parent and subsidiary are the owners of the IP. Therefore, for the exploitation of this IP the Indonesian company is also entitled to its share of rewards. It was stated by two respondents that tax auditors try to verify the entitlement to intangible property (Appendix 10). One of them expressed their opinion as follows:

> "With regards to the entitlement, we usually conduct an assessment of the party who should receive the payment. So, we usually ask for reports of IP development activities, a list of employees working with that IP, asset lists, and financial reports if necessary.The bottom line is any activity could convince us that the party is reasonable enough to be considered as the IP developer. If the party can develop IP, it means that they must have employees, and the employees must be experts in their fields. Then, they must have money. Nowadays, IP can be subcontracted for its development, but at least they should have the money" (R4).

Tax auditors' stand on entitlement is in line with economic ownership which represents the view that income from intangible property belongs to the entity which bears the economic costs and risks in the development of the intangible (Przysuski et al., 2004b).

In summary, in dealing with transfer pricing cases arising from intangible transactions, tax auditors conduct in-depth analysis, provide evidence of the existence of intangibles, classify types of intangibles, identify evidence of benefits, find comparables, find 'arm's length' prices, verify the transfer, and verify entitlement.

Theme 7: Role of the Head of the District Tax Office

4.3.3 Role of the Head of the District Tax Office

Two themes emerged from the thematic analysis conducted on the transcripts of interviews in relation to the role of the Head of the District Tax Office as a leader and inspiration for the tax auditors. There were also comments about the Head of the District Tax Office acting as a quality assurance of audit works.

4.3.3.1 The Head of the District Tax Office as a leader and inspiration for tax auditors

The Head of the District Tax Office leads discussions and inspires tax auditors to think critically with regard to the nature of the business of distributors, which could be associated with simply 'trading'. No additional royalty is imposed when a trader buys goods from independent parties, as discussed by four respondents (Appendix 10).Two of them shared their ideas as follows:

> "Mr. S at that time discussed royalty issues. Ford Indonesia and L'Oreal Indonesia, [they] only sold products of their parents. [Distributors] bought from them [principals], but why did they [principals] impose royalties? What were the royalties on? Logically we [distributors] only acted like traders" (R1).

> "Mr.S had other ideas about the royalties. He said, if you buy a pen, your purchase included the name of the pen, for example a "Pilot" pen. It is impossible to buy and be expected to pay more [for] royalties" (R3).

These findings were supported by the OECD. If the reward for the utilisation of intangible property might already be incorporated in the price of goods, further investigations need to be conducted based on facts and circumstances in order to test whether or not the rewards for intangibles are already covered by the price of the goods. If so, then any extra payments for royalties should not be allowed by the tax administration (OECD, 2010a).

The Head of the District Tax Office pointed out a further possibility whereby intangible transactions might be used as a means of tax avoidance. Principals allocated some parts of the price of goods as royalties, as a means of reducing sales tax on luxury goods. Sales tax on luxury goods are imposed on imports, but not on the royalty component. The rate of sales tax on luxury goods is usually very high. Seven respondents pointed out this issue (Appendix 10). Two of them shared their opinions as follows:

> "This is actually avoidance. For example if if royalties are included in the price, with the higher price of imports, sales tax on luxurious goods will increase. This usually is avoided by automotive companies, so there are some parts of the price allocated to the royalty. Royalties are generally administrative expenses and not included in the price of goods. If they are included in the price of goods, the sales tax on luxurious goods will be higher" (R3).
> "Sometimes if sales tax on luxurious goods is imposed [and] if royalties [are] unreasonable but [the company] makes a reasonable profit, we are suspicious of [the avoidance of] the sales tax on luxurious goods" (R9).

Furthermore, with regard to a company that suffers loss for several consecutive years; one respondent mentioned the possibility of tax avoidance for corporate tax.

> "Moreover there is a trend. Our taxpayers suffered losses, or even profits were slim, for years, with a wide range of expenses from the head offices in terms of overheads and royalties" (R1).

These experiences were quite different from the opinions from experts. According to Robbins and Stobaugh (1973, as cited in Li, 2005b), the parent company might establish a high transfer price on goods delivered to its subsidiaries in response to limitation on the amount of transfer of royalty or management fees from their subsidiaries imposed by the tax authorities of the countries in which the multinational enterprises operate.

The head office conducted productive discussions with tax auditors on the nature of business of affiliated distributors, which represent the majority of taxpayers in the Foreign Investment Three District Tax Office. In the absence of related-party relationships, distributors would act as "traders" and would not pay royalties to the owners of the goods they sold. Instead they should receive a reward for the success of their sales to third parties. Tax auditors apparently concluded that reimbursement for the costs associated with intangible property transactions were already included in the price of goods. Any other arrangement might be suspicious, as a tool for tax avoidance. When the parents prefer to charge royalties rather than having higher selling prices to their subsidiaries in Indonesia, tax auditors are likely to conclude that such a scheme is a kind of tax avoidance. By having lower selling prices, the taxes associated with imports, such as excise taxes, value added taxes for import, and sales tax on luxury goods, would be lower. Furthermore, if a subsidiary suffers a loss after paying intangible transactions such as royalties to their principal, tax auditors might conclude that such a payment was used to avoid paying corporate taxes in Indonesia.

4.3.3.2 The Head of the District Tax Office acts as a quality assurance for audit works

The role of the Head of the District Tax Office as a quality assurance for audit works is discussed by two respondents (Appendix 10). One respondent highlighted this issue as follows:

> "He would be last filter. Mr. S is a capable person. Sometimes there were issues raised by him, for example royalties on trading. Mr. S usually had a better monitoring, so he sometimes provided improvements. Sometimes we did not address problems quite well, and Mr. S and Mr. J would put us back on track. Once we began research, they would explore with us." (R1).

The Head of the District Tax Office acts as the quality assurance before the audit results are officially released. The Head of the District Tax Office does reviews and makes necessary corrections for the improvement of the audit. Also during the audit, they provide directions and investigate the taxpayer being audited along with the tax auditors.

To sum up, the Head of the District Tax Office had a role as leader and inspiration for the tax auditors, and as the quality assurance before the audit results are officially released, by conducting reviews and making necessary corrections.

Theme 8: Role of the Head Office of the Directorate General of Taxes

4.3.4 Role of the Head Office of the Directorate General of Taxes

Three themes appeared from the thematic analysis with regard to the role of the Head Office of the Directorate General of Taxes: the Directorate of Tax Audits and Collections and the Directorate of Tax Regulations II coordinate with each other in providing assistance to the tax auditors conducting transfer pricing audits and in dealing with transfer pricing rules and regulations. Also, the Directorate of Tax Audit and Collections coordinates with the Directorate of Tax Objections and Appeals in reviewing decisions of the Tax Courts that are unfavourable to the Directorate General of Taxes.

4.3.4.1 The Directorate of Tax Audits and Collections and the Directorate of Tax Regulations II provide assistance to the tax auditors who carry out transfer pricing audits

The Directorate of Tax Audits and Collections offers continuous training programs to increase the skills of tax auditors according to four respondents (Appendix 10). One respondent explained as follows:

> "Formally through our human resources division we invite [tax] auditors to have training because they are in direct contact with the case, especially in the Large Tax Office and Special Offices" (R6).

The Directorate of Tax Audits and Collections provides assistance to tax auditors when they face difficulties in handling transfer pricing cases from intangible transactions. This assistance is voluntary, so that only tax auditors who need help will come for consultation. The assistance covers guidance in completing working papers with regard to related-party relationships, affiliate details, affiliate transaction schemes, industry analysis, supply change, FAR analysis, comparables, and other relevant issues. These supports were mentioned by three respondents as follows:

> "The headquarters is actually very open to it [provide assitance]. They may come at any time, but [we prefer] they make an appointment by sending an official letter" (R4).

> "But not all of the them come, only those who feel that they need help. It is voluntary" (R9)

> "We try to help our friends [tax auditors] with any technical assistance in completing their working papers for related-party relationships, affiliate details, affiliate transaction schemes, industry analysis, supply change, FAR analysis, comparables". (R6).

The Directorate of Tax Audits and Collections manages transfer pricing cases from the headquarters of the Directorate General of Taxes, however only cases reported and consulted with them are monitored. In addition, a regulation was also released to handle transfer pricing cases at regional tax office level, but it only works well in the Large Taxpayers Regional Office, as they have one TP expert in their office. Three respondents discussed this issue (Appendix 10). Two respondents shared their ideas below:

> "Yes, all TP (Transfer Pricing) cases are managed by the Directorate of Tax Audits and Collections (R6).

> "Actually we already had PER-55 in 2010 that asked us to form a task force for TP cases. So, hopefully they'll handle it first in the regional office. It went well in the Large Taxpayers Regional Office, but in the Special Regional Office, they still come here, because they do not dare [do not wish to take risk]. In the Large Taxpayers Regional Office, they have Mr. A there" (R10).

The Directorate of Tax Regulations II also provides voluntary assistance to the tax auditors in dealing with complicated transfer pricing cases. They may come directly to have discussion with designated staff, or they send a formal letter to the Directorate of Tax Regulations II. Two respondents mentioned this during interviews as follows:

> "Indeed, there is no obligation for the auditors to consult with the Directorate of Tax Regulations II but if they have quite a complicated case, they usually visit the Directorate of Tax Regulations II to discuss the case at hand." (R7).

> "they ask our friends [dedicated staff] here, or sometimes they ask for a confirmation letter as well." (R12).

4.3.4.2 The Directorate of Tax Audits and Collections coordinates with the Directorate of Tax Regulations II to deal with transfer pricing rules and regulations

The Directorate of Tax Regulations II coordinates with the Directorate of Tax Audits and Collections in developing transfer pricing regulations in order to minimise overlapped regulations. The Directorate of Tax Regulations II is responsible for providing general guidance on transfer pricing (material[7]), while the Directorate of Tax Audits and Collections is responsible for making policy guidelines for auditing TP cases (formal[8]). Five respondents discussed how to handle transfer pricing rules and regulations so that transfer pricing cases could be carried out properly (Appendix 10). Three respondents expressed their ideas as follows:

> "We [Directorate of Tax Regulations II] coordinate with the Directorate of Tax Audits and Collections on drafting the regulations, and we discuss with them about what things need to be regulated in Indonesia because [they] have more [experience in] practice in the field." (R7).

> "The Directorate of Tax Audits and Collections, according to Mr.T, is not allowed to regulate 'material', they can only regulate 'formal'. The domain of the 'material' belongs to the Directorate of Tax Regulations II" (R9).

> "We [Directorate of Tax Regulations II] provide general guidance on transfer pricing. Those will be relied upon by the Directorate of Tax Audits and Collections to make policy guidelines for auditing TP cases. We have TP audit policies based on Perdirjen [Director General of Taxes Regulation] 32" (R12).

4.3.4.3 The Directorate of Tax Audits and Collections coordinates with Directorate of Tax Objections and Appeals in reviewing the decisions of tax courts.

The Directorate of Objections and Appeals conducts evaluations of the outcome of objections and appeals. The results of evaluation are sent to the Directorate of Tax Audits and Collections. If the decision was in favour for the Directorate General of Taxes, it will be shared with the tax auditors as a reference when they face similar cases. If the Directorate General of Taxes loses

[7] Material refers to the content of regulations
[8] Formal refers to the procedures for applying regulations

the case, the Directorate of Tax Audits and Collections will conduct an evaluation of the case and inform the tax auditors of the reasons the case was lost. Three respondents discussed possible actions following decisions by the tax courts that were unfavorable to the Directorate General of Taxes (Appendix 10). One respondent shared his view as follows:

> "[The Directorate of] Objections and Appeals has a subdirectorate for evaluations. The outcome of objections and appeals are compiled and are sent to the Directorate of Tax Audits and Collections. If it is good one [DGT won the case], it will be shared with the auditing unit. A bad one [DGT lost the case] will be evaluated for its weaknesses" (R4).

In short, the role of the Head Office of the Directorate General of Taxes is represented by the following: the Directorate of Tax Audits and Collections and the Directorate of Tax Regulations II provide assistance to the tax auditors who carry out transfer pricing audits and coordinate with each other in dealing with transfer pricing rules and regulations; and the Directorate of Tax Objections and Appeals coordinates with the Directorate of Tax Audit and Collections in reviewing the decisions of the Tax Courts that are unfavourable to the Directorate General of Taxes.

Theme 9: Role of Account Representatives

4.3.5 Role of Account Representatives

Account representatives support tax auditors in providing data and in-depth analysis on transfer pricing cases before taxpayers are officially audited by tax auditors. One respondent mentioned the role of account representatives in dealing with transfer pricing cases.

> "The taxpayers that are not audited will fall under the responsibility of the account representative. We propose that account representatives should conduct analyses, so that special audits can be proposed and semi-finished, and steps of functional analyses are required outside the audit term. Cooperation between account representatives and auditors is needed. I ask if there is data and so on to [pass them to] the functional [tax auditors].

Cooperation between account representatives and tax auditors is needed in dealing with transfer pricing cases. Account representatives are responsible for non-refund taxpayers having transfer pricing transactions that are not yet audited. They conduct in-depth analyses on tax returns submitted by taxpayers before they propose special audits for taxpayers involved in transfer pricing transactions. Any data gathered by account representatives needs to be delivered to tax auditors for further investigations.

4.4 Conclusion

The outcome of thematic analysis from the interviews was combined with the Indonesian Tax Court's decisions on intangible disputes between the Indonesian Tax Authority (ITA) and the taxpayers namely PT. Ford Motor Indonesia, PT. L'Oreal Indonesia, and PT. Halliburton Indonesia in order to address two research questions. For research question one: "What difficulties do Indonesian tax auditors face during the audit process of intangible transactions?" four themes were identified: difficulties with reference to technical matters of tax audits; difficulties arising from taxpayers; difficulties arising from current regulations; and problems related to organisation of the Directorate General of Taxes and human resources. While for

research question two: “How do Indonesian tax auditors deal with transfer pricing cases derived from intangible assets?”, five themes were identified: legal bases used as reference in audits of transfer pricing cases; role of tax auditors; role of the head of district tax office; role of the head office of the Directorate General of Taxes; and role of account representatives. The summary of findings is presented in the table below:

Table 4.1
Summary of Findings

Research Questions	Findings
1. What difficulties do Indonesian tax auditors face during the audit process of intangible transactions	Difficulties Faced by the Indonesian Tax Auditors during Audit Process of Transfer Pricing Cases Derived from Intangible Property 1 Difficulties with regard to technical matters of tax audits a Determining the existence of intangible property b Definition, differentiation, and classification of intangible property c Finding appropriate comparables for intangible property transactions d Verifying the transfer of intangible property e Determining the benefits of intangible property f Determining the fair value of intangible property g Determining the entitlement to intangible property h Difficulties in relation to infrastructure (databases, budgets, Internet) 2 Difficulties arising from taxpayers a Problems with transparency of taxpayer bookkeeping b Lack of taxpayer cooperation in providing data and documents 3 Difficulties arising from current regulations a Workload and limited time for completion of audits, especially for tax refund audits b Transfer pricing regulations are too loose and lack detail 4 Problems related to organisation and human resources a Rotation system b Organisational structure for handling transfer pricing cases c Level of knowledge of tax auditors
2 How do Indonesian tax auditors deal with transfer pricing cases derived from intangible assets?	Ways Indonesian Tax Auditors and Officials Deal with Transfer Pricing Cases Derived from Intangible Assets 1 Legal Bases Used as References in Audits of Transfer Pricing Cases a Article 18 paragraph 3 of the Income Tax Law and domestic regulations b Legal documents, contracts, or agreements entered into among affiliated enterprises c OECD Transfer Pricing guidelines 2 Role of tax auditors a Tax auditors conduct in-depth analysis of taxpayers being audited b Tax auditors seek evidence of the existence of intangible property owned by taxpayers c Tax auditors classify intangibles d Tax auditors look for evidence of benefits received by taxpayers from intangible property e Tax auditors find comparables for intangible asset transactions f Tax auditors find ‘arm’s length’ prices for intangible asset transactions g Tax auditors verify a transfer of intangible property

Research Questions	Findings
	h Tax auditors verify the entitlements to intangible property 3 Role of the Head of the District Tax Office a The Head of the District Tax Office acts as a leader and inspiration for tax auditors b The Head of the District Tax Office acts as the quality assurance for audit works 4 Role of the Head Office of the Directorate General of Taxes a The Directorate of Tax Audits and Collections and the Directorate of Tax Regulations II provide assistance to the tax auditors who carry out transfer pricing audits b The Directorate of Tax Audits and Collections coordinates with the Directorate of Tax Regulations II to deal with transfer pricing rules and regulations c The Directorate of Tax Objections and Appeals coordinates with the Directorate of Tax Audits and Collections in reviewing the decisions of tax courts that are unfavourable to the Directorate General of Taxes. 5 Role of Account Representatives a To support tax auditors in handling transfer pricing cases in terms of providing data and in-depth analysis on transfer pricing cases before taxpayers are officially audited by tax auditors

CHAPTER FIVE – SUMMARY AND CONCLUSION

5.1 Introduction

This chapter provides an overview of the study, and discusses its background. The objective of the research, the approach undertaken, data collection, and data analysis are also discussed, followed by conclusions, limitations, practical contributions, and future research.

5.2. Overview of the Study

Tax administrations around the world have identified that transfer pricing is a significant issue to address, as they struggle to maintain tax revenue derived from multinational enterprises conducting business in their countries. Transactions between affiliated companies create concerns that prices and profits might be set up in the interests of associated enterprises, as one party could easily influence an affiliate. As a result, the tax revenue of host countries could be distorted.

Dealing with intangible transfer pricing cases is not an easy task for Indonesian tax auditors owing to difficulties in searching comparable transactions under comparable circumstances, especially for transactions derived from intangible property. If the tax auditors make adjustment to intangible transfer pricing cases, taxpayers can challenge these adjustments using objection, appeal, or mutual agreement procedures. If a taxpayer wins the case, and if they had already paid the additional tax imposed by the ITA, the Government has an obligation to pay back that amount, plus interest of 2% per month for a maximum of 24 months. Also, settling a dispute over transfer pricing at the international level is very difficult, and many rounds of bilateral negotiations might take place between competent authorities in which significant resources are spent.

The objective of this research is to investigate what difficulties Indonesian tax auditors face during a transfer pricing audit, and how Indonesian tax auditors and tax officials cope with transfer pricing cases derived from intangible properties. The research will benefit the ITA in terms of providing a good understanding of how to handle transfer pricing cases so that the financial risk borne by the government can be minimised.

Because the objective of this research is concerned with deriving rich descriptions and explanations from Indonesian tax auditors and officials in dealing with transfer pricing cases derived from intangible transactions, a qualitative research approach was chosen. An interpretive paradigm was adopted, since the focus of the research was on how Indonesian tax auditors interpret accounting numbers, not as a representation of objective reality, but as subjective products. The case study approach was chosen, since it facilitates the unveiling and portrayal of individual insight on the subject being examined. The case study was adopted as a research strategy since it is suited to addressing “how” research questions. Also, it works best under conditions in which researchers have no ability to control the investigated subject, and the

research has real life contexts. Moreover, case studies provide a comprehensive analysis of issues supported by intensive investigation of their background.

Documents and interviews were used to collect the data. The documents used are the Indonesian Tax Court's decisions on intangible disputes between the ITA and the PT. Ford Motor Indonesia (Put.30538/PP/M.V/15/2011); PT. L'Oreal Indonesia (Put.24631/PP/M.II/ 15/2010) and PT. Halliburton Indonesia (Put.32485/PP/M.I/15/2011). The three cases listed above were selected as samples because they were settled from 2010 to 2011, so that they reflect the current standards of transfer pricing.

A semi-structured interview which followed predetermined guidance was utilized to interview the tax auditors involved in the aforementioned cases. This semi-structured approach was selected as it was expected to fulfil research objectives, and allow flexibility to respond to participants' replies and to follow-up on emerging issues. In addition, for corroboratory purposes, an open-ended interview was conducted with the persons in charge at the Directorate of Tax Audits and Collections and the Directorate of Tax Regulations II. The open-ended method was used for these interviews because these interviewees are all policy makers, and the questions which they would be asked were related to their insights into transfer pricing regulations and management. Thirteen respondents were interviewed.

The interviews were conducted in Bahasa Indonesia, the official Indonesian language, and were recorded with the consent of participants. The interviews were transcribed by a professional transcriber. The interviews produced 1,753 quotations including questions or further clarification from the researcher. For respondent validation purposes, the transcriptions were sent by the researcher to the participants to receive their approval. After the transcriptions were validated, data analysis was conducted in Bahasa Indonesia. Thematic analysis was chosen, since the features of the data consist of subjective judgements. As key points needed to address the research questions would be revealed during the interview process, thematic analysis was an effective tool to summarize the data's key characteristics, identify similarities and differences across the data set, and generate unexpected insights. Also, thematic analysis could go further, by inferring features of the findings. Thus, main themes could be identified convincingly. Data analysis was conducted using the following steps: familiarisation with the data, generation of initial codes, identification of themes, review of themes, definition and naming of themes.

Relevant quotations were translated into English and were classified based on themes, along with quotation numbers from each participant, so that it would be easier to trace issues to the original transcripts later on. The results of the thematic analysis were combined with relevant quotations from the abovementioned documents of the Indonesian Tax Court's decisions on intangible disputes between the Indonesian Tax Authority and the following taxpayers: PT. Ford Motor Indonesia, PT. L'Oreal Indonesia, and PT. Halliburton Indonesia. These have been translated by the researcher. The results of the data analysis are presented in English.

5.3. Conclusion

With regard to research question one, the study showed that the difficulties faced by Indonesian tax auditors during audits of transfer pricing cases derived from intangible property are:

- Technical matters of tax audits: determining the existence of intangible property; defining, differentiating, and classifying kinds of intangible properties; finding appropriate comparables for intangible property transactions; verifying the transfer of intangible property; determining the benefits of intangible property; determining the fair value of intangible property; verifying the entitlement to intangible property; and difficulties in relation to infrastructure (databases, budgets, and the Internet).
- Issues with taxpayers: lack of transparency of taxpayers' bookkeeping and lack of cooperation in providing data and documents.
- Current regulations: work load; lack of time for the completion of audits, especially for tax refund audits; and transfer pricing regulations being too loose and lacking detail.
- Organisation and human resource issues: rotation system; organisational structure for handling transfer pricing cases; and the lack of knowledge of tax auditors.

In connection with research question two, the study found that the ways in which Indonesian tax auditors and officials deal with transfer pricing cases derived from intangible assets are:

- Indonesian tax auditors and officials use legal bases as references in the audit of transfer pricing cases, such as Article 18 paragraph 3 of the Income Tax Law and domestic regulations; legal documents, contracts, or agreements entered into among affiliated enterprises; and the OECD transfer pricing guidelines.
- Each actor has a role in handling transfer pricing cases, namely:
    - Role of tax auditors: Tax auditors conduct in-depth analyses of taxpayers being audited; seek evidence of the existence of intangible property owned by taxpayers; classify kinds of intangible property; identify benefits received by taxpayers from intangible property; find comparables for transactions of intangible assets being audited; find 'arm's length' prices for transactions of intangible assets; verify the transfer of intangible property; and verify the entitlement to intangible property.
    - Role of Head of the District Tax Office: The Head of the District Tax Office acts as a leader and inspiration in discussions with tax auditors and serves as the quality assurance for audits, in terms of providing reviews and making necessary corrections for the improvement of audit.
    - Role of the Head Office of the Directorate General of Taxes: The Directorate of Tax Audits and Collections and the Directorate of Tax Regulations II provide assistance to tax auditors who carry out transfer pricing audits; the Directorate of Tax Audits and Collections coordinates with the Directorate of Tax Regulations II in dealing with transfer pricing rules and regulations; and the Directorate of Tax Objections and Appeals coordinates with the Directorate of Tax Audits and Collections in reviewing the decisions of tax courts that are unfavourable to the Directorate General of Taxes.
    - Role of account representatives: to provide data and conduct TP analysis for non-audited taxpayers.

5.4 Practical Contributions

The policy makers in the Head Office of the Directorate General of Taxes might use the outcome of this study to improve the quality of transfer pricing audit. In terms of better management of human resources, including the rotation system for tax auditors, “the right man in the right place principle” might need to be applied. Tax auditors assigned to certain regional offices, such as the large taxpayers regional office and the special regional office, should be those with a high level of knowledge and expertise in transfer pricing, since the regional offices handle most transfer pricing cases. Further, current regulations need to be amended, especially in connection with the time limit on completion of tax refund audit for transfer pricing cases. Moreover, databases for comparables should be increased in number, and they should be located more widely than in Head Office, so that tax auditors can access them readily during the audit process. Further, the level of expertise dedicated to transfer pricing cases should be located higher in the organisational structure.

The head of the district tax office, in dealing with transfer pricing cases derived from intangible properties, should adopt the roles described in this study, of leader and inspiration in discussions with tax auditors, and as the last filter in audits, providing reviews and making the necessary corrections for the improvement of audit.

Tax auditors and account representatives who do not have enough experience in auditing transfer pricing cases derived from intangible properties might use the outcomes of this study as a guide for dealing with those cases.

5.5 Limitations

The first limitation of this study is related to the small sample size. Up to this point, there have been only five cases settled by the Indonesian Tax Court for intangible property disputes. Of the five, three cases were selected as examples because they were settled between 2010 and 2011, and reflect the current standards of transfer pricing. Furthermore, the number of respondents interviewed could be viewed as a weakness, as the conclusions were limited to the respondents who audited the three abovementioned case studies and the persons in charge at the Directorate of Tax Regulations II and the Directorate of Tax Audits and Collections.

5.6 Future Research

The findings of this study open an opportunity for future research. It might be valuable to have future research that uses similar methodology and methods, focusing on examining audits of intangible property from the point of view of multinational companies. That would provide a balanced perspective on the issue. Considering the complexity of handling transfer pricing disputes, future research on “advanced pricing agreements”, by which tax administrations and tax auditors could handle transfer pricing cases without an audit, might provide advantages for all parties.

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Appendix 1

Indicative Questions for Semi-structured Interview

Name of Taxpayer	:	**PT. Ford Motor Indonesia**
Tax Year	:	2004
Number and Date of the Tax Court Decision	:	Put.30538/PP/M.V/15/2011, 23 March 2011
Name of Dispute Case	:	Royalty Payment (Distribution Right Fee Expense)
Amount of Dispute case	:	IDR 111,618,915,279.00

Indicative Questions for Semi-structured Interview for the Tax Auditors of PT. Ford Motor Indonesia

No	Indicative Questions
1	What was the basis or legal ground used by the tax auditors in making positive adjustments to the "royalty payment (distribution right fee expense)" paid by PT. Ford Motor Indonesia to its affiliates namely Ford Motor Company, Ford Trading Company, LLC and Volvo Car International AB ?
	Apakah yang menjadi dasar atau landasan hukum tim pemeriksa dalam melakukan koreksi positif terhadap "royalty payment (distribution right fee Expense)" yang dibayarkan oleh PT. Ford Motor Indonesia kepada pihak afiliasinya yaitu Ford Motor Company, Ford Trading Company, LLC dan Volvo Car International AB ?
2	In making positive adjustments to the "royalty payment (distribution right fee expense)", did the tax auditors refer to the contract between PT. Ford Motor Indonesia and its affiliates namely Ford Motor Company, Ford Trading Company, LLC and Volvo Car International AB ?
	Dalam melakukan koreksi positif terhadap "royalty payment (distribution right fee Expense)" apakah tim pemeriksa mengacu pada kontrak antara PT. Ford Motor Indonesia dengan pihak afiliasi yaitu Ford Motor Company, Ford Trading Company, LLC dan Volvo Car International AB?
3	In making positive adjustments to the "royalty payment (distribution right fee expense)", did the tax auditors consider the tax treaty between the Government of the Republic of Indonesia and the Government of the United States as well as the tax treaty between the Government of the Republic of Indonesia and the Government of Sweden?
	Dalam melakukan koreksi positif terhadap "royalty payment (distribution right fee Expense)" apakah tim pemeriksa mempertimbangkan Persetujuan penghindaran Pajak Berganda (tax treaty) antara Pemerintah Republik Indonesia dengan Pemerintah Amerika Serikat serta Pemerintah Republik Indonesia dengan Pemerintah Swedia?
4	In making positive adjustments to the "royalty payment (distribution right fee expense)", did the tax auditors refer to the "OECD Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations" for guidance and guideline? How significant did the role of OECD TP Guideline in auditing of transfer pricing cases derived from intangible assets?
	Dalam melakukan koreksi positif terhadap "royalty payment (distribution right fee Expense)" apakah tim pemeriksa menjadikan "OECD Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations" sebagai rujukan dan referensi? Sejauh mana peranan OECD TP Guideline tersebut dalam pemeriksaan transfer pricing untuk intangible assets?
5	What steps and approaches are taken by the tax auditors in auditing transfer pricing cases derived from intangible assets in this regards "royalty payment (distribution right fee expense)"?
	Langkah-langkah dan pendekatan apakah yang ditempuh oleh tim pemeriksa ketika melakukan pemeriksaan terhadap kasus transfer pricing terkait dengan intangible asset dalam hal ini "royalty payment (distribution right fee expense)"?
6	What difficulties did the tax auditors face during the audit process of transfer pricing cases derived from intangible assets in this regards "royalty payment (distribution right fee expense)"? How did the tax auditors deal with transfer pricing cases derived from intangible assets?
	Kesulitan-kesulitan apakah yang dihadapi tim pemeriksa dalam melakukan pemeriksaan terhadap kasus transfer pricing terkait dengan intangible assets dalam hal ini "royalty payment (distribution right fee expense)"? Bagaimana tim pemeriksa menangani kasus transfer pricing terkait dengan intangible assets tersebut?
7	Did the tax auditor make a comparable transaction analysis? If so, what steps were taken by the tax auditors in finding comparable transaction for "royalty payment (distribution right fee expense)"?
	Apakah tim pemeriksa melakukan comparable transaction analysis? Jika benar, langkah- langkah apakah yang ditempuh oleh tim pemeriksa untuk menemukan comparable transactions terhadap "royalty payment (distribution right fee Expense)"?
8	How did the tax auditors consider the fact that the Income Tax of Article 26 and Value Added Tax for Foreign Services were already collected from this "royalty payment (distribution right fee expense)" ?
	Bagaimana tim pemeriksa mempertimbangkan fakta bahwa telah dilakukan pemotongan dan pemungutan PPh Pasal 26 dan PPN Jasa Luar Negeri terhadap "royalty payment (distribution right fee Expense)"?
9	Why did the tax auditors make positive adjustment to the "royalty payment (distribution right fee expense)" while in the last two tax years the previous tax auditors did not make such positive adjustment?
	Mengapa tim pemeriksa melakukan koreksi positif terhadap "royalty payment (distribution right fee Expense)" sedangkan dua tahun pajak sebelumnya tidak dilakukan koreksi positif oleh tim pemeriksa sebelumnya?

Name of Taxpayer	:	**PT. L'Oreal Indonesia**
Tax Year	:	2005
Number and Date of the Tax Court Decision	:	Put.24631/PP/M.II/15/2010, 13 July 2010
Name of Dispute Case	:	Royalty Payment
Amount of Dispute case	:	IDR 13,888,591,263.00

Indicative Questions for Semi-structured Interview
for the Tax Auditors of PT. L'Oreal Indonesia

No	Indicative Questions
1	What was the basis or legal ground used by the tax auditors in making positive adjustments to the "royalty expense" paid by PT. L'Oreal Indonesia to its affiliates namely L'Oreal France?
	Apakah yang menjadi dasar / landasan hukum tim pemeriksa dalam melakukan koreksi positif terhadap "biaya royalty" yang dibayarkan oleh PT. L'Oreal Indonesia kepada pihak afiliasinya yaitu L'Oreal France?
2	In making positive adjustments to the "royalty expense", did the tax auditors refer to the contract between PT. L'Oreal Indonesia and its affiliates namely L'Oreal France?
	Dalam melakukan koreksi positif terhadap "biaya royalty" apakah tim pemeriksa mengacu pada kontrak antara PT. L'Oreal Indonesia dengan pihak afiliasinya yaitu L'Oreal France?
3	In making positive adjustments to the "royalty expense", did the tax auditors consider the tax treaty between the Government of the Republic of Indonesia and the Government of the Republic of France?
	Dalam melakukan koreksi positif terhadap "biaya royalty" apakah tim pemeriksa mempertimbangkan Persetujuan penghindaran Pajak Berganda (tax treaty) antara Pemerintah Republik Indonesia dengan Pemerintah Republik Perancis?
4	In making positive adjustments to the "royalty expense", did the tax auditors refer to the "OECD Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations" for guidance and guideline? How significant did the role of OECD TP Guideline in auditing of transfer pricing cases derived from intangible assets?
	Dalam melakukan koreksi positif terhadap "biaya royalty" apakah tim pemeriksa menjadikan OECD Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations sebagai rujukan dan referensi? Sejauh mana peranan guideline tersebut dalam pemeriksaan transfer pricing untuk intangible assets?
5	What steps and approaches are taken by the tax auditors in auditing transfer pricing cases derived from intangible assets in this regards "royalty expense"?
	Langkah-langkah dan pendekatan apakah yang ditempuh oleh tim pemeriksa dalam melakukan pemeriksaan terhadap kasus transfer pricing terkait dengan intangible assets dalam hal ini "biaya royalty"?
6	What difficulties did the tax auditors face during the audit process of transfer pricing cases derived from intangible assets in this regards "royalty expense"? How did the tax auditors deal with transfer pricing cases derived from intangible assets?
	Kesulitan-kesulitan apakah yang dihadapi tim pemeriksa dalam melakukan pemeriksaan terhadap kasus transfer pricing terkait dengan intangible assets dalam hal ini "biaya royalty"? Bagaimana tim pemeriksa mengatasi kesulitan tersebut?
7	Did the tax auditor make a comparable transaction analysis? If so, what steps were taken by the tax auditors in finding comparable transaction for "royalty expense"?
	Apakah tim pemeriksa melakukan comparable transaction analysis? Jika benar, langkah- langkah apakah yang ditempuh oleh tim pemeriksa untuk menemukan comparable transactions terhadap "biaya royalty"?
8	How did the tax auditors consider the fact that the Income Tax of Article 26 and Value Added Tax for Foreign Services were already collected from this "royalty payment (distribution right fee expense)" ? *Bagaimana tim pemeriksa mempertimbangkan fakta bahwa terhadap "biaya royalty" tersebut telah dilakukan pemotongan dan pemungutan PPh Pasal 26 dan PPN Jasa Luar Negeri?*

Name of Taxpayer	:	**PT. Halliburton Indonesia**
Tax Year	:	2005
Number and Date of the Tax Court Decision	:	Put.32485/PP/M.I/15/2011, 6 July 2011
Name of Dispute Case (1)	:	Technical Assitance Fee
Amount of Dispute case	:	US$ 3,324,792.00
Name of Dispute Case (2)	:	Royalty Payment
Amount of Dispute case	:	US$ 26,197.00

Indicative Questions for Semi-structured Interview
for the Tax Auditors of PT. Halliburton Indonesia

No	Indicative Questions
1	What was the basis or legal ground used by the tax auditors in making positive adjustments to the "technical assistance fee and royalty payment" paid by PT. Halliburton Indonesia to its affiliates namely Halliburton Energy Services?
	Apakah yang menjadi dasar / landasan hukum tim pemeriksa dalam melakukan koreksi positif terhadap "technical assistance fee dan royalty payment" yang dibayarkan oleh PT. Halliburton Indonesia kepada pihak afiliasinya yaitu Halliburton Energy Services ?
2	In making positive adjustments to the "technical assistance fee and royalty payment", did the tax auditors refer to the contract between PT. Halliburton Indonesia and its affiliates namely Halliburton Energy Services?
	Dalam melakukan koreksi positif terhadap "technical assistance fee dan royalty payment" apakah tim pemeriksa mengacu pada kontrak antara PT. Halliburton Indonesia dengan pihak afiliasi yaitu Halliburton Energy Services?
3	In making positive adjustments to the "technical assistance fee and royalty payment", did the tax auditors consider the tax treaty between the Government of the Republic of Indonesia and the Government of the United States?
	Dalam melakukan koreksi positif terhadap "technical assistance fee dan royalty payment" apakah tim pemeriksa mempertimbangkan Persetujuan penghindaran Pajak Bergannda (tax treaty) antara Pemerintah Republik Indonesia dengan Pemerintah Amerika Serikat ?
4	In making positive adjustments to the "technical assistance fee and royalty payment", did the tax auditors refer to the "OECD Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations" for guidance and guideline? How significant did the role of OECD TP Guideline in auditing of transfer pricing cases derived from intangible assets?
	Dalam melakukan koreksi positif terhadap "technical assistance fee dan royalty payment" apakah tim pemeriksa menjadikan OECD Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations sebagai rujukan dan referensi? Sejauh mana peranan guideline tersebut dalam pemeriksaan transfer pricing untuk intangible assets?
5	What steps and approaches are taken by the tax auditors in auditing transfer pricing cases derived from intangible assets in this regards "technical assistance fee and royalty payment"?
	Langkah-langkah dan pendekatan apakah yang ditempuh oleh tim pemeriksa dalam melakukan pemeriksaan terhadap kasus transfer pricing terkait dengan intangible assets dalam hal ini "technical assistance fee dan royalty payment"?
6	What difficulties did the tax auditors face during the audit process of transfer pricing cases derived from intangible assets in this regards "technical assistance fee and royalty payment"? How did the tax auditors deal with transfer pricing cases derived from intangible assets?
	Kesulitan-kesulitan apakah yang dihadapi tim pemeriksa dalam melakukan pemeriksaan terhadap kasus transfer pricing terkait dengan intangible asset dalam hal ini "technical assistance fee dan royalty payment"? Bagaimana tim pemeriksa mengatasi kesulitan tersebut?
7	Did the tax auditor make a comparable transaction analysis? If so, what steps were taken by the tax auditors in finding comparable transaction for "technical assistance fee and royalty payment"?
	Apakah tim pemeriksa melakukan comparable transaction analysis? Jika benar, langkah- langkah apakah yang ditempuh oleh tim pemeriksa untuk menemukan comparable transactions terhadap Technical Assitance Fee dan Royalty Payment?
8	How did the tax auditors consider the fact that the Income Tax of Article 26 and Value Added Tax for Foreign Services were already collected from this "technical assistance fee and royalty payment"?
	Bagaimana tim pemeriksa mempertimbangkan fakta bahwa terhadap Technical Assitance Fee dan Royalty Payment tersebut telah dilakukan pemotongan dan pemungutan PPh Pasal 26 dan PPN Jasa Luar Negeri?

Appendix 2

Indicative Questions for Open-ended Interview
for Person In Charge in the Directorate of Tax Audit and Collections

No	Indicative Questions
1	What steps are conducted by the Directorate of Tax Audit and Collections in managing tax audit of transfer pricing cases derived from intangible assets?
	Langkah-langkah apakah yang ditempuh oleh Direktorat Pemeriksaan dan Penagihan mengelola pemeriksaan terhadap kasus transfer pricing terkait dengan intangible assets?
2	Have assistance and guidance from the Directorate of Tax Audit and Collections been available when the tax auditors face transfer pricing cases derived from intangible assets?
	Apakah tersedia asistensi dan pendampingan dari Direktorat Pemeriksaan dan Penagihan ketika pemeriksa menjumpai kasus transfer pricing terkait dengan intangible assets?
3	Do the tax auditors actively consult and discuss to the Directorate of Tax Audit and Collections when they face transfer pricing cases derived from intangible assets?
	Apakah tim pemeriksa secara aktif melakukan konsultasi dan diskusi ke Direktorat Pemeriksaan dan Penagihan ketika mereka menghadapi kasus transfer pricing terkait dengan intangible assets?
4	How significant does the role of "OECD Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations" have on policy making adopted the Directorate of Tax Audit and Collections to deal with transfer pricing cases derived from intangible assets?
	Seberapa besar peranan OECD Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations dalam perumusan kebijakan yang dilakukan oleh Direktorat Pemeriksaan dan Penagihan ketika menghadapi kasus transfer pricing terkait dengan intangible assets?

Indicative Questions for Open-ended Interview
for Person In Charge in the Directorate of Tax Regulations II

No	Indicative Questions
1	What steps are conducted by the Directorate of Tax Regulations II in managing tax audit of transfer pricing cases derived from intangible assets?
	Langkah-langkah apakah yang ditempuh oleh Direktorat Peraturan perpajakan II dalam mengelola pemeriksaan terhadap kasus transfer pricing terkait dengan intangible assets?
2	Do the tax auditors actively consult and discuss to the Directorate of Tax Regulations II when they face transfer pricing cases derived from intangible assets?
	Apakah tim pemeriksa secara aktif melakukan konsultasi dan diskusi ke Direktorat Peraturan perpajakan II ketika mereka menghadapi kasus transfer pricing terkait dengan intangible assets?
3	How significant does the role of "OECD Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations" have on policy making adopted the Directorate of Tax Regulations II to deal with transfer pricing cases derived from intangible assets?
	Seberapa besar peranan OECD Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations dalam perumusan peraturan yang dilakukan oleh Direktorat Peraturan Perpajakan II ketika menghadapi kasus transfer pricing terkait dengan intangible assets?
4	How will the Directorate of Tax Regulations II consider the fact that the Income Tax of Article 26 and Value Added Tax for Foreign Services were already collected from this "technical assistance fee and royalty payment"? How to deal with double taxation issues? *Bagaimana Direktorat Peraturan Perpajakan II mempertimbangkan fakta bahwa terhadap Technical Assitance Fee dan Royalty Payment tersebut telah dilakukan pemotongan dan pemungutan PPh Pasal 26 dan PPN Jasa Luar Negeri? Bagaimana cara untuk menyelesaikan isu pajak berganda ini?*

Appendix 3

Participant Information Sheet

Date Information Sheet Produced: [Tanggal Lembar Informasi dibuat]
05 March 2013

Project Title [Judul Proyek]
Tax Audit of Transfer Pricing Cases Derived from Intangible Assets: A Case Study in Indonesia
(Pemeriksaan Pajak atas Kasus Transfer Pricing yang Berasal dari Aktiva Tidak Berwujud: Studi Kasus di Indonesia)

An Invitation [Undangan]
Let me introduce myself, my name is Abdul Haris Muhammadi, Directorate General of Taxes's staff on study assignment under Human Resource Division. I am an awardee of New Zealand – ASEAN Scholars Awards with main qualification of Doctor of Philosophy (Accounting). Now, I am doing a bridging program of Master of Business (Accounting) at Auckland University of Technology, New Zealand. This project is partial fulfillment of the requirements for the Degree of Master of Business (Accounting).

[Perkenankan saya untuk memperkenalkan diri, nama saya Abdul Haris Muhammadi, pegawai tugas belajar pada bagian kepegawaian Direktorat Jenderal Pajak. Saya memperoleh beasiswa dari New Zealand – ASEAN Scholars Awards untuk menempuh program Doctor of Philosophy dalam bidang Akuntansi. Sekarang saya sedang menempuh program bridging Master of Business (Accounting) di Auckland University of Technology, New Zealand. Proyek ini merupakan salah satu syarat untuk memperoleh gelar Master of Business (Accounting).]

You are warmly invited to this survey to share your experience and expertise in conducting tax audit of transfer pricing cases derived from intangible assets. The objective of this study is to investigate how the Indonesian Tax Auditors cope with those transfer pricing cases. This survey is voluntary and you are free to withdraw from this survey at any time before the completion of data collection.

[Dengan hangat Anda diundang untuk berpartisipasi dalam survey ini untuk berbagi pengalaman dan keahlian Anda dalam melakukan pemeriksaan pajak atas kasus transfer pricing yang timbul dari aktiva tidak berwujud. Tujuan studi ini adalah untuk melakukan investigasi bagaimana pemeriksa pajak Indonesia menangani kasus-kasus transfer pricing tersebut. Survey ini adalah sukarela dan anda bebas menarik diri dari survey ini kapanpun sebelum proses pengumpulan data selesai.]

What is the purpose of this research? [Apakah Tujuan Riset Ini?]
The research output will be a dissertation which is a partial fulfillment of the requirements for the Degree of Master of Business (Accounting) at University of Technology, New Zealand.

[Hasil riset ini adalah disertasi yang merupakan sebagian syarat untuk memperoleh gelar Master of Business (Accounting) dari Auckland University of Technology, New Zealand.]

How was I identified and why am I being invited to participate in this research? [Bagaimana saya diidentifikasi and mengapa saya diundang untuk berpartisipasi dalam riset ini]
A Formal request to conduct interviews will be submitted to the Director of Tax Counseling, Service, and Public Relations and then he will make formal letters to the relevant District Tax Offices where the taxpayers of selected case studies are officially registered in and the Directorates where the Indonesian Tax Officials who manage transfer pricing cases derived from intangible assets work on.

[Permohonan resmi untuk melakukan interview akan diajukan kepada Direktur Penyuluhan, Pelayanan dan Hubungan Masyarakat yang kemudian diteruskan kepada Kantor Pelayanan Pajak di mana Wajib Pajak dari studi kasus yang dipilih secara resmi terdaftar dan Direktorat terkait di mana staf Direktorat Jenderal Pajak bekerja untuk menangani kasus transfer pricing yang timbul dari aktiva tidak berwujud.]

You are identified and chosen to take part in this research because you are a tax auditor who have audited one of the following cases: PT. Ford Motor Indonesia (Put.30538/PP/M.V/15/2011), PT. L'Oreal Indonesia (Put.24631/PP/M.II/15/2010), and PT. Halliburton Indonesia (Put.32485/PP/M.I/15/2011).

[Anda diidentifikasi dan dipilih untuk berpartisipasi dalam penelitian ini karena anda adalah pemeriksa salah satu kasus yang telah diputus oleh Pengadilan Pajak sebagai berikut: PT. Ford Motor Indonesia (Put.30538/PP/M.V/15/2011), PT. L'Oreal Indonesia (Put.24631/PP/M.II/15/2010), and PT. Halliburton Indonesia (Put.32485/PP/M.I/15/2011).]

You are identified and chosen to take part in this research because you persons in charge for transfer pricing matters in the Directorate of Tax Audit and Collection or Directorate Tax Regulations II.

[Anda diidentifikasi dan dipilih untuk berpartisipasi dalam penelitian ini karena anda adalah staf yang bertanggung jawab untuk transfer pricing di Direktorat Pemeriksaan dan Penagihan atau Direktorat Peraturan Perpajakan II.]

What will happen in this research? [Apa yang akan terjadi dengan penelitian ini?]
The objective of this study is to investigate how the Indonesian Tax Auditors cope with transfer pricing cases from intangible assets. It is expected that the you wish to share your experiences and expertise in dealing with and managing transfer pricing cases derived from intangible assets.

[Tujuan dari penelitian ini adalah untuk menginvestigasi bagaimana pemeriksa pajak Indonesia menangani kasus transfer pricing yang timbul dari aktiva tidak berwujud. Diharapkan Anda akan berkenan untuk berbagi pengalaman dan keahlian anda dalam menangani kasus transfer pricing dari aktiva tidak berwujud tersebut.]

What are the discomforts and risks? [Apakah ada ketidaknyamanan dan risiko?]
It is expected that the level of discomfort is relatively low. Discomfort might occur because you need to go back to the documents that you have audited many years ago. You need to refresh your memory back.

[Diharapkan bahwa level ketidaknyamanan dalam penelitian ini adalah rendah. Ketidaknyamana mungkin terjadi karena anda perlu kembali ke dokumen yang telah anda periksa beberapa tahun yang lalu. Anda perlu menyegarkan ingatan Anda kembali.]

It is expected that there is no risk for participants in this research.

[Diharapkan bahwa tidak ada risiko bagi Anda untuk turut serta berpartisipasi dalam penelitian ini.]

How will these discomforts and risks be alleviated? [Bagaimana cara mengurangi ketidaknyamanan dan risiko?]
You could skip the questions if you consider that those questions are not related to your experiences or expertises. The information that has been gathered from you will be analyzed and presented in the way that others will not be able to identify the source of information. The research findings and final report will not disclose your identity so that your privacy and confidentiality will be protected.

[Anda dapat mengabaikan untuk tidak menjawab pertanyaan yang Anda fikir tidak sesuai dengan pengalaman dan keahlian Anda. Informasi yang diperolah dari Anda akan dianalisa dan dipresentasikan sedemikian rupa sehingga pihak lain tidak akan dapat mengidentifikasi sumber informasi. Hasil penelitian dan laporan akhir tidak akan menampilkan identitas Anda sehingga privasi dan konfidensial Anda akan terjaga.]

What are the benefits? [Apakah ada keuntungan?]
The outcome of the interview along with the documentation of selected case studies will be used to produce a dissertation which is a partial fulfillment of the requirements for the Degree of Master of Business (Accounting) at Auckland University of Technology, New Zealand.

[Hasil dari wawancara ini bersamaan dengan dokumentasi dari kasus yang dipilih akan digunakan untuk menyusun disertasi yang merupakan salah satu syarat untuk memperoleh gelar Master of Business (Accounting) pada Auckland University of Technology, New Zealand.]

The research will benefit the Indonesian Tax Authorities in terms of providing a good understanding in handling transfer pricing cases so that financial risk borne by the Government could be minimized.

[Penelitian ini akan memberikan manfaat pada otoritas perpajakan Indonesia dalam bentuk pemahaman yang memadai untuk menangani kasus transfer pricing sehingga risiko keuangan yang ditanggung Pemerintah dapat diminimalkan.]

How will my privacy be protected? [Bagaimana privasi saya dilindungi?]
Limited confidentiality will be offered to you since other DGT's staff who have task to administer tax audits might be able to recognize the name of the tax auditors of the cases being investigated. After

the letter of permission to conduct research is granted by the Director of Tax Counseling, Service, and Public Relations, the name of potential respondents will be obtained from the relevant District Tax Offices, the Directorate of Tax Audit and Collections, and the Directorate of Tax Regulations II. Your name is chosen randomly among the available potential respondents.The information that has been gathered from you will be analyzed and presented in the way that the public will not be able to identify the source of information. In addition, you will be offered an opportunity to check your interview transcripts in order to ensure there is no inclusion of any identifiable information. The research findings and final report will not disclose your identity so that your privacy and confidentiality will be protected in a limited way.

[Konfidensial terbatas akan diawarkan kepada Anda karena staf DJP lain yang mengadministrasikan pemeriksaan pajak mungkin dapat mengenali nama Anda sebagai pemeriksa pajak dari kasus yang diinvestigasi. Setelah ijin untuk melakukan riset diberikan oleh Direktur Penyuluhan, Pelayanan dan Hubungan Masyarakat, nama-nama yang berpotensi menjadi responden akan diperoleh dari Kantor Pelayana Pajak terkait, Direktorat Pemeriksaan dan Penagihan, dan Direktorat Peraturan Perpajakan II. Nama Anda terpilih secara acak dari nama-nama yang berpotensi menjadi responden. Informasi yang diperolah dari Anda akan dianalisa dan di presentasikan sedemikian rupa sehingga publik tidak akan dapat mengidentifikasi sumber informasi. Di samping itu Anda juga akan diberikan kesempatan untuk mengecek transkrip interview untuk meyakinkan bahwa tidak ada informasi yang dapat diidentikasi terkait dengan diri Anda yang dimasukkan. Hasil penelitian dan laporan akhir tidak akan menampilkan identitas Anda sehingga privasi dan konfidensial Anda akan terlindungi secara terbatas.]

What are the costs of participating in this research? [Apakah ada pengorbanan untuk berpartisipasi dama penelitian ini?]
You will be interviewed approximately half to one hour to share your experiences and your expertises in dealing with transfer pricing of intangible assets.

[Anda akan diwawancara kira-kira selama setangah jam sampai dengan satu jam untuk berbagi pengalaman dan keahlian Anda dalam menangani kasus transfer pricing dari aktiva tidak berwujud.]

What opportunity do I have to consider this invitation? [Kesempatan apa yang saya miliki untuk mempertimbangan undangan ini?]
Yes, you have one week (five working days) to consider whether you will participate or not in this survey.

[Benar, Anda mempunyai waktu satu minggu (lima hari kerja) untuk mempertimbangkan apakah Anda akan berpartisipasi atau tidak dalam penelitian ini.]

How do I agree to participate in this research? [Bagaimana jika saya setuju untuk berpartisipasi dalam penelitian ini?]
This survey is voluntary and you are free to withdraw from this survey at any time before the completion of data collection. If you agree to take part in this survey, you need to complete Consent Form before an interview is conducted. The Consent Form will be provided.

[Survey ini adalah sukarela dan Anda mempunyai hak untuk menarik diri dari survey ini kapanpun sebelum selesainya proses pengumpulan data. Jika Anda setuju untuk berpartisipasi dalam survey ini, Anda perlu untuk mengisi "Consent Form" sebelum wawancara dilakukan. Consent Form akan disediakan untuk Anda.]

Will I receive feedback on the results of this research? [Apakah saya akan memperoleh feedback hasil penelitian ini?]
Copy of final report will be sent to the library of Head Office of Directorate General of Taxes as a reference for further study. You will receive summary of research finding and you will be informed that the copy of final report will be available in the the library of Head Office of Directorate General of Taxes.

[Fotokopi laporan akhir akan dikirim ke perpustakaan Kantor Pusat Direktorat Jenderal Pajak sebagai bahan referensi untuk studi lebih lanjut. Anda akan diberikan rangkuman temuan penelitian and Anda akan diberi informasi bahwa fotokopi dari laporan akhir akan tersedia di perpustakaan Kantor Pusat Direktorat Jenderal Pajak.]

What do I do if I have concerns about this research? [Apa yang harus saya lakukan jika saya mempunyai concern atas penelitian ini?]
Any concerns regarding the nature of this project should be notified in the first instance to the Project Supervisor, Dr. Zahir Ahmed, *zahir.ahmed@aut.ac.nz*, +64 9 921 9999 ext 5755

[Jika Anda mempunyai perhatian terkait dengan sifat proyek ini, Anda dapat menghubungi Project Supervisor, Dr. Zahir Ahmed, zahir.ahmed@aut.ac.nz, +64 9 921 9999 ext 5755]

Concerns regarding the conduct of the research should be notified to the Executive Secretary, AUTEC, Dr Rosemary Godbold, *rosemary.godbold@aut.ac.nz* , +64 921 9999 ext 6902.

[Jika Anda mempunyai perhatian terkait dengan bagaimana penelitian dilakukan, Anda dapat menghubungi Executive Secretary, AUTEC, Dr Rosemary Godbold, rosemary.godbold@aut.ac.nz , +64 921 9999 ext 6902.]

Whom do I contact for further information about this research? [Siapa yang bisa saya hubungi untuk informasi lebih lanjut terkait penelitian ini?]

Researcher Contact Details:
Abdul Haris Muhammadi, *abdulharis.muhammadi@gmail.com*,
abdul_haris_muhammadi@yahoo.com

Project Supervisor Contact Details:
Dr. Zahir Ahmed, *zahir.ahmed@aut.ac.nz*

Approved by the Auckland University of Technology Ethics Committee on *type the date final ethics approval was granted*, AUTEC Reference number *type the reference number*.

Appendix 4

Consent Form

For use when interviews are involved.

Project title: ***Tax Audit of Transfer Pricing Cases Derived from Intangible Assets: A Case Study in Indonesia***

Project Supervisor: ***Dr Zahir Ahmed***

Researcher: ***Abdul Haris Muhammadi***

- ○ I have read and understood the information provided about this research project in the Information Sheet dated dd mmmm yyyy.
- ○ I have had an opportunity to ask questions and to have them answered.
- ○ I understand that notes will be taken during the interviews and that they will also be audio-taped and transcribed.
- ○ I understand that I may withdraw myself or any information that I have provided for this project at any time prior to completion of data collection, without being disadvantaged in any way.
- ○ If I withdraw, I understand that all relevant information including tapes and transcripts, or parts thereof, will be destroyed.
- ○ I agree to take part in this research.
- ○ I wish to receive a copy of the report from the research (please tick one): Yes○ No○

Participant's signature:

.....

Participant's name:

.....

Participant's Contact Details (if appropriate):

……..

……..

……..

……..

Date:

Approved by the Auckland University of Technology Ethics Committee on 4 March 2013
AUTEC Reference number Ethics Application: 13/18 Tax audit of transfer pricing cases derived from intangible assets: A case study in Indonesia

Note: The Participant should retain a copy of this form.

Appendix 5

Confidentiality Agreement

For someone transcribing data, e.g. audio-tapes of interviews.

Project title: ***Tax Audit of Transfer Pricing Cases Derived from Intangible Assets: A Case Study in Indonesia***

Project Supervisor: ***Dr Zahir Ahmed***

Researcher: ***Abdul Haris Muhammadi***

- ○ I understand that all the material I will be asked to transcribe is confidential.
- ○ I understand that the contents of the tapes or recordings can only be discussed with the researchers.
- ○ I will not keep any copies of the transcripts nor allow third parties access to them.

Transcriber's signature:

.....

Transcriber's name:

.....

Transcriber's Contact Details (if appropriate):

……..
……..
……..
……..

Date:

Project Supervisor's Contact Details (if appropriate):
Dr. Zahir Ahmed ...……..
zahir.ahmed@aut.ac.nz ...……..
……..
……..

Approved by the Auckland University of Technology Ethics Committee on 4 March 2013 AUTEC Reference number Ethics Application: 13/18 Tax audit of transfer pricing cases derived from intangible assets: A case study in Indonesia

Appendix 6

Coding Process

Quotation Number	Person	Quotations	Initial Codes	Initial Code Reference
4	R1	Iya jadi awalnya dari pemeriksaan terkait dengan omset. Omset dengan biaya royalti, jadikan penjualannya kan produk dari merek grupnya L'Oreal Perancis terus ada muncul… Sebenarnya, adalah hal yang normal muncul biaya royalty, cuma kan kita harus lihat di sini ada beberapa produk, ada Maybeline, L'Oreal, Kerastase, Dralle, Redken, ini royaltinya menyangkut apa? Iya kan kemudian kita pelajari dari dokumen yang dikasihkan oleh dia tentang perjanjian license agreement, yang terkait dengan royalty. Kita pelajari definisi royalti apa, dan atas apa. Ternyata atas teknologi, license trademark, licensed product. Terus yang dimaksud teknologi itu apa, dan menyangkut apa saja ya, kaitannya dengan produk yang dijual itu macam-macam produknya itu Mas. Ternyata kan di pasal poin 1.3 di perjanjian itu kan selaku istilah licensed product kan yang dimaksud dengan produk-produk yang di-license itu kan meliputi produk cosmetics, hygiene, toiletry, yang di produksi dengan teknologi, terus di poin pasal 1.2 merek dagangnya seperti ini kan, ternyata kan atas royalti yang terkait dengan merek ini, di penjualan 2000 ini tidak muncul gitu Mas, sengketanya. Jadi seharusnya biaya royalti itu kan gak muncul - gak ada, gak dibebankan, gak di charge oleh L'Oreal Perancis.	Hubungan biaya royalty dan omset (relationship between royalty and sales) Peranan agreement (role of agreement)	R1-1 R1-2
…	...	...	...	...
4	R13	Saya rasa bukan masalah ruling, ini masalah skill dan knowledge dan kemauan untuk menaati aturan. Nah, jadi itu yang harus didorong di DJP supaya mereka memahami aturan secara benar, dan mematuhi aturan yang sudah dibuat. Karena saya pikira aturan kita standard; mirip dengan apa yang dimiliki oleh OECD. Jadi, sudah jelas. Tinggal kalau misalnya ada dispute kemampuan kita untuk menginterpretasikan, antara fakta-fakta yang ada dengan kaidah TP yang seharusnya. Itu saja.	Problems with skill and knowledge. Kemauaun untuk manaati aturan (willingness to obey the rules)	R13-3 R13-4

Appendix 7

Identifying Theme Phase

1. Role of Article 18 paragraph 3 of the Income Tax Law and domestic regulations
2. Role of contract / agreement entered among affiliated enterprises
3. The use of “OECD Transfer Pricing guideline
4. Conducting in-depth analysis.
5. Looking for evidence of the existence
6. Looking for evidence of benefit enjoyed by the taxpayers
7. Searching for comparable
8. Finding arm’s length price (fair value)
9. Looking for “transfer” of Intangible property.
10. Looking for “entitlement” of Intangible property.
11. Distributors issue : discussion between the head of district tax offices and tax auditors
12. Tax avoidance issues: discussion between the head of district tax offices and tax auditors
13. Role of the head of district tax offices: the quality assurance for audits
14. Role of the head of district tax offices: last negotiator with the payers.
15. Assistance for the tax auditors from the Directorate of Tax Audit and Collections
16. Assistance for the tax auditors from the Directorate of Tax Regulations II
17. Dealing with transfer pricing rules and regulations
18. Dealing with decisions of Tax Courts which are unfavorable to the Directorate of General of Taxes.
19. Role of Account Representatives
20. Mutual Agreement Procedures (MAP)
21. Advanced Pricing Agreement (APA)
22. Withholding tax and value added tax issues
23. Double taxation issues
24. Shifting profit issues
25. Problem with the existence of intangible property
26. Find appropriate comparable of the intangible property transaction
27. Problem with the transfer of Intangible property
28. Problem with the benefit of intangible property
29. Problem with the fair value of intangible property
30. Problem with the entitlement of intangible property
31. Problem with Database
32. Problem with Budget
33. Problem with internet
34. Problem with transparency of taxpayers’s bookkeeping
35. Uncooperative taxpayers in providing data and documents
36. Work load of tax auditors
37. Limited time for completion of audit especially for tax refund audit
38. Transfer pricing regulation is too loose
39. Rotation system
40. Organizational structure for handling transfer pricing cases
41. Level of knowledge of the tax auditors
42. Others

Appendix 8

Review Themes Phase

1. Legal basis used in audit of transfer pricing cases:
   a. Article 18 paragraph 3 of the Income Tax Law and domestic regulations
   b. Contract/agreement entered among affiliated enterprises
   c. "OECD Transfer Pricing guideline"
2. Role of Tax Auditors
   a. The tax auditors conduct in-depth analysis.
   b. The tax auditors seek for evidence of the existence
   c. The Tax Auditors try to classify kind of intangible
   d. The tax auditors seek for evidence of benefit enjoyed/received by the taxpayers
   e. The tax auditors put their effort to find comparable for the transaction of intangible assets being audited by those of transaction conducted by independent parties.
   f. The tax auditors try to find arm's length price for the transaction of intangible assets
   g. The tax auditors try to find "transfer" of Intangible property.
   h. The tax auditors try to find "entitlement" of Intangible property.
3. Role of Head of District Tax Office
   a. As a leader and inspiration in discussion with the tax auditors
   b. As the quality assurance for audits
4. Role of Head Office of Directorate General of Taxes
   a. assistance for the tax auditors who engage transfer pricing audit
   b. dealing with transfer pricing rules and regulations
   c. dealing with the decisions of Tax Courts which are unfavorable to the Directorate of General of Taxes.
5. Difficulties with regard to technical matters of tax audit:
   a. Determine the existence of intangible property
   b. Find appropriate comparable of the intangible property transaction
   c. Determine the transfer of Intangible property
   d. Determine the benefit of intangible property
   e. Determine the fair value of intangible property
   f. Determine the entitlement of intangible property
   g. Difficulties in relation to infrastructure (Database, Budget, internet)
6. Difficulties arise from taxpayers
   a. Problem with transparency of taxpayers' bookkeeping
   b. Uncooperative taxpayers in providing data and documents
7. Difficulties arise from current regulations
   a. Work load
   b. Limited time for completion of audit especially for tax refund audit
   c. Transfer pricing regulation is too loose
8. Problems related to organization and human resource
   a. Rotation system
   b. Organizational structure for handling transfer pricing cases
   c. Level of knowledge of the tax auditors
9. Role of Account Representatives
10. Mutual Agreement Procedure and Advanced Pricing Agreement
11. Withholding tax, value added tax and double taxation issues
12. Shifting profit issues
13. Others

Appendix 9

Defining and Naming Themes

I. Difficulties Faced by the Indonesian Tax Auditors during Audit Process of Transfer Pricing Cases Derived from Intangible Property (Research Question – 1)

1. Difficulties with regard to technical matters of tax audits
   a. Determining the existence of intangible property
   b. Differentiation and classification of intangible property
   c. Finding appropriate comparables for intangible property transactions
   d. Verifying the transfer of intangible property
   e. Determining the benefits of intangible property
   f. Determining the fair value of intangible property
   g. Determining the entitlement of intangible property
   h. Difficulties in relation to infrastructure (databases, budgets, Internet)
2. Difficulties arising from taxpayers
   a. Problem with transparency of taxpayers' bookkeeping
   b. Lack of taxpayer cooperation in providing data and documents
3. Difficulties arising from current regulations
   a. Workload and limited time for completion of audits, especially for tax refund audits
   b. Transfer pricing regulations are too loose and lack detail
4. Problems related to organisation and human resources
   a. Rotation system
   b. Organisational structure for handling transfer pricing cases
   c. Level of knowledge of tax auditors

II. Ways Indonesian Tax Auditors and Officials Deal with Transfer Pricing Cases Derived from Intangible Assets (Research Question – 2)

1. Legal Bases Used as References in Audits of Transfer Pricing Cases
   a. Article 18 paragraph 3 of the Income Tax Law and domestic regulations
   b. Legal documents, contracts, or agreements entered into among affiliated enterprises
   c. OECD Transfer Pricing Guidelines
2. Role of tax auditors
   a. Tax auditors conduct in-depth analysis of taxpayers being audited
   b. Tax auditors seek evidence of the existence of intangible property owned by taxpayers
   c. Tax auditors classify intangible property transactions
   d. Tax auditors look for evidence of benefits received by taxpayers from intangible property
   e. Tax auditors try to find comparables for intangible asset transactions
   f. Tax auditors try to find arm's length prices for intangible asset transactions
   g. Tax auditors try to verify a transfer of intangible property
   h. Tax auditors try to verify the entitlements of intangible property
3. Role of the Head of the District Tax Office
   a. The Head of the District Tax Office as a leader and inspiration for tax auditors
   b. The Head of the District Tax Office acts as the quality assurance for audits
4. Role of the Head Office of the Directorate General of Taxes
   a. The Directorate of Tax Audits and Collections and the Directorate of Tax Regulations II provide assistance to the tax auditors who carry out transfer pricing audits
   b. The Directorate of Tax Audits and Collections coordinates with the Directorate of Tax Regulations II to deal with transfer pricing rules and regulations
   c. The Directorate of Tax Objections and Appeals coordinates with the Directorate of Tax Audits and Collections in reviewing the decisions of tax courts.
5. Role of Account Representatives
   a. Account Representatives provide data and conduct TP analysis for non-audited taxpayers.

III. Themes excluded from the Discussion

1. Mutual Agreement Procedure and Advanced Pricing Agreement
2. Withholding Tax, Value Added Tax and Double Taxation Issues
3. Shifting Profit Issues
4. Others

Appendix 10

Translated Selected Quotations from Interviews Based on Themes

Research Question 1: What difficulties do the tax auditors face during the audit process of intangible transactions?

1. Difficulties with regard to technical matters of tax audits

a. Determining the existence of intangible property

Quotation Number	Person	Quotations
6	R4	The first thing that needs to to be proved is the existence of intangible property, something that is intangible must be proved, whether it exists or not.
2	R5	The first one, it should be obvious that the intangible assets it does exist, in the sense of legal and economical terms.
104	R6	The first thing needs to be checked is whether that intangible exist or not...
106	R6	Yes, to prove the existence of intangibles is the most difficult task
18	R7	to make positive adjustment, auditors tend to focus on the existence, that we were (auditor) finally trapped in what actually the existence is.
24	R7	…They rely heavily on what is called the existence, so the existence of the intangible assets, which are often very difficult for them.
141	R8	...difficulty in finding evidence.
286	R10	Wow, that's a classic problem.. Usually the problem is the existence of intangible assets. So, usually they treat that intangible assets do not exist and directly deemed as nil.
312	R9	The problem is in the past, people [tax auditors] would like to bring existence [of intangible property] into the legal. Where is the proof?
314	R9	In fact, the existence of transfer pricing is not always supported legally and is not always included on the balance sheet
6	R4	Moreover, those transactions are conducted between affiliated parties, because they are not independent, but inter-affiliate, then something that does not exist, could be deemed to exist.
14	R9	Well.. the first one is whether or not they need to pay for intangible property and royalties
16	R9	....from the characteristics of the taxpayer's business. For example, for "contract" and "toll" manufacturer, by using the American approach, no need for them to pay royalties. However, in the reality, those manufacture limited risks always pay royalty-mostly.

b. Definition, differentiation, and classification of intangible property

Quotation Number	Person	Quotations
104	R6	The second obstacle occurs when we would like to define whether certain assets are intangible property or not and classify the types of intangible property, so sometimes a bit similar when they claim something as an intangible property but it is actually a service.
16	R8	First, we have to check, under which category the certain payment will fall—royalties or services?...if it is classified as a royalty, then we have to scrutinise the components of the royalties

c. Finding appropriate comparables of intangible property transactions

Quotation Number	Person	Quotations
36	R1	... sometimes for transfer pricing, after substance of transfer pricing is found, the next step is finding comparable.... sometimes, the taxpayer could argue that it is natural for her business around it ... sometimes the level of data availability for comparable is quite difficult...
38	R1	Comparable ... since we did not have guidance for FAR analysis (Function, Assets, Risks) yet .... Thus, we only relied upon on the interpretation of regulations under Article 18 paragraph 3...that's KEP 01
2	R4	... The main difficulties is to find a comparison which is comparable to affiliate transactions ...the comparable transactions must meet five criteria
4	R4	(1) the characteristics of the goods or characteristics of the product, (2) the function of assets and risks, (3) the contractual terms (4) business strategy (5) economic conditions. Those five criteria according to TP guidelines can affect the price of the transaction. Indeed, the first difficulty is to find comparable transactions. And usually the difficulties worsen since the affiliate transaction typically is unique, which means that its contractual term is also unique. Then,

Quotation Number	Person	Quotations
		sometimes its economic condition also varies. Well the most difficult in the affiliate transactions in my opinion is intangible. Indeed, the first problem is to find comparable transactions, and matters are further complicated because affiliate transactions are typically unique, which means that their contractual terms are also unique. Then, sometimes the economic conditions also vary. Indeed, intangibles are very difficult. Why are they so difficult? First, intangible property is abstract, so it is difficult to conduct assessments or measurements. Second, in the matter of transfer pricing, intangible assets should have a unique value, and a unique value will have unique characteristics, so finding its comparison is very difficult. So from the characteristics of intangibles alone, it can only be deemed as intangible if it has unique characteristics that have a unique value. On the other hand, to find a unique comparable is contradictory, and that is the main difficulty.
112	R6	Not easy to find a reliable comparison for royalty payment transaction, because usually taxpayers deny and do not wsh to be compared with other royalty payment transaction when the amount of the transaction is questionable.
18	R7	The first one, the difficulty is they are having trouble finding a comparison ...

d. Verifying the transfer of Intangible property

Quotation Number	Person	Quotations
8	R4	The second difficulty relates to the transfer of intangible property. The payment of intangible property will be justified once such intangible property is transferred from the parent to the subsidiary, from the owner of the intangible property to the licensee, from the licensor to the licensee...to prove the transfer of intangible property is not easy because unlike goods, which have physical features, intangible property is not visible.

e. Determining the benefit of intangible property

Quotation Number	Person	Quotations
2	R5	The second one is the benefit; the company will have an additional benefit of using the intangible property

f. Determining the fair value of intangible property

Quotation Number	Person	Quotations
8	R4	the third difficulty is to prove how much is the real value...
2	R5	After that, determine how much the fair value is...
104	R6	Then, at the end, tax auditors have to determine/decide how much the fair value of that payment.
14	R9	The second one, how much is the value?
301	R10	Valuation...Yes, to be honest, it is valuation in my opinion. If we are the owner of the intangible property, we have to be able to demonstrate that our intangible property has economic value. For this reason, tax auditors request a parent company to provide these calculations. However, tax auditors usually face difficulties retreiving the abovementioned documents
302	R9	But the problem is even though they provide the calculation, how do they find the calculation? We do not have economic aspects. Those employ economic assumptions. Thus, we tend to take it for granted. Yes, it is quite good. That's the problem.

g. Determining the entitlement of intangible property

Quotation Number	Person	Quotations
8	R4	The fourth one is the entitlement of intangible property—who is truly entitled to the intangible property. By logic, the one that is entitled to the intangible property is the one who created it, who developed it...but in fact, because it is an affiliated transaction, intangible property will move from the country in which it was developed to a new country, for example, the most common one is from the United States to Ireland. However, it couldn't be proved that Ireland could maintain that intangible property....are there any persons there who could develop that intangible property or have capital to do so...Those things are not easy due to cross-border transactions...

h. Difficulties in relation to infrastructure (database, budget, Internet)

Quotation Number	Person	Quotations
66	R1	actually at that time, we had very limited (infrastucturenya), the internet ....
68	R1	on our own ... not installed yet ... had the opportunity to browse, we got the data but eally difficult to find it ..... OSIRIS didn't exist yet.
91	R3	Yes (have to find comparable to the Head Office)
96	R2	Sometimes, because staff of Head Office do not know the characteristics of the taxpayers- only know the name and the business, the way they find comparable data might not fit.
174	R6	Expensive (database) is second issue, we're talking the nature and character of this data
176	R6	Yes, because of budget constraints.... and budget accountability.
75	R6	the problems are obvious, the first one is at the district tax office level, they do not have database.
40	R9	Yes, only head office has database.
51	R11	Kalibata Tax Office complex does not have (database).
53	R11	We already asked for database in the past, but its was very expensive.

2. Difficulties arising from taxpayers

a. Problem with transparency of taxpayers' bookkeeping

Quotation Number	Person	Quotations
124	R1	Indeed [XCo] has a closed bookkeeping and accounting system; they have so many codes and no descriptions.
128	R1	A chart of accounts exists, but there is no description; we didn't know what the codes on these accounts were for. The transactions for instance were about the TAC; this is an expense but with no descriptions of them just codes. When we requested to open the codes they said that permission from [its headquarters] must be obtained.
154	R1	If I am mistaken, they mixed up TAC and royalty...that's strange...indeed It's also a little too weird, Haliburton is full of oddities ..
158	R1	Then, they made their bookkeeping confusing...

b. Lack of taxpayer cooperation in providing data and documents

Quotation Number	*Person*	*Quotations*
104	R6	The biggest obstacle is the availability of data provided by the taxpayer. Second, the openness of the taxpayers themselves....it might be because of ignorance, it might be because of the position of the taxpayer that I audited before was a subsidiary...and the level of knowledge of taxpayers can also be a problem.
47	R3	Well, we were not provided with the data. It was also hard to find...the difficulty was to get the data. Could we ask for the data from [other] jurisdictions in the US or Europe? Maybe we could do it through exchange of information, but it might take a long time, and there would be no guarantee that it would succeed. If we asked taxpayers, they would not provide the data.
48	R2	They provided data from the Philippines and South Africa, which was not useful as those countries are similar to Indonesia in that they are developing countries…
87	R2	Sometimes, it is difficult to obtain financial statements of the parent company if they are not transparent. If it were a non-listed company, it would also be very difficult"

3. Difficulties arising from current regulations

a. Workload and limited time for completion of audits, especially for tax refund audits

Quotation Number	Person	Quotations
95	R3	Yes, indeed, it is very difficult if it coincides with a tax refund claim
56	R5	The second one is a limitation of time. Tax audits for intangibles are complicated because it is impossible to conduct an in-depth analysis in only one or two days, and rigorous reseach and much evidence are needed. Time is restricted, because for example if the case falls under the requirements for a tax refund claim audit, then it is very difficult to cover transfer pricing audits properly" (R5).
99	R6	Yes (one year), except if for the revision of tax return. Indeed, except for special audits, they have timeframe. It used to have 2 years time for completion, now is 18 months according to the the latest regulation.
108	R6	…and this became an obstacle when the examination period that does not very suitable to supply the data of the taxpayer.. the time for comp[letion for audit is four months.

Quotation Number	Person	Quotations
110	R6	Regardless of the refund claim or not, our examination period is four months
112	R6	Could be extended. For transfer pricing with regards to special audit, it has two years time frame.
141	R8	... (constraint) time. Because time constraints relates to the completion period of tax audit for refund claim.
210	R9	But the main reason is actually because of workload. One audit team could get 100 assignment letters. So, they do not have any chance to manage transfer pricing, which involves a long procedure....We make a broad analysis first to learn the character of the business for transfer pricing, complete a FAR analysis, and search for comparables. It takes a long time, so many tax auditors give up" (R9).
212	R9	Yes, because we have so many tax refund claims.
214	R9	Even thousands ... for us we conduct audit manually. For refund claim, we visit the taxpayers' address. It's time consuming. Thus, we couldn't conduct special audit, only in rare condition we have that kind of audit.. within tax refund audit, many transfer pricing cases could not be handle properly.
216	R9	Indeed, not achieve maximum level.
218	R9	Yes, still refer to the time frame for tax refund, time frame for transfer pricing does not apply.
220	R9	could not (deep) ... because the deadline is 8 months time, right? Or a year? For the special audit of transfer Pricing... it has four month for deadline and could be extended 5 times.
65	R11	(the diffulty is) considerable time needed.

b. Transfer pricing regulations are too loose and lack detail

Quotation Number	*Person*	*Quotations*
56	R5	Then the third one [problem] is our regulations; they are too loose to provide justification for royalty payments. So, we look at PER 32, which states that all royalty payments are reasonable regardless of whether or not they are of a significant amount. Thus, our regulations are too loose compared with section 1482, which is very rigid
58	R5	.. Not even compared with Section 1482, Australia's Transfer Pricing Rules with regards to Intangible Property has very rigid steps. And do not be mistaken that the United States never make whole royalty payment and turn it to zero, there are many court decision which treated royalty to zero. Royalty was aid by the taxpayers and adjusted by transfer price to zero, in the US does exist.
20	R6	Unfortunately, our domestic rules are not detailed enough, and we would like to make these clearer
	R12	Then in our own regulations audit transfer pricing and transfer pricing are still relatively new and need improvement, and the legal basis is still based on regulations of the Directorate General of Taxes. We would like to upgrade to the level of Finance Minister Regulation

4. Problems related to organisation and human resources

a. Rotation system

Quotation Number	Person	Quotations
390	R1	... Sometimes there are conflicts...between the needs of ... recently auditors of Large Tax Office ... many of those are experts in mining, coal, oil and gas
392	R1	.. they are posted to Medan Petisah and Makassar, this is very regretful..
394	R1	... Like me, I attended two training ... oil, mineral and coal ... and I got certificates, they promised ..
396	R1	.....here, those knolwledge are useless and have to stugy ...trade, paper...
400	R1	should be the right man on the right place..
402	R1	the interests of the Directorate of Tax Audits and Collections are different from those of the Human Resource Division...AS, an expert in oil and gas, would be posted in Oil and Gas District Tax Office based on interesr of Mr. D (the Direcor of Tax Audit and Collections), However, he already posted at around ten tears in Jakarta...what to do ?
404	R1	he was posted to Tigaraksa District Tax Office in Tangerang...
408	R1	Actually, the Director of Tax Audits and Collections is already aware that rotation for auditors must
410	R1	be nationwide for turn purposes but the skilled persons should get exceptions
416	R1	actually from the year 2009 that Mr. AA along with Mr. O, already told that ... I was the first batch training foe coal ...."you guys would be posted to the District Tax Office delaing with coal industry"...and then I attended another training of oil

Quotation Number	Person	Quotations
		and gas...but the reality was, oil and gas expert,Mr. W, was posted to Palembang....big regret...
422	R1	...also the resignation of WF ....big regret...
424	R1	...WF is an expert in coal....
274	R9	Yeah, at least not immediately cleared all. At least the first half.
276	R9	Right now, rotation is based on equal basis. The barrier on rotation again. Mr. P said that in Australia, before tax auditors handle transfer pricing cases, they have to attend three years of training...
278	R9	Yes, for this reason our transfer pricing cases are so magic
280	R9	...considerable time is needed to study transfer pricing. Its knowledge is specific..
351	R9	because once a team has been formed, then the team members are rotated... The barrier on rotation again
353	R9	Yeah, that should not be generalized. Or given a longer time or do not take all of them out ftom one tax office in the same time.

b. Organisational structure for handling transfer pricing cases

Quotation Number	Person	Quotations
372	R9	Oh, shortage. We can still handle this assistance, still not too many. But then if they ask for assistance in one time, we wil get confuse. And our job is not only assistance, but training as well.
16	R12	Then, the second problem, is that we do not have the human resources that specifically address transfer pricing audits in the field. So, we do not have tax auditors specialised in transfer pricing audits. The third problem, is our organisational structure for handling transfer pricing audits is not specific and is only in the Level 4 echelon. It is too small, isn't it?
18	R12	Yes, it is too small. Yeah, isn't it? Organizational structure we also still can not. Then our own regulations, the audit Transfer Pricing and Transfer Pricing are still relatively new, and still need improvement, and legal basis is still based on Regulation of Director General of Taxes. We are in the opinion to upgrade to the level of Finance Minister Regulation.

c. Level of knowledge of the tax auditors

Quotation Number	Person	Quotations
27	R3	But at that time, we didn't know transfer pricing yet. Transfer pricing was not yet developed. I just recently trained. The first training in Directorate General of Taxes, was in 2007 with Mr. Edu
28	R2	Mine in 2009 Sir.
31	R3	Yes learning by doing.
33	R3	Indeed, we knew of transfer pricing. We already knew from the beginning. Frankly it's just we did not go into it - the process, methodology, we didn't get.
56	R5	The main difficulty is the lack of understanding by tax auditors regarding concepts of fairness (arm's length) of intangibles..
75	R6	Then the second, limited knowledge of our tax auditors, meaning that they need more trainings...
147	R8	The other possible difficulties could be from their own level of competence of the auditors which need .... eventhough right now probably have a lot of training, the number training needs to be increased, the ability more widely spread...
208	R9	Yes. Actually the cases in the practice are a lot. like PMA5. Times ago, we conducted peer review, there were 16 that we took as sample. None of them related to the TP.
210	R9	Yes, because most of them did not understand the TP.
270	R9	Well, our weaknesses in is that… Overseas the one who deals with transfer pricing is not the common staff but the one who is already well trained...
272	R9	that's quite different from us. The rotation system replaces tax auditors with new ones. That creates issues for us...we have to educate the auditors beginning with basic skills, and these rotations happen again and again...
16	R12	The first problem is that our human resources-that have very diverse background and levels
4	R13	I think the ruling is not a problem...the problems are a lack of skills, knowledge, and willingness to abide by regulations. Well, those need be encouraged in the DGT so that they understand the regulations correctly, and abide by the regulations they have been made. Because I think our regulations are standard; similar to thoses owned by the OECD. So, it is obvious. If there is a dispute, we need to rely on our ability to interpret the facts and the TP regulations. That's it.

Research Question 2: How do the Indonesian Tax Auditors deal with transfer pricing cases derived from intangible assets?

1. Legal bases used as references in audits of transfer pricing cases

a. Article 18 paragraph (3) of the Income Tax Law and domestic regulations.

Quotation Number	Person	Quotations
20	R1	Related-party relationships are defined in Article 18 paragraph 3 of the Income Tax Law, so with the authority of this article we decide that certain related-party transactions need to be explored more...
24	R1	entry gate from there (Article)
356	R1	in principal, Article 18 paragraph 3 provides the key and entry gate...If a related-party relationship exists, then it must be examined further"
149	R3	That's legal basis
151	R3	.... not related to the treaty. That's not it's subordinate. Unless related to the article 26. It's been domestic tax matters. Treaty does not take into account expense incurrred there. It's just sharing.
153	R3	Treaty doesn't involve in anycost incurred in other country, I thought, it couldn't. No Article supports this…
12	R5	First, use Article 18 paragraph (3), then try to find domestic rules...KEP-01 1993, PER 43, or PER 32. If it cannot be addressed by PER 32, then try to refer to the internationally-agreed principle.
22	R6	Yeah, sure for the legal basis (Article 18, paragraph 3).
26	R7	Yes they made positive adjustment (referred to the Article 18 paragraph 3) with rule of thumb
10	R8	Yes, it is right [Article 18 paragraph (3)] is the starting point...it must be determined that a related-party relationship exists and then we look for the level of reasonableness.
66	R9	18 paragraph 3.
70	R9	.. Yes we are not based on affiliate transactions. It was just the entrance. The reasonableness, if it is not reasonable, then we make positive adjustment....
18	R13	.... 18 paragraph 3, it only grants authority to the Director General to make positive adjustment, if it does not arm's length ....

b. Legal documents, contracts, or agreements entered into among affiliated enterprises

Quotation Number	Person	Quotations
142	R1	It's quite similar to H Co... agreement did exist, but did the transaction exist? It's a service ... ... okay. At least if it is service, we can trace back, can't we? Trace back the evidence of the person conducted that services...
32	R4	Always, the concept is that legal documents are used as a starting point to determine "who does what," but judgment should be based on factual conditions...Tax auditors visit the plant and look at production processes. Are the factual conditions in accordance with the agreement? Often, factual conditions do not adhere to legal conditions.
6	R5	Contract is a document that is taken into account by the tax auditors.. Because the contract in accordance with Civil Code Article 1338, as pacta sunt servanda.
8	R5	.. That the contract will be recognized as valid contract as long as not contrary to Article 1320 Civil Code Act. And there are four requirements, if I am not mistaken, need to be fulfilled to have a valid contract. However, the contract does not necessarily prove the existence of intangible property...
74	R5	Ok, from point of view agreement, we might consider that the agreement exist legally and the brand is registered to the Ministry of Human Rights, Directorate General of Intellectual Property Rights, but It's affiliate in Indonesia conducts marketing activities, so that the brand of ABC has more value and getting better, that;s the Indonesian company.
54	R6	... The contract should also be compared with existing facts, whether it is in accordance with; need to be taken into consideration is the equivalence of the contract with the with a business model refcently developed. Is the distributor contract, a contract between a subsidiary and a parent in manufacturing, we see, what model does take place in that business. What is important is whether Indonesia's entity has a role to that intangible property?
56	R6	Yes, the role of the entity in Indonesia, whether it has contributed to thr development to the brand or intangible property. ... if indeed Indonesia's entity, let's say it's a distributor-and then it set up the marketing plan, and also conduct marketing activities, which cost above the normal cost of other distributors; hence the tax auditors should be aware that the Indonesian entities have

Quotation Number	Person	Quotations
		contributed, although it should be checked in more accurate way.
150	R6	Yes, usually we still pay attention to the contract but we have to look at the facts...
152	R6	Still, we respect the legal documents, but the substance must be seen.
154	R6	Yes, (subtance over form)
30	R8	... besides the contract, substance must be observed, are there any activities being conducted for the services being paid? This will test its existence. For the agreement, it was to examine the documents I guess...
34	R9	Yes, that's why the contract we are looking for is the one made by non related parthis contract was not sought a related party, sir.
4	R1	.. so initially it was associated with the audit of turnover. Turnover with royalty fees ..... then, we examine documents provided by taxpayers regarding license agreements...We learned the definition of royalties, and for what. It turned out that it related to technology, trademark licences, and licensed products.
8	R1	In its license agreement L'Oreal SA granted an exclusive right to L'Oreal Indonesia to use its technology, licensed trademarks, and distribute and sell its licensed products in Indonesia. Associated with granting such permission, L'Oreal SA France is entitled to a proportion of the net sales of the licensed products at two rates: 5% for the right to use the technology....and 1% for the right to use the licensed trademark.
10	R1	The definition of technology is stated in point 1.4…valuable information developed by L'Oreal related to the composition or production process of licences...so, associated with production processes, so that L'Oreal Indonesia produced based on a formula from there. Then, the second point is related to the licensed product .... It is defined in Point 1.3 ... cosmetic products, hygiene and toiletry produced in relation to technology and agreed upon by the interested parties to market in the territory of Indonesia. The terms of licensed trademark was described in points 1.2 as follows licensed trademarks shall mean the L'Oreal, Maybelline, Dralle and Redken trademarks as well as all other trademarks and any and all names, abbreviations, symbols, and other distinctive signs including the designs, which are used at the present time or which will be used later on, in combination or in association with one and/or another of the main above-mentioned trademarks on L'Oreal initiatives, or any other trademarks that the parties will decide by common consent to exploit in accordance with this agreement… Then, based on this agreement…we have the opinion that referring to the definition of technology and the licensed trademark as stated in this agreement, we, the audit team, concluded that the use of technology and the licensed trademark was only going to happen if L'Oreal Indonesia produced licensed products as stated in the agreement...technology, etc…Based on the examination of 2005 there was no production of licensed products
12	R1	Yes, it's distributor only
14	R1	L'Oreal France are entitled to royalties, in this regards technology relates to compositions, certain formulas mentioned .... based on the audit, no production in the year
16	R1	... 2005, pure trading, there was no production, so pure purchase...
18	R1	yes , all from the groups, so based on point 1.2 and 1.4 of the agreement ... Royalties charged by L'Oreal France were not reasonable referred to the agreement. Furthermore if we examined the relationship between L'Oreal Indonesia and L'Oreal France, it satisfied [the related-party relationship]
20	R1	... i.e. by getting back to the original agreement, by looking it's substance, whether this royalty payment exist or not... That transaction was production based on formula described in the that agreement...
26	R1	... that point dealt with h the use of technology, didn't it? That 5% ...
34	R1	Yes, we still look at the substance, so any form of agreement undertaken by two parties having a special relationship could take place, but DGT has a principle of substance over form rule...does the substance of the transaction make sense to the their business? If so, the agreement would be followed...even though, we will still refer to its fairness...firstly, substance of the transaction itself, then reasonableness of its values...if we know that its substance was not fair, and it does not make sense, we ignored it.
140	R1	... so, we compared the agreement with the substance of the transaction... indeed, transaction was stated in the agreement, but was the transaction mentioned by the agreement exist? Production, use of formulas, but it turns out no production...

50	R2	Agreements between 'father' and 'child'...not between independent parties, so, it could be set up.
51	R3	I've read that if related party relationship exists, contract will be ignored. It is stated in their Laws. Thus, no need to refer to that contract, because it is "under pressure", it's bias... But, logically or in general, we see if there is an agreement that does not balance between the father and the child, so surely it's awkward, something wrong must have happened. So, we do not really refer to the contract
57	R11	Thus, the contract is not taken into account; instead from a transfer pricing point of view, it is existence, the economic benefits....although in the past, court was considered contract; but now court does not consider the contract again.
59	R11	(Affiliated contract) could be set up.
61	R11	Once the company violated a contract, subsequently they could make a new one directly in next day. There is even one example of a contract using stamp without any validity of time period, so, it's valid time period was 2008 or 2009, they affixed it. 'this contract didn't enforced yet' I tried to follow up this for further investigation but still waiting for the decision from Regional Tax Office.

c. OECD Transfer Pricing Guidelines

Quotation Number	Person	Quotations
42	R1	We will use the OECD as guidance as long as all the provisions of laws and treaties have not been set up yet...it could be said that the OECD is the last reference when we can't find the relevant information in the domestic laws and treaties.
10	R5	Oh, the (role of the OECD) is one thing that is very central. In accordance with article 9 of Treaty, .. actually, almost all the same, 90% of the sentence that is in our treaty are the similar. Then we see the commentary. Commentary Article 9 of the treaty stated that the group of experts from the UN group of experts, stated that 'to examine the TP should be used generally accepted principle, which is reflected in the OECD TP guidelines'. Well, from the bridges that we use the OECD TP guidelines as a guidance or reference, but not a legal basis. Still the legal basis is article 9 of treaty or Article 18 paragraph 3.
12	R5	And in fact, PER 32 might not able to answer all of the questions; many things in practice cannot be addressed with it...our laws and regulations only mention five methods being used, namely CUP, cost plus, resale price, TNMM, and profit split. PER 32 outlines which methods are suitable for which practices. But, how to do it...did not set up yet, did it? No guidance yet. Thus, we refer to the OECD guidelines.
18	R6	The OECD transfer pricing guidelines are a major reference in the audit of transfer pricing in Indonesia and a reference also when constructing regulations. Although, we are also looking for comparisons or to enrich our thought or understanding of the intangible property... from the UN model as well, or from literature; for example, transfer pricing handbook, Robert Feinscheiber or from ATO, it is also our reference related to marketing intangible, they just have released that one, we downloaded then we compare to the OECD...
34	R7	For sure because TP Guideline, before TP manual being released, is the only guidance. So, we adopt significantly from the OECD transfer pricing guidelines. However, we also attempt to adopt from other provisions such as China and India, to have another view form the developing countries. Because sometimes cases faced by developed countries are different from those pf developing countries. So, we have to look at other positions, from another angle.
36	R7	UN TP manual, yes. We observe that UN TP Manual is being released and its position is also not much different from the OECD only a few things that I think are not too principle they are different: we also adopt that one. We now also consider more to the TP Manual because it is more applicable, since it has characteristics as manual.
10	R12	Oh (the role of OECD TP Guidelines in the formulation of regulations), vare very significant.
12	R12	True (we basically follow the OECD TP Guidelines)
244	R9	Yes, but it is not allowed. So, the legal basis for making positive adjustments are still our laws and regulations. If only for an argument, that's ok…
246	R9	It could be, the OECD could be as an argument..... we are using the concept of fairness. It is impossible to put all of the concept of fairness existed in the business into regulations. if the concept of fairness that's not possible all fairness principles in the business world it is placed into the regulations. ... Thus, the argument of fairness could be obtained from anywhere. From an expert's opinion, or from the opinion of business associates, or from the Internet, it

Quotation Number	Person	Quotations
		works...But, the legal basis for making positive adjustments is still Article 18 paragraph 3.

2. Role of Tax Auditors

a. Tax auditors conduct in-depth analysis of taxpayers being audited

Quotation Number	Person	Quotations
6	R6	A comparability analysis and FAR analysis of taxpayers should be completed because they relate to the analysis of the industry as well. So, the tax auditors should look at it in more detail, in this industry, whether specific intangible property is needed or not... And back to the industry, we will know whether in this industry need know-how, if it's already become knowledge it is not necessary. This is related to the existence of royalty payments for use of the intangible asset or right to use the intangible property.
40	R6	In addition, this test is also equipped by the analyzes. Analysis of the industry, FAR analysis, including the issue of type intangibles..
52	R6	in the early detection, 'oh there is something'. Although it was suitable, but comparable is still neded. We talk about comparative analysis, industry analysis and what types, but we need to ask 'whether here need [intangible property] ..' then principle of economic benefits. ...If they pay royalties but suffer continous loss, then it should be questioned. It is an indication of the time series.
140	R9	Well, its existence is usually like that. We see its FAR, and what is its function? Then, what is being charged?
48	R9	[if a company is only] a contract manufacturer but it is required to pay royalties on trademarks, that's obviously no longer relevant because of its function as a seller to the market and as a service provider.
50	R9	Yes, handyman. So, no relation between trademark and handyman.
150	R9	Why should contract manufacturing pay for this? If it produces something, like a cd player or other products, it might require to pay royalty]. In this case the parent has the licence for a particular component, and the licence belongs to a third party. So, their argument goes like this, 'this payment does not belong to the parent instead to other parties.' Actually, it does not make any difference whether it belongs to the parent or others since it does not affect their function, still as handyman of services. I think that should be the business of the parent.
240	R1	We had been suspicious of [XCo] from the very beginning, and they didn't pay income tax for ten years due to continous loss...
242	R1	Yes, 10 years loss.
252	R1	Imagine, he could offer thier the selling price to the Pertamina or another company with 40% discount Imagine, they would offer their price to the their clients with a 40% discount...
254	R1	the reason was they adopted the standard price, and they said they were using international price standards…But the funny thing is the rig equipment, they paid rent to their group not at a discount but at 100% of the rental expense...so [XCo] continued to suffer a loss, and there was no need to include other expenses, and with this rental cost alone, they already had a loss.
258	R1	... at that time I asked, why did you give a discount for selling price while you didn't get discount for leasing...
260	R1	So yes, it was suspicious that the headquarters was demanding the selling price be discounted while the leasing price from [the headquarters] was still 100%.
262	R1	... The rental fee was, in fact ..that money was back and forth fromone of their pocket to their other pocket, allof the money belong to them..
268	R1	it was reported to the Finance Minister at that time ...
270	R1	yes, 10 years never book any profit
272	R1	Yes, service company but never book profit, so weird...
274	R1	Is that logic? If the cost is paid to a third party it could be ok, but it may be partly at risk of market penetration or for another reason...but, if all of the transactions from the group, it becomes so weird, rental from the group, technical assistance from the group, so all of these from the group...they charge like crazy...what does it mean?...
276	R1	purposely made to be loss
37	R3	.. We do not see offshore first...If for example in our country, someone becomes a car dealer or sole distributor of cars, they would get a fee, wouldn't they?

Quotation Number	Person	Quotations
		Expect a profit? They would sell enough cars to receive a certain amount of bonuses. However, in this case, why do we have to pay pay [royalty to the principal]? This is a related-party relationship. Were the related-party relationship absent, is there anyone who would like pay [that royalty]? That's the question. If we are not having related party relationship for example Mr. E would you like to sell my products? But you have to pay royalties. From where will I get profit then? Mr. X you will definitely give bonus to us, right? CNI example, we can earn so many bonuses. [similar to] Multi level marketing. So, the the initial question was like that, too. This one is not fair. Well, we put it - even though it's from transfer pricing methodology, perhaps there is basis as that? Should be tested mathematically, price comparisons, and all sorts.
74	R3	... we try to calculate the costs of goods sold. The gross profit is only 3%. What percentage did they hope to have? Even general expenses were not taken into account. Also, we have seen the financial structure in the financial statements, and it was very harmful [to the taxpayer]. So, we see the analysis such as calculation mentioned earlier, net profit, expense with 9.5%., it's actual figure was eight point something.
113	R3	This company is not fair, [it's profit is] too low ...Moreover, the bottom line is loss. If this was taken out, the company would show a profit. Lose 20 billion - if I am not mistaken, If it is added by 111 million then turned to profit. So, if the company is a normal business with no frills, it is running well. By using this scheme, this is a foreign investment company that has suffered a continuous loss for seven consecutive years and didn't pay taxes accordingly. How could they exist? That's it, they actually made a profit. Because, existing cost paid to the parent..it's artificial, only a trick. But, if we take those out, actually the company made a profit over seven years" .
36	R5	With regards to [Y Co], we could not accept [distribution right fee as intangible] at that time. There were no intangibles. Intangibles are transferable, unique, and have clear coverage...The right to sell is not intangible in my opinion, and no references state this either. It means that the compensation given in return for selling might be considered profit rather than royalties. The right to sell is not an intangible property because it cannot be transferred. The licensee cannot sell the rights to another party...It is possible to move the contract, but it is not possible to revoke the license and transfer it to someone else.
22	R9	... . for the distributor, usually its value added not directly related to the products; but it relates to the marketing ...
24	R9	... there are certain limitations as well. If for example, if the marketing activities are normal and independent distributors also willing to spend that amount, then the distributors will receive any rewards.
26	R9	Yes sir (only extra-ordinary costs will receive rewards)
128	R6	It means...the sale of branded goods, like [Z] milk, etc., it's not our brand. They [Indonesian companies] either pay a royalty or have been charged through the purchase price...
130	R6	That's just a method, how do they take the money back....for example the original price is 100 and then it becomes 120 by considering that it already contains a brand, or they still have to pay 100 but later on they need to pay royalty in the amount of 20, it's same whether separated or in one package.
132	R6	Both of them are used by taxpayers and we have to check that...
134	R6	The principle is the same as a singer who recorded her song and then the her production house or her label, sell those and she will receive royalty, similar...
136	R6	Yes [the distributor may pay a royalty], typically for the brand...we have to check, even if they didn't pay a royalty we also need to check this. How can a distributor selling branded goods not pay a royalty? It becomes our problem, and it means there is something wrong with the purchase price, its import value... In principal we check how much the fair price is...if there are no royalty payments, if they are not visible, there may still be the purchase price, so it's hard to check it. So finally we use the cost plus or TNMM approach...Finally we can only test the purchase price because in that price royaties are already included.
138	R6	Yes, it is easier if we look at royaty as a percentage of sales so we can find the comparison, we can use the comparable uncontrolled transaction. How much is the royalty rates for the distributor, it's so hard when the royalty is included the purchase price, the difficulty is getting higher.

Quotation Number	Person	Quotations
120	R9	Usually royalties from sales, sir. If there are no sales , the royalty should be zero.
124	R9	..goods produced by themselves.

b. The tax auditors seek for evidence of the existence of intangible property owned by the taxpayers

Quotation Number	Person	Quotations
130	R1	... at that time we asked Mr. J sent an offial letter to Houston... already sent letter to X Co, they did not want open, didn't dare..... ...related to the technical assistance fee, what evidence do they have to prove that services were being delivered? What services did really they perform? If they [service provider] came here, there should be immigration evidence, time sheets...OK, [if taxpayer said] do not always stick on physical apperance...We [taxpayer] simply use technology...
132	R1	For know-how, at least correspondence should exist…I said at the time, where was the correspondence? Phone calls? Email?...They couldn't provide that evidence. How could services suddenly arise without any correspondence? The amount was significant and we made a positive adjustment to this.
142	R1	...[X Co] was also similar, it had agreement but did the transactions exist? ...At least if there were services being performed, we could trace them back...evidence from persons performing the services must exist.
144	R1	yes, if they came here, where was the proof of immigration? Where was time sheets for work conducted here...Ok, know how, what was correspondence to support this?
146	R1	They didn't provide the evidences
100	R3	It is very difficult [to determine the existence of intangibles]. Usually, we ask for some sort of reports, performance reports, and so on...
103	R2	Sometimes, we ask for the ticket or proof of the person being here...
105	R2	What have they done? Where are their reports? What kind of reports do they have? What have they done for the company?
188	R1	Well, there was bill...moreover this bill from [P Co]...
190	R1	...its parent...sometimes there was an expense which did not correspond with appropriate invoices...there should be expenses of the head office but [these expenses are] shifted to Indonesia...
198	R1	we asked for existence [of intangible property]. Sometimes there are actually allocations... there might be allocations of parents' over head...it should be based on rational calculation and this should be accountable...
204	R1	so based on allocation, the allocation should be clear and fair. ... a contractual should be exist... I asked for at that time, they could not provide... so, that's false, just expense it ... Without a logical calculation, what was actually they receive? From the parent, they got over head expense, or allocation of over head or royalty like that ...
44	R5	…and indeed it [intangible transaction] is rendered not merely charged...
10	R4	...with regards to the existence, if the intangible property is the brand, to find the existence should be easy because we just need to physically see the brand, then check its registration with the Directorate of Intellectual Property Rights here [in Indonesia]. Indeed, intellectual property could be classified into two categories: registered and non-registered. For the registered ones, it is easier to prove their existence and prove transference. However, for non-registered intellectual property it could be dangerous [risky].
108	R6	If certain intangible property is patented, it would be easy [to prove its existence] because taxpayers provide evidence of their patents with legal documents...but for a subsidiary, it could take longer time ...
120	R6	If the intangible are classified as brands, then those brands will be patented .... and (tax auditor) requires legal document, then followed by searching in the internet to ensure ..... for well-known products, there are no existence issues with those brands because indeed they exist...but if the intangible property is identified as know-how, it will not be patented purposely because it would allow people to imitate it, and it would become public...
122	R6	Well, this [testing of know-how] indeed has a high level of difficulty. In the end, we will look at similar industries, for example, on average, do paper mill companies pay royalties? If no, then, it is not know-how anymore...it becomes public knowledge.
2	R7	The first, identifying the existence of intangible assets.

Quotation Number	Person	Quotations
		Here we will see whether the product contained the intangible property. Identification of existence of an intangible asset is a very complicated issue in Indonesia, because the tax auditors request legality or patent of the intangible property. So, protection banned law is demanded.Then, bookkeeping records also highly requested.
10	R4	...non-document or indirect evidence should be compared to documented evidence. First, for example, with the matter of existence, certainly there is documented evidence in the form of an agreement between the licensor by licensee, in this case, usually between the parent and subsidiary or between the developer and user...this is the documented evidence...but, once again, sometimes facts are different to what is agreed upon in the agreement. Thus, the tax auditors usually conduct steps as follows: ...Firstly, usually we [tax auditors] come to division at which intangible property should be used, for example, if [the company] said that there was 'know-how' used in production, so we interview relevant plant division, whether they used a unique technology or not...for example with formulas, whether there was a formula in developing a product...manufacturing a product...if so, what kind of formula [are they using]? Basically [tax auditors are] looking for factual evidence that has economic value. So, [tax auditors] go to the production division, conduct an interview with the production division, directly observe that production process and ask which part of the production process uses IP [Intangible Property]? We ask for an explanation from the taxpayers and ask them to make an official report and produce testimony given by competent persons. Usually [we] ask for two, one from the production department and one from its chief, who is responsible for the statement made by the production division.
316	R9	Tax auditors directly go to the field so that they can observe immediately how the production process takes place.
333	R9	To determine existence usually directly refers to the field, immediately see the process.
335	R9	One of auditors told the story. He conducted an audit and confirmed that these products contained intangible property. But when he went to the field he found that a machine performed the work. Raw material was put inside, processed and finished. Thus, where is the intangible property? Thus, no intangible property was transferred. It was in the machine, but not a license...[the company] bought the machine..... if the IP becomes common knowledge, t it is not considered IP anymore. So, be worth zero. If the information of production process of paper we can get from the internet, the library, or anywhere, that's not an IP, an IP should be secret ...
4	R5	First, there is a request of the taxpayer to provide the requested document so that an analysis can be carried out. Otherwise, tax auditors will conduct an analysis using their own methods. From there, tax auditors will try to find the best calculations, meaning that if it is stated that the royalty is 5%, as long as the taxpayer could not prove the existence or the benefit of the royalty, the royalty will be treated as a non-arm's length condition and will be adjusted to nil. Recent development in the Tax Court shows that many decisions of the Tax Court are in favour of the Directorate General of Taxes, for example ITA vs. Ford Motor and ITA vs. Frisian Flag in which the DGT won the case because the taxpayers couldn't provide documents or an arm's length calculation.
153	R8	Taxpayers should provide this [burden of proof]. Taxpayers have the obligation to make transfer pricing documentations (TP Doc)...Then, tax auditors will assess based on other sources, perhaps from another documents. If the TP Doc is not valid, it could be used to make a judgment...
155	R8	In the past, since taxpayers didn't provide documents requested by tax auditors, then tax auditors tried to find evidence. If for example, taxpayers were requested to supply documents but nothing happened, then finally all of intangible assets would be adjusted to nil.
250	R9	In PER-32, there is limit. The company with transactions at least in the amount of 10 billion should submit TP Doc
256	R9	...Yes, we only need to criticise but for the transaction below the limit, the burden of proof lies with us.
266	R9	Usually its contents (TP Doc) is about the industry, broadband analysis of the industry, its trend and the most important is FAR analysis. What does function company [perform? What kind of assets do it have? What kind os riske do they will face?...then ended by the comparable and conclusion that it's TP Doc is

Quotation Number	Person	Quotations
		arm's length...wha is the proof thatn TP doc is in arm's length? Usually it makes direct comparison to the company havuing similar net margin. Rarely they make a comparison for transaction. Such as royalties. However, it happened before, they provide us a direct comparison to the transaction.
4	R7	Actually, the case of 'existence' must be viewed in a broader and simpler context in a sense that when there is a product with high technology, for example mobile products, the technology is quite advanced. In this context, we cannot deny there is intangible property in the mobile phone technology. It applies to the brand as well; if the brand is very well known by the public, then it cannot be denied that there are marketing intangibles in that product. So, it is as simple as that.

c. The tax auditors try to classify kind of intangible.

Quotation Number	Person	Quotations
6	R6	In order to test transactions related to intangible property, We must first identify the type or types of intangible property. If we talk about a type of intangible property, then we should find out in advance which types of intangible property are trade and commercially intangible.Trade intangibles relate to the production of goods, while marketing intangibles relate to the how goods are sold. If it is related to a trade intangible, there are some types that must be analysed - whether it is know-how or a patent. If it is know-how, it will be hard to get a patent. Know-how tends not to be patented because it is confidential. If the know-how were patented, it would be easily accessed by the public."

d. The tax auditors look for evidence of benefit received by the taxpayers from intangible property.

Quotation Number	Person	Quotations
17	R3	...after we conducted an analysis, the distribution right fee (DRF) was very detrimental to the company...it resulted in a direct loss...Then, in terms of the benefits, for us [tax auditors], it didn't benefit the company as well...
25	R3	we would like to highlight that there were unreasonable costs that were not in accordance with the benefits that were received. They [the company] have bought stuff, why do they need to pay royalties? Thus, the thinking about royalties evolved...
131	R3	It was not reasonable, there was no benefit received by the company here. So, that payment had no benefit. Supposedly, if we paid, there should be something that would benefit us. It did not exist
20	R4	For distributors it is necessary to scrutinise the contract ..and the most important thing is whether the contracted items provided economic benefits to the user.
44	R5	The technical assistance fee is classified as services...the main requirement is that it provides an advantage to the company...

e. Tax auditors try to find comparables for intangible asset transactions

Quotation Number	Person	Quotations
48	R1	..Initially we're Googling, searching on the Internet, and browsing for any similar cases like this...
70	R1	At one time, I came across an audit for an oil and gas company...when we were browsing this rig with a depth of several thousand meters.... apparently there must always be a point of distinguishing between one rig and another...functions were made in different technologies [the rigs were made using different technologies], so that loop hole will be used to deny comparability...
38	R1	Comparable.....At that time there was no guidance with regards to the FAR analysis...So, we purely interpreted regulations under Article 18, paragraph 3 and then KEP 01...
40	R1	year 1993. Its agreement was compared with the prevalence of the business and the substance of event...for the core business trading, was it appropriate that such expenses incurred?
48	R1	…Then, we continued to analyse the agreement between L'Oreal Indonesia and L'Oreal French and then we compared it with the business actions that took place... We conclude from the agreement, that what took place in [L'Oreal] Indonesia could not be applied to royalties...
70	R1	L'Oreal royalties case in Indonesia it's not too complex because the truth of the

Quotation Number	Person	Quotations
		agreement is a little bit easier to be interpreted because the agreement is quite detailed ..
16	R5	With a note [assumption] that it [intangible property] as been proven that there are benefits and there is existence, the first approach is to ask the taxpayer, 'Is that the same intangible, being licensed to the independent party?' If so, we can use it. This means that the same intangible is licensed to two parties who have different relationships—one affiliate and one independent. It means there is an internal comparable and that's great.
20	R5	Yes, ever, Nissan for example
46	R2	I asked for the taxpayer to prove [that F Co] in Europe or in Australia—whether F Co in Europe and also paid the DRF, it was never shown to me. Instead they provided [Ford in] the Philippines and South Africa. These are equally poor countries...Sometimes we just used our logic alone.
145	R3	We tried to find internal comparability, but we only found an example in the Phillipines that was not representative…If for example we could have found an example from Europe, then this would have been internally comparable.
30	R5	... comparable (from other countries) have never been there.
28	R9	The OECD also prefers internal comparables. They also prefer the use of CUP as an internal comparable....[basically, internal comparable will reveal when] a parent company grants a licence to another company, so that the licence is granted to the independent party and its affiliates....[However] I have not met this yet…So, it's rather difficult.
30	R9	...Usually for multinational enterprises, they are a bit reluctant to grant a licence to an independent party. Multinational enterprises feel more secure licensing to their affiliates in order to protect their secrets. Intangible property is a secret of their business, and the heart of success in their business are their intangible properties. So if intangible properties are licensed to another party, they feared that these intangible properties could be released the public.
40	R6	We identify whether internal comparables can be used, if not, we use the external comparable [from our] database.
20	R5	if the taxpayer does not have a internal comparable, then we will use external comparable. To find external comparables in my opinion we should follow the OECD guidelines in Chapter 6. Firstly, we need to differentiate what kind of intangible that taxpayer has? For example: a trademark, patent, know-how, or trade secrets; this needs to be determined first because each one has its own protection. Therefore, we look for external comparisons for each type of intangible. They cannot be combined because it will lower the reliability of the comparative results later on.
22	R5	So far taxpayer' contracts are combined. One contract can include trademarks, patents, know-how, or services. That is what makes it difficult, and ultimately a practical soultion was found by the applicaton of the 25% rule or the rule of thumb.
24	R5	In an application like this, the royalty is paid for a maximum of 25% of the operating profits before royalties...The Intangible Property (IP)'s owner [licensor] and the manufacturing company [licensee] collaborate in production. The licensor is the one that contributes to the IP, while the licensee is the one that performs the production processes based on the abovementioned IP. The results are in the form of profits derived by the licensor. Those profits are divided by giving 25% to the owner or licensor and 75% for the licensee
50	R6	"...Before that there was testing using a simple rule of thumb. We called it a "test case" and used the 25% rule of thumb principle. We considered what percent of royalties had been taken by the licensor? Did they exceed 25%?...[25% rules serves as] detection tools
2	R13	They [tax auditors] have started to use the rule of thumb approach. This approach might not be most appropriate, but it seems the best position taken by the DGT lately.
366	R1	...Similarly, a comparable is not necessarily the same in all aspects...[if] in general, it is the same, [it should be fine for comparable]…
368	R1	so sometimes like with BMW and Mercy even though technically they were different but both of them are classified as premium [so, they are deemed to be comparable]...For Toyota, we can compare it with Daihatsu...To find a perfect comparable is really difficult, but essentially we are looking for a proxy...If we find a similar comparable [with] the majority of its characteristics are almost the

Quotation Number	Person	Quotations
		same, we will use it.
43	R3	The DRF is not universally absolute. If it were, and it was necessary to list the payment, then the problem would be shifted to the rate. The problem is that this cost does not exist generally...
143	R3	Yes, [we referred to] Toyota and Suzuki [for external comparable]
184	R1	At that time, my team was a specialist for Company X, all group of [Company X] went to my team. My team member compared Company X with company X' affiliate [listed in the same tax office]
186	R1	...between Company X with company X' affiliate...
38	R2	We were also looking at [Company Y] and they did not have to pay [such payment]"
39	R3	"[We found that] other distributors do not pay for such rights. Well, with regards to a comparability analysis, we're looking for the systems with similar business organisation. [The company we audited was] a principal with dealers and distributors in Indonesia, so we're looking for that, with the same characteristics. [We found] Company T, incidentally, was our taxpayer too before it moved to the large tax office. We had the data. We are looking for financial reports. Those costs didn't incur at all"
40	R2	They are in one management,... in MT. Haryono, .. all of their offices located there.
34	R4	Actually [it is] not about allowed or not allowed... It [secret comparable] is not highly supported because in order to prove affiliate transactions both parties should have equal access to comparative information; if only one has the information it is not fair
26	R5	From a regulation point of view, there should be no ban. We refer to the PER-32, PER-43, or even KEP 01 that there is no ban on the use of secret comparables. But in terms of propriety, it should not be like that. That's apply for the examination [audit]. However in my opinion, it could be applied in court as long as the judge could accept the secret comparable
168	R6	We do not recommend the use of secret comparables
170	R6	just follow OECD or UN guidelines...We use public data so that it can be accessed by the public, and it will be more fair.
172	R6	We Yes, it was there in the public databases that are sold to the public.
86	R3	[The burden of proof] lies with the taxpayers. They already made [comparables], we find the one with more similarity. We also face difficulties in finding comparables, so if taxpayers also have calculations, they should be able to prove that their calculations or comparables are valid
46	R12	The burden of proof is obvious. According to PER-32, the burden of proof lies with the taxpayer based on self-assessment. Firstly, the taxpayer needs to convince the auditor that its rate of royalty is at arm's length. Then, the DGT will conduct a review and in-depth analysis.
84	R3	Right now, we have [databases of] Oriana, Osiris and Royalstat. Oriana and Osiris have comparable data in financial reports to the level of net profit, while Royalstat has comparable data for royalty rates. But, [to find comparable] for the price of goods, it is difficult as well...To sort comparables out is very difficult. Like the principle of transfer pricing, there are no two identical transactions. If we can have a comparable population, our population is often in-challange. It's not comparable. Once there is weaknes, taxpayers argue that their products are slighly different. The perception is the same that there is no perfect comparable. It is very difficult.
34	R6	For comparables, we try to find them in the database software
36	R6	[We use software] KT Mine
38	R6	It's subscription. It's OSIRIS
32	R9	Our approach is as follows, we don't directly compare on an apple-to-apple basis using CUP. We see certain limitations of royalstats. In certain industries, for example, how much is the royalty rate? Once we get that data, for example a 10% royalty rate, then, we scrutinise the contract. What are the terms and conditions? Do they have exclusive, non-exclusive, or geographic boundaries? If the geographic coverage is only in Indonesia and later on there is comparison with world geographic coverage, this should be excluded.
66	R8	The TNMM method could be used which will seek from certain margins, from the company that is totally independent, which is taken from (Osiris/Oriana).

Quotation Number	Person	Quotations
74	R8	If you would like to compare royalties, it means the CUP method will be applied. I think this does not fit because royalties have a unique character, which may differ from one company to another.
4	R12	The transfer pricing method they use to distribute the R&D cost will be received later on in the form of royalties. Surely we will test the method they use. Then, we look for benchmarks in the form of variable comparables.

f. Tax auditors try to find arm's length price for intangible asset transactions

Quotation Number	Person	Quotations
10	R4	Regarding the arm's length value, we use the following strategy because Indonesian [companies] are mostly licensees, users, usually we use the CUT method [comparable uncontrolled transaction] to look for other licencees from independent parties for the same industry. We look at how much their royalty rate is. IP can be grouped into two categories. First there is routine IP whose value is not unique...These licences usually use a routine IP. Second, there is IP with a unique value. For the routine IP, we could compare them, looking for an equally comparable licence, while for unique IP, the commonly used method is the profit split method.
16	R4	…In reality, even though IP is unique, people will not want to pay too much for it. Take an Ipad for example. When it was first released, it was described as spectacular, but as time went by, there were increasing numbers of imitators. I think CUT method could be applied. Because this is a business, if something unique is found, then there will be many imitators so, that from the user side, the [royalty] rate will certainly not be much different.
114	R6	When tax auditors can confirm that intangible property exists, the next step is to determine the fair value. At the end, tax auditors usually come to the Directorate of Tax Audits and Collections to find comparables by using the OSIRIS or ORIANA databases.The method being used is the comparable uncontrolled transaction method
40	R6	Then in addition to the CUT method, we also try to search for the aggregate basis. This [CUT] has a transaction-to-transaction [basis] meaning it's head-to-head. We try to find a comparison from the company's point of view, so we use the TNMM. What's the Profit Level Indicator (PLI) of their performance? We use the aggregate basis at the level of the net operating margin.
48	R6	[We] search for comparisons in the OSIRIS and Oriana databases. Then if the profit performance is different, it is addressed at that point. There are two approaches we use to test it. The CUT method will check whether the amount of royalty is reasonable or not, look for comparable royalties, and check this by using the TNMM method. So we test whether the CUT method is suitable or not because we are also simultaneously checking for comparison. [For example] We find royalties of seven percent here and three percent there. It means that there is a difference of four percentage points. If we use a three percent royalty, how much profit will they earn? Then we check again by using the TNMM method, if it is suitable means that the profit of three percent earlier is correct.
50	R6	[TNMM serves as second opinion], to strengthen [CUT Method].
6	R7	Then finally, we have to determine reasonable compensation or a reasonable rate on intangible asset transactions. In the current context, our draft stated that intangible property is considered reasonable if the case has been tested through several methods. There are four methods: first with CUP (Comparable Uncontrolled Price or in the United States, Comparable Uncontrolled Transaction (CUT)); then the TNMM method, for the indirect [method] we also use the TNMM; profit split; and the valuation base. The base valuation could be in the form of post base, market base, or income base.
28	R7	It is important to senative check to test whether what we predict is true or not by using the TNMM method. It is important to test the validity of adjustments that we have done.
356	R9	So if we use TNMM, we use company wide basis.There is a question of whether it should be distributed to the royalties, services, or purchases. We will determine which one has the highest risk. For example, which transaction takes place in a tax haven, such as Country S or if the transaction with County S is not significant we look for another.
2	R9	The standard is that we always look at the net margin. We see indications in the operating margin. If its operating margin is too low or has limited risk, they suffer a loss, such as a 'contract' or 'toll.'.

Quotation Number	Person	Quotations
72	R9	[To determine its ridiculousness], the first indication that we look at is the net margin.

g. Tax auditors try to verify a transfer of intangible property

Quotation Number	Person	Quotations
10	R4	The same thing applies to 'transfer' as well so, we ask for proof. For example, to produce paint, the producer must use a certain formula. We have to look for evidence of the delivery of the formula either via email or through people who explain the technology to the user. Sometimes it can be considered technical assistance whether the person providing technical assistance comes or not
6	R7	Then in a comparable independent transaction, the transfer of intangible assets is deemed to have occurred. I would like to illustrate what happens in Batam. In Batam, there are a lot of contract manufacturing companies which lose money because they pay royalties. Well, for independent parties, contract manufacturers typically do not pay royalties to the principle (his parents) because they produced in the interest of their principal. In practice, especially in Batam, many of them also pay royalties, so contract manufacturing companies suffer losses. Well, in our opinion, if the conditions of contract manufacturing are independent, they are not supposed to pay royalties, or if they need to pay royalties, royalties should become a component of the cost, so that the selling price increases.

h. Tax auditors try to verify the entitlements of intangible property

Quotation Number	Person	Quotations
12	R4	With regards to the entitlement, we usually conduct an assessment of the party who should receive the payment. For example, if the IP is owned by the tax haven country, with no one there, and the company only has a PO box, its definitely no money there, too. So, we usually ask for reports of IP development activities, a list of employees working with that IP, asset lists, and financial reports if necessary. From financial statements if we're lucky, they state that the company has a certain number of employees...
14	R4	The [financial statements] of the IP developer, could be from the parent or any party. The bottom line is any activity could convince us that the party is reasonable enough to be considered as the IP developer. If the party can develop IP, it means that they must have employees, and the employees must be experts in their fields. Then, they must have money...Nowadays, it is allowed this way. IP can be subcontracted for its development, but at least they should have the money, but they might not have experts. Thus, we look for the evidence that shows that indeed that party should be the one who has the capability to develop the IP and own the resources.
4	R7	The second factor is more important—who has developed the intangible property? In the event that the one who develops is, let's say, Indonesia contributes to the research and development, actually, research and development conducted in Indonesia has a significant contribution to the development of the product. In this case, both the parent and the subsidiary in Indonesia have contributed to the development of the IP, therefore both are the owners of the IP. For the exploitation of this IP, Indonesia is also entitled to its share. With regards to marketing, in the case that Indonesia significantly contributes to the marketing of the product, including its strategy, then Indonesia is entitled to the Marketing IP. But if Indonesia does not contribute et all, either in R&D or in marketing, Indonesia is obligated to pay royalties to the principal abroad. Thus, [it is very important to determine] who is formed, who is developed, because these will determine the owner" (R7).

3. Role of Head of District Tax Office

a. The Head of the District Tax Office as a leader and inspiration for tax auditors

Quotation Number	Person	Quotations
30	R1	Mr. S at that time discussed royalty issues, so we [tax auditors] thought for example BMW, Ford, BMW Indonesia, Ford Indonesia, and L'Oreal Indonesia only sold products of their parents. We [distributors] bought from them, but why

Quotation Number	Person	Quotations
		did they impose royalties? What were the royalties on? Logically we only acted like traders. We bought their products, and then we sold them. Why did we impose a royalty? Royalties should relate to the kind of knowledge and confidential information, which has exclusive rights. For example, we manufacture or assemble goods here or use the brand from overseas, then apply royalty agreements...We understood....for this case, this really was just pure trading, right?
17	R3	Then we had discussions under the guidance of Mr.S…Mr.S had other ideas about the royalties.
21	R3	He said, if you buy a pen, your purchase includes the name of the pen, for example a "Pilot" pen. It is impossible to buy and be expected to pay more [for] royalties. A royalty is just like 'prescribed.' We make this product here [in Indonesia], so that it becomes a product, then we sell that product. It's been converted into goods. So, at that time, a lot of companies did the same thing. They sold products, but charged royalties. That's trading [company] not industry [one] but [they paid] many royalties
35	R11	Moreover, distributors are simply selling products..such as milk. They're produced in Thailand or the Philippines and then sold here...
41	R11	Royalties actually relate to the production, they are [produced] there-in the Philippines or in Thailand that - it certainly also be charged royalties as well. Why are they charged that cost here if they only conduct sales? The Taxpayers of Foreign Investment Three District Tax Office is a distributor.
90	R1	indeed, at that time transfer pricing was not that popular yet. Even among our audit team with the team of Regional Office team, we had different interpretations of royalty ... so royalty was not necessarily related to production ... yes, even the brand was also part of royalties, they said....
92	R1	when Carrefour purchased laptops, indeed Crrefour was selling laptops, they bought from Toshiba....Did Carrefour had to pay royalty? They're confused... if someone produced something by using technology "A" or brand "A" , yes, indeed as a consequenc, they should pay royalty.... But for trading, we bought product "A", did we need to pay royalty? ...really weird...
104	R1	yeah, even we sold their products, why did we have to pay royalties?
106	R1	Yes, should be. That's out logic
108	R1	... in marketing .... if ... (we have) a god selling, many ... in addition to the normal commission, (we will) get additional incentives actually ..... instead, this should be subject to a charge...
94	R1	(Taxpayers of Foreign Investment Three District Tax Office) are distributors. [The Taxpayers of Foreign Investment Three District Tax Office] is a distributor
100	R1	...started from wholesale car...
102	R1	(electronics: electrolux..., cosmetics: L'Oreal....)
3	R11	(Foreign Investment Three Distric Tax Office) all are distributors
5	R11	Yeah, there are royalties, management fees and also buy from related party, as well as sales to related party...
76	R1	For trading, all kinds of production costs, including R&D, are associated with royalties and should have been counted at the unit cost in its price. Why should they be separated? This is some sort of trick to shrink the basis to charge import, import duties, and other things related to this.
20	R2	Ever mentioned also during Mr.J, this purchase is too low for the avoidance of sales tax on luxurious goods
21	R3	So it was mentioned that this is actually avoidance. For example if the figure was included in the price, it would be inflated—if royalties are included in the price, with the higher price of imports, sales tax on luxurious goods will increase. This usually is avoided by automotive companies, so there are some parts of the price allocated to the royalty. Royalties are generally administrative expenses and not included in the price of goods. If they are included in the price of goods, the sales tax on luxurious goods will be higher. We discussed with Mr.J. at that time but we didn't find the sound reason yet.
23	R3	Well, was included in the selling price of goods. R & D all kinds, those were costs, weren't they?... Well, some stated obviously that they paid royalties, called royalties. Well, Ford, named DRF because he has the exclusive right to sell.
43	R11	[Royalties are] already charged in the production, and are already included in the cost of goods sold. Here there should be no such cost. Thus, a positive adjustment is made.

Quotation Number	Person	Quotations
40	R5	In order to have cheap prices, they [distributors] try to lower import duties, and they make the value of imports low; then they take the money back via royalties.
42	R5	Especially for branded goods, for example import company bags, the price is usually low. But later the company would [receive] kick back [payment] again in whatever form, with a sophisticated scheme that would not use royalties, and instead would use for example, cash discounts, incentives or anything but not royalties.
30	R7	The possibility of taxpayers reducing import duties, because of import was pointed out. The purpose was so that they could be sold on the market at competitive prices
86	R9	There were so many allegations that they were actually avoiding sales tax on luxurious goods.
88	R9	But they were not willing to take [their money back] from the selling price, because if the selling price were higher, there would be higher sales tax on luxurious goods.
90	R9	Yes, at the time of import.
94	R9	Sometimes if sales tax on luxurious goods is imposed, we are suspicious of that. If royalties unreasonable, but [the company] makes a reasonable profit, we are suspicious of the sales tax on luxurious goods.
96	R9	Yes, they took from royalties. Many believed that. I also guess that...
104	R9	Yeah, so sometimes if sales tax on luxurious goods is imposed, we always be suspicious on that. If royalties weird, but reasonable profit, we are suspicious to the sales tax on luxurious goods.
30	R1	Moreover there is a trend. Our taxpayers suffered losses or even profits, and profits were slim for years with a wide range of expenses from the head offices in terms of overheads and royalties. At that time Mr.S said that this was not logical - why did people conduct trading but they were charged royalties? Maybe we could dig deeper into the existing agreement with them.

b. The Head of the District Tax Office acts as a quality assurance of audit works

Quotation Number	*Person*	*Quotations*
320	R1	The [Head of the District Tax Office}, he would be last filter...He didn't decide [result of audit], he didn't command...Mr. S is a capable person, while the others sometimes didn't understand...Mr. S, he's so smart, so he would be the last filter. Sometimes there were issues raised by him for example royalties on trading. He invited us to discuss it, and he delivered a briefing for us. [Also], Mr. S usually had a better monitoring, so he sometimes provided improvement, it should be like this.
328	R1	Yes, become the last filter for Mr. S. Sometimes we did not address problems quite well, and Mr. S and Mr. J would put us on track. Specifically, the head office really understands [the problems], and he would be the last filter for us. They [head office] didn't direct us nor directs us, but once we began research, they would explore with us.
45	R11	I just provide directions, our TP experts are spread across many teams; they conduct analysis.

4. Role of the Head Office of the Directorate General of Taxes

a. Directorate of Tax Audits and Collections and Directorate of Tax Regulations II provide assistance to the tax auditors who carry out transfer pricing audits.

Quotation Number	Person	Quotations
158	R3	[I attended TP training] twice
159	R2	I had four trainings on TP, but they were always basic
77	R6	Formally through our human resources division we invite auditors to have training because they are in direct contact with the case, especially in the Large Tax Office and Special Offices
337	R9	"[To increase auditors' knowledge of TP] they usually ask for in-house training.
341	R9	If they have cases, then we educate them.
38	R4	The headquarters is actually very open to it [provide assistance]. In principle, with a limited team, we try to serve them as much as possible. So the challenge is a matter of having qualified people for transfer pricing, but we don't have that many.

Quotation Number	Person	Quotations
40	R4	They [tax auditors] may come at any time, but [we prefer] they make an appointment by sending an official letter.
12	R6	We offer assistance [but this is voluntary], so they [tax auditors] come. This relates to the independence of the tax auditors, except for cases that we initiate the examination. So, if it's a routine audit that has appeared in the District Tax Office, which we did not initiate, meaning that their independence has to be maintained and we [only] provide a second opinion and enlightenment to the tax auditors.
81	R6	We try to help our friends [tax auditors] with any technical assistance in relation to completing their working papers. [We guide the tax auditors to provide] working papers for related-party relationships, affiliate details, affiliate transaction schemes, industry analysis (whether the industry is in a good or bad condition, the types of markets, or who are the main players), supply change, and FAR analysis to characterise the taxpayers and whether they are toll, contract, or fully fledge manufacturing. For distributors, we examine if they classify as full or limited distributors, from which we can determine the tested party. There are working papers for comparables.
83	R6	particularly the use of internal comparables, in the event there are sales to affiliates or non-affiliates. In the case of the purchases, they can find out whether there are internal buyers or not. A comparability analysis of internal buyers is also undertaken. We look at whether it is a good comparable. If not, then we need to find external buyers.
4	R9	Many [assistance or guidance from Directorate of Tax Audit and Collections to the tax auditors].
6	R9	But not all of the them [tax auditors] come [to consult], only those who feel that they need help
10	R9	It is voluntary
206	R9	Yes, we've created the initiative several times ago, It's called intensive program for technical assistance. The the first one to assist the tax auditors and the second to reduce our work load as well. Later, it will burden us, to the court and to the Mutual Agreement Procedures. So we've sent offers mentioning what things should be included in the technical assistance. There were few District Tax Offices provided responses. Just stumble with SOP problem. Well, according to the SOP, it should go voluntary, instead we are asking for. So, we're confused too. Finally, just tell them to go to the headquarters.
347	R9	Yes, as I mentined before, voluntary
85	R6	Yes, all TP cases are managed by the Directorate of Tax Audits and Collections
89	R6	They are also monitored. Because of the system in the DGT there is decentralisation. Actually there is the intention from us to centralise as advised by Mr. PW.
91	R6	The problems are with our human resource [tax auditors] at the headquarters. Will they be able to handle all of the TP cases?
350	R10	Actually we already had PER-55 in 2010 that asked us to form a task force for TP cases. So, hopefully they'll handle it first in the regional office. It went well in the Large Taxpayers Regional Office, but in the Special Regional Office, they still come here, because they do not dare [do not wsih to take risk]. In the Large Taxpayers Regional Office, they have Mr. A there
1	R11	I suggest that if adjustments need to be made on TP cases, just adjust because we also ask for assistance from the Directorate of Tax Audits and Collections. So, once a case arises, I always send a letter of assignment, and they go to the Directorate of Tax Audits and Collections to ask for assistance, ask for the data, how to deal with it, and so on
47	R11	We always ask for assistance. It [intangible property] is also seen its existence, its economic capabilities, the benefits of all that. Is that worth adjusting? Then we consult the Directorate of Tax Audits and Collections.
65	R11	So we discussed with the headquarters [of the Directorate Genral of Taxes] and that really needs is personal judgment. The purpose of TP cases is not to make positive adjustments as much as possible but instead to negotiate. Would it be better to choose MAP or APA? The main objective should be right there because it is not a criminal offense. This is indeed a common thing. It is just a matter of whether the price is reasonable or not.
8	R7	Indeed, there is no obligation for the auditors to consult with the Directorate of Tax Regulations II. But if they have quite a complicated case, they usually visit the Directorate of Tax Regulations II to discuss the case at hand. But again, this only started happening recently; before they consulted the Directorate of Tax

Quotation Number	Person	Quotations
		Audits and Collections
8	R12	Right now, usually tax auditors make objections or appeals to the Directorate of Tax Audits and Collections. So, also on this request...they ask to come to our office, they ask our friends [dedicated staff] here, or sometimes they ask for a confirmation letter as well. But, in the future we will be 'proactive,' especially with the district tax offices for medium and large taxpayers and foreign investment, which do have a lot of transfer pricing issues.
28	R7	The tax auditors also often forget that royalty transactions are very closely linked to the purchase price, for example, the purchase price of raw materials. In the price of raw materials or semi-finished goods that we buy from the same party, there is the possibility that royalties are already included in the purchase price so that royalties paid later on is not that much or vice versa because the purchase price is too low then the royalty may be high, but in the end, the net margin of taxpayers remains within a reasonable range. Here there is a close linkage between the purchase price and the royalty rate.
38	R7	The important thing is we do not look at specific IP, but at the whole [comprehensive] transactions. We must look at the close relationship between intangible property or royalties with other transactions. In the last case I mentioned earlier, I used the example of the purchase—is there a relationship or not? I hope to have a clearer view, a wiser point of view and to see whether it was reasonable or not that they paid royalties. So far they [tax auditors] see only partially—in a sense stand-alone IP, but in fact IP is related to many other things. That's the most important thing. It is not fair when we do not allow royalties to be collected, and then the net margin after adjustment becomes much larger than similar companies.
355	R10	Most transactions are not singular in nature. On average there are the purchase of raw materials, sale of tangible goods, and royalties collected. So, there is not only one that is associated with its IP alone
2	R12	intangible is a kind of intellectual property and intangible usually produce goods or products. The technology used to produce the products.... maybe she could take the form of know-how, methods of work, and so on that it is useful to produce a product, needed goods.Usually the one that has intellectual property is a multi national corporations. Well, usually we see that if the IP (intellectual property) contributes to the company in Indonesia in the production goods and services, for sure the consideration given to the owner of the intellectual property in substance are acceptable. The meaning is this, …If indeed there are obviously other parties' intellectual property that we use to produce goods, then there must be compensation, as users, to pay the owner of the intellectual property. This is what we call propriety testing...Next we have to ensure that the compensation we paid will be received by the true recipient—the owner of the intangible property. Furthermore, we need to determine whether the intellectual property we used has become public domain or has expired. There are countries that limit the economic life of the intellectual property. If the IP has become public domain, we would not have to pay benefits. Then, how much is fair value? Assuming that others were fulfilled before, these steps are sequency not alternative. So, of course, we are here to test arm's length—how much is the arm's length price, and how much must be paid?"

b. Directorate of Tax Audits and Collections coordinates and collaborates with the Directorate of Tax Regulations II to deal with transfer pricing rules and regulations

Quotation Number	*Person*	*Quotations*
2	R7	In terms of the regulations we are trying to upgrade, we are revising the regulations on transfer pricing guidelines in Indonesia. Currently we are preparing a draft of the Minister of Finance's Regulation concerning the implementation of transfer pricing in Indonesia. Now, this is still being discussed at the Fiscal Policy Office One of the items discussed was about intangible property. For intangible property we adopted the latest draft of the OECD guidelines on intangible property. However, we were not limited to that. We also used the guidelines from other countries, such as the United States, China, India, and also the Journal, written by Deloris Wright on transfer pricing and intangibles…[whose guidelines have been] adopted by the OECD now
10	R7	We coordinate with the Directorate of Tax Audits and Collections on drafting the regulations, and we discuss with them about what things need to be regulated in

Quotation Number	Person	Quotations
		Indonesia because the Directorate of Tax Audits and Collections have more [experience in] practice in the field. They know what their needs are and we try to capture the needs of auditors and of the Directorate of Tax Audits and Collections. Then, we put transfer pricing guidelines in the draft of Minister of Finance Regulation. So, we regularly discuss with them and even now they're preparing circulars regarding 'Instructions for Handling Audit Transfer Pricing'
14	R7	No overlapped [takes place between the Directorate of Tax Audits and Collections and the Directorate of Tax Regulations II. So the rules made by the Directorate of Tax Audits and Collections focus on how to handle cases of transfer pricing, but the regulations are made by the Directorate of Tax Regulations II.
107	R8	...progress of regulations, compared to the previous period, we move forward significantly.
117	R8	....(Directorate) of Tax Audit and Colections should regulate standard operating procedures of audit or how to audit transfer pricing. But for general guidance should be Directorate of Tax Regulations II, the one that proposes should still conducted by Directorate of Tax Regulations II.But in my opinion, the level of harmonization do exist , right there in the DGT we have harmonization, in the Ministry of finance we have Bureau of Law. All of interesting parties must be invited ... solved there. So that after regulations being officially released, but yet "mature", still someone challenge that regulation, cspeak out outside...
121	R8	... when discussing it (draft), synergize, coordinate with each other.
143	R8	maybe for the time constraints of tax return-refund may need a breakthrough in terms of regulation. Is it possible, for refundto be released first, but later on for the TP it can be xtended, meaning that it could be audit again.
358	R9	It is used to frequently [overlapped]...but if now is not [overlapped again]. So, just recently when we wrote the draft of the PER [the Directorate General of Taxes Regulations] and the SE [circular], we asked Mr.J whether this fit with the RPMK [Draft of Minister of Finance Regulations] or not
360	R9	because the Directorate of Tax Audits and Collections, according to Mr.T, is not allowed to regulate 'material,' they can only regulate 'formal.' Yes, the domain of the 'material' belongs to the Directorate of Tax Regulations II.
361	R10	Directorate of Tax Audits and Collections will deal with] audit procedures
362	R9	*Yes, the domain of "material" belongs to the Directorate of Tax Regulations II.*
20	R12	So, we provide general guidance on transfer pricing. Those will be relied upon by the Directorate of Tax Audits and Collections to make policy guidelines for auditing TP cases. We have TP audit policies based on Perdirjen 32…we plan to change the Minister of Finance Regulations
10	R13	"...Because we divide transfer pricing into two, it's the big picture as stated in PER-43 and amended by 32...
12	R13	If the Directorate of Tax Audits and Collections would like to make those [regulations more] details, that's ok. That's the standard for transfer pricing audits. So there will be no overlap there, and they must refer to the existing regulations.
16	R13	The Directorate of Tax Regulations II it talks about how we are to address TP cases while the Directorate of Tax Audits and Collections addresses detailed problems and its standard operating procedure. So if for example want to audit the arm's length principle, what things need to be checked—for services and intangible assets, what things need to be checked?...So, there will be no overlap then.

c. Directorate of Tax Objections and Appeal will coordinate with Directorate of Tax Audit and Collections in reviewing the decisions of Tax Courts which are unfavorable to the Directorate of General of Taxes.

Quotation Number	Person	Quotations
52	R4	[The Directorate of] Objections and Appeals has a subdirectorate for evaluations. The outcome of objections and appeals are compiled, and cases are sent to the Directorate of Tax Audits and Collections. If it is good one [DGT won the case], it will be shared with the auditing unit. A bad one [DGT lost the case] will be evaluated for its weaknesses.
79	R6	...not necessarily like that [losing the case will not be adjusted again, and winning case will be adjusted again]. We scrutinise the cases because sometimes we find cases that we have to adjust, but [we] lost. And there are also cases in which we have less precise way to adjust, but we won, that's the difficulty, could not be a benchmark, it's the first one. Second, it could be between one year and another where the condition is different when the taxpayer conducts business

Quotation Number	Person	Quotations
		restructuring, the contract may be different, or the economic conditions may be different. That would have an influential impact when the target market by each of us was in the European region. There are some very reputable taxpayers, and usually their contracts may be amended. It was different. Thus, could not be the basis [to make positive adjustment] also. Moreover, a court decision may need a considerable time to be settled, while the audit is of the current year so there may be a time lag of about three to four years.
85	R11	I scrutinise why we were defeated, perhaps it could have been incomplete documentation for example, but it will serve as jurisprudence if we really lost. However, if we lost due to lack of evidence or standard operating procedures that didn't take place, indeed we will try again
87	R11	Once the tax court decisions reach the desk of the Head of the District Tax Office, I will have a look...especially at the last part. We could find out why we were defeated.

5. Role of Account Representatives

Quotation Number	Person	Quotations
11	R11	If they [taxpayers] have TP documentation, we ask for that; if they do not, we do our execution[action plan] and send them questionnaires that they need to answer. Now there is an amendment of PER-43. The role of the account representative begins so that during audit time it will run smoothly.
13	R11	The taxpayers that are not audited will fall under the responsibility of the account representative.
15	R11	From my observation, there are proposals from each section of supervisors and consultation for TP auditing cases. Thus, we scrutinise TP from tax returns.
17	R11	Yes, we propose that account representatives should conduct analyses, so that special audits can be proposed and semi-finished, and steps of functional analyses are required outside the audit term.
19	R11	Yes, cooperation between account representatives and auditors is needed.
21	R11	I ask if there is data and so on to [pass them to] the functional. We used to have Account Representative Forum but it didn't work well. I allocate as follows, section of supervisory and consultation I for functional team I, section of supervisory and consultation II for functional team II and so forth...There could also be a matrix for consultation purposes because we do not have many experts on TP, and not all of them are really experts, but can still handle the cases.
23	R11	We have one 'real expert' in the functional team and in account representatives.

Appendix 11

Translated Selected Quotations from the Indonesian Tax Court's Decision Based on Themes

Research Question 2: How do the Indonesian Tax Auditors deal with transfer pricing cases derived from intangible assets?

II. Ways Indonesian Tax Auditors and Officials Deal with Transfer Pricing Cases Derived from Intangible Assets

1. Legal Bases Used as References in Audits of Transfer Pricing Cases

a. Article 18 paragraph 3 of the Income Tax Law and domestic regulations

"The shareholders of PT Ford Motor Indonesia, based on note 14 of the audit report of 2004 and Form 1771-V of the corporate income tax return of 2004, which was received by the District Tax Office of Foreign Investment III on 12 December 2005 with receipt of S-0296600/PPWB/WPJ.07/ KP.0403/2005 are as follows:

Shareholders of PT Ford Motor Indonesia

Name of shareholders	2004			
	Percentage of ownership (%)	Number of Shares	Amount US$	Amount IDR
Ford Motor Company, USA	75	2,514	1,257,000.00	11,834,655,000.00
Ford Motor Services, Inc.	25	838	419,000.00	3,944,885,000.00
Total	*100*	*3,352*	*1,676,000.00*	*15,779,540,000.00*

[Source: Page 14 of Put.30538/PP/M.V/15/2011].

"Based on financial statements of the audit report of 2004 number 16a, Nature of Transaction and Relationship, it was found that the transaction with related parties was as follows:

PT Ford Motor's Relationship with Related Parties

Related Parties	Relationship with Related Parties	Transaction
Ford Motor Company, USA	Shareholders	Management service, distribution right fee
Ford Trading, LLC	Affiliated Company	Purchase of vehicle and spare parts, distribution right fee
Volvo Car Overseas	Affiliated Company	Payment of distribution right fee and management fee

Thus, based on the facts and abovementioned circumstances, the tax auditors concluded that a related-parties transaction took place according to Article 18 paragraph (3), paragraph 4 and elucidation of Article 18 paragraph 4 of the Income Tax Law, Ford Motor Company, USA owned 75% shares of PT Ford Motor Indonesia, and also PT Ford Motor Indonesia could not prove that Ford Trading Company, LLC (an affiliated company) and Volvo Car Overseas (an affiliated company) did not have a special relationship as related parties to PT Ford Motor Indonesia as stated" (Page 15 of Put.30538/PP/M.V/15/2011).

"These non-arm's length conditions took place because L'Oreal S. A. France and PT. L'Oreal Indonesia were related parties in which 99% of shares of PT. L'Oreal Indonesia were owned by L'Oreal S. A. France (Page 16, 18, 36 of Put.24631/PP/M.II/15/2010) and 1 % of shares is owned by Holdial SNC, France (Page 17 of Put.24631/PP/M.II/15/2010).

"Based on the audit reports for the years ending 31 December 2005 and 31 December 2004, the composition of shareholders of PT. Halliburton Indonesia is as follows:

Shareholders of PT. Halliburton Indonesia

Name of Shareholders	Number of Shares	% of Ownership	Amount (USD)
Halliburton Energy Services	4,400	80.00%	$4,400.00
PT Adhiraksha Tama	1,100	20.00%	$1,100.00
Total	*5,500*	*100.00%*	*$5,500.00*

[Source: Page 15, 38 of Put.32485/PP/M.I/15/2011.]

"Based on audit report, Halliburton Energy Services had 80% shares of PT. Halliburton Indonesia. Thus, related party relationship took place" (Page 15 of Put.32485/PP/M.I/15/2011).

"Article 18 Paragraph (3) of the Income Tax Law number 17 Year 2000 states that "the Director General of Taxes is authorised to reallocate income and deductions between related parties and to characterise debt as equity for the purposes of the computation of taxable income for the taxpayers who have related-party relationships with other taxpayers to assure that transactions between those related parties have been

made between independent parties" (Page 12 of Put.30538/PP/M.V/15/2011-*ITA vs. Ford Motor*; (Page 16 of Put.24631/PP/M.II/15/2010-*ITA vs. L'Oreal);* (Page 14, 18, 37,47 of Put.32485/PP/M.I/15/2011-*ITA vs. Halliburton*).

Article 18 paragraph (4) of the Income Tax Law number 17 Year 2000 defines a 'related taxpayer' as follows:

a. "A taxpayer who owns directly or indirectly at least 25% of equity of other taxpayers; a relationship between taxpayers through ownership of at least 25% of equity of two or more taxpayers, as well as a relationship between two or more taxpayers concerned;
b. A taxpayer who controls other taxpayer[s]; or two or more taxpayers are directly or indirectly under the same control;
c. A family relationship either through blood or through marriage within one degree of direct or indirect lineage."

(Page 12 of Put.30538/PP/M.V/15/2011-*ITA vs. Ford Motor*); (Page 14, 17, 37, 47 of Put.32485/PP/M.I/15/2011-*ITA vs. Halliburton*)

"Article 18 paragraph (4) of the Income Tax Law number 17 Year 2000 states that a special relationship between taxpayers may result from the dependency or the relationship of the following conditions between those parties:

a. An ownership or share of equity;
b. Participation in management or technology;
c. In addition, related parties between individual taxpayers may also result from their relationship by blood or by marriage"

(Page 12 of Put.30538/PP/M.V/15/2011-*ITA vs. Ford Motor*).

"A circular of the Directorate General of Taxes number SE-04/PJ.7/1993 dated 09 March 1993 regarding Guidelines to Handle Transfer Pricing Cases states that universally, transactions between taxpayers with a related-party relationship are known as a transfer price. This could lead to the transfer of income/revenue of taxable income and/or expenses from one taxpayer to another, which could be used to decrease the amount of tax payable by taxpayers' related-party relationships. Such non-arm's length transactions could take place on sales prices (Page 14, 15, 18, 37, 47 of Put.32485/PP/M.I/15/2011-*ITA vs. Halliburton*).

"Tax auditors should make positive adjustments based on Article 18 Paragraph (3) of the Income Tax Law number 17 Year 2000 for non-arm's length transactions with affiliated companies" (Page 12 of Put.30538/PP/M.V/15/2011-*ITA vs. Ford Motor*).

"Thus, based on Article 18 Paragraph (3) of the Income Tax Law number 17 year 2000 the tax auditors should make positive adjustments to royalty payments and reclassify those payments as dividend payments (profit sharing)" (Page 16 Put.24631/PP/M.II/15/2010-*ITA vs. L'Oreal*).

"Tax auditors made a positive adjustment based on Article 18 of the Income Tax Law to the royalty payment in a group of deductions of gross income in the amount of US$3,324,792.00 because the tax auditors could not ensure that there was any work being performed in return for the technical assistance fee" (Page 11, 13, 36 of Put.32485/PP/M.I/15/2011-*ITA vs. Halliburton*)

"Tax auditors made a positive adjustment to the royalty payment in the amount of US$26,196.54 under a group of income expenses arising from non-core business based on Article 18 of the Income Tax Law Number 7 year 1983" (Page 16, 46 of Put.32485/PP/M.I/ 15/2011-*ITA vs. Halliburton*).

b. Legal documents, contracts, or agreements entered into among affiliated

"The tax auditors made positive adjustments to the whole royalty payment in the amount of IDR13,888,591,263.00 according to the "license agreement" between L'Oreal SA and PT. L'Oreal Indonesia. L'Oreal SA France was granted an exclusive right and permission to use technology, licensed trademarks, and to distribute and sell the licensed products in the territory" [Page 5, 15 of Put.24631/PP/M.II/15/2010-*ITA vs. L'Oreal*].

It was stated in the agreement that:

"2.1. Subject to the terms and conditions herein set forth, L'Oreal grants to the licensee the exclusive right and licence to exploit the licensed products in the territory. This licence is limited to the following use:

- The exclusive right to use the technology and the licensed trademarks
- The exclusive right to distribute and sell the licensed products in the territory, and exceptionally outside the territory to L'Oreal's subsidiaries that have specific short-term needs.

2.2. The right to market the licensed products, including the exclusive right to exploit the licensed patents.

Upon the licensee's request, L'Oreal shall execute and sign all confirmative deeds and documents necessary to comply with formalities which might be required by the laws and regulations prevailing in the territory to make such exploitation right valid and enforceable against third parties" (Page 7 of Put.24631/PP/M.II/15/2010-*ITA vs. L'Oreal*).

"L'Oreal S.A. France has granted an exclusive right and license to PT. L'Oreal Indonesia to use technology and licensed trademarks and to distribute and sell licensed products in Indonesia. In return, PT. L'Oreal Indonesia will pay royalties to L'Oreal S.A. France based on the proportion of the net sales of the licensed products as follows:

- 5% for the use of technology
- 1% for the use of licensed trademarks*"*

(Page 15 of Put.24631/PP/M.II/15/2010-*ITA vs. L'Oreal*)

"The term 'technology' stated in Point 1.4 of the license agreement shall be defined as all the valuable information developed by L'Oreal SA France with regard to the composition and/or process of the production of licensed products" (Page 15 of Put.24631/PP/M.II/15/2010-*ITA vs. L'Oreal*).

"The term 'licensed products' stated in Point 1.3 of the license agreement shall include cosmetic, hygiene, and toiletry products produced using the 'technology' and were agreed by related parties to market those products in the certain territory under 'licensed trademarks' " (Page 15 of Put.24631/PP/M.II/15/2010-*ITA vs. L'Oreal*).

"The term 'licensed trademarks' stated in Point 1.2 of the license agreement shall mean the *L'Oreal, Maybelline, Kerastase, Dralle* and *Redken* trademarks as well as all other trademarks and any and all names, abbreviations, symbols and other distinctive signs including the designs, which are used at the present time or which will be used in the future, in combination or in association with one and/or another of the main abovementioned trademarks on L'Oreal initiatives, or any other trademarks that the parties will decide by common consent to exploit in accordance with this agreement" (Page 15, 16, 19 of Put.24631/PP/M.II/15/2010-*ITA vs. L'Oreal*).

"Based on this agreement, the tax auditors concluded that an invoice of payable royalties would occur only if PT. L'Oreal Indonesia have used 'technology' and 'licensed trademarks' owned by L'Oreal SA France" (Page 16 of Put.24631/PP/M.II/15/2010-*ITA vs. L'Oreal*).

"Based on the meaning of the terms 'technology' and 'licensed trademark,' the tax auditors concluded that the use of 'technology' and 'licensed trademarks' will only takplace if PT. L'Oreal Indonesia produces licensed products owned by L'Oreal SA France" (Page 16, 36 of Put.24631/PP/M.II/15/2010-*ITA vs. L'Oreal*).

"Based on audit results it was found that during 2005, PT L'Oreal Indonesia never produced a 'licensed product' owned by L'Oreal SA, France (Page 16, 36 of Put.24631/PP/M.II/15/2010-*ITA vs. L'Oreal*)*,* but only performed a distribution function" (Page 36 of Put.24631/PP/M.II/15/2010-*ITA vs. L'Oreal).*

"Since PT. L'Oreal Indonesia never produced 'licensed products' during 2005, a royalty invoiced to L'Oreal SA France is not in accordance with the arm's length condition. This non-arms length condition could take place because L'Oreal S.A. France and PT. L'Oreal Indonesia are related parties in which 99% of the shares of PT. L'Oreal Indonesia are owned by L'Oreal S.A. France (Page 16, 18, 36 of Put.24631/PP/M.II/15/2010-*ITA vs. L'Oreal*). Thus, tax auditors made positive adjustments to the royalty payments and reclassified the payment into dividend payments (profit sharing)" (Page 16, 18, 36 of Put.24631/PP/M.II/15/2010-*ITA vs. L'Oreal).*

"In note 17 of the audit report, there was a Distributorship Agreement based on a Distribution Rights Agreement ('the agreement') between Volvo Cars Overseas Corporation Aktiebolag (previously Volvo Car International AB); Ford Trading Company, LLC; and Ford Motor Company, USA ('the grantors'). The grantors appointed the Company as an exclusive distributor of Volvo, Mazda and Ford products in the territory of the Republic of Indonesia, with the right to order, purchase, receive and resell the products to dealers and other customers as authorised by the grantors.

The company shall pay to the grantors a distribution rights fee amounting to 9.5% of net sales price for the applicable period. The distribution rights fee shall apply only to distributors' sales within the territory of the Republic of Indonesia. The parties shall review from time to time, but not less than once annually, the distribution rights fee rate based on current sales volumes, costs and other market conditions.

The agreements are valid beginning in 2001 and will continue for an indefinite period of time. Each party has the right to terminate the agreement by giving the other party not less than 6 months prior written notice of intention to terminate the agreement" (Page 13, 24 of Put.30538/PP/M.V/15/2011-*ITA vs. Ford*).

Based on note 17 of the audit report of 2004, PT Ford Motor Indonesia signed the following agreements as follows:

- The Distribution Rights Agreement signed on 1 March 2001 between Ford Motor Company, a Delaware corporation, with its principal place of business at One American Road, Dearborn, Michigan 48126 USA, hereinafter called the 'grantor' and PT. Ford Motor Indonesia, Jl. MT Haryono Kav. 8,

Kelurahan Bidara Cina, Kecamatan Jatinegara, Kotamadya Jakarta Timur, Indonesia, hereinafter called the 'distributor.'

- The Distribution Rights Agreement signed on 29 October 2001 between Ford Trading Company, LLC, a Delaware limited liability company, with its principal place of business at One American Road, Dearborn, Michigan 48126 USA, hereinafter called the 'grantor' and PT. Ford Motor Indonesia, Jl. MT Haryono Kav. 8, Kelurahan Bidara Cina, Kecamatan Jatinegara, Kotamadya Jakarta Timur, Indonesia, hereinafter called the 'distributor.'
- The Distribution Rights Agreement signed on 1 June 2001 between Volvo Car International AB, S-405 31 Goteborg, Sweden, hereinafter called the 'grantor' and PT. Ford Motor Indonesia, Jl. MT Haryono Kav. 8, Kelurahan Bidara Cina, Kecamatan Jatinegara, Kotamadya Jakarta Timur, Indonesia, hereinafter called the 'distributor' (Page 13 of Put.30538/PP/M.V/15/2011-*ITA vs. Ford).*

2. Role of tax auditors

a. Tax auditors conduct in-depth analysis of taxpayers being audited

"The tax auditor argued that the amount of the distribution right fee expensed in the Income Statement of 2004 was 8.89% of the net sales (according to the contract the amount should be 9.5%). That amount accounted for 60% of the general and administrative expenses. That expense burdened PT Ford Motor Indonesia so that it suffered loss for that year. If the existing cost of goods sold was combined with the expenses paid to its affiliate overseas, such as distribution right fees, management fees, and global marketing fees, gross profit to maintain other general and administrative expense only accounted for 3.46% or IDR43 billion of the net sales of IDR1.256 trillion" (Page 12, 24, 35 of Put.30538/PP/M.V/15/2011-*ITA vs. Ford Motor*).

"Based on the statement of income from the audit report of 2004, evidence was found that there was a distribution right fee expense in the amount of IDR111,618,916,000.00 as an operating expense in calculating net income of PT. Ford Motor Indonesia. Further, in the note 16f of that audit report, it was found the allocation of the distribution right fee was as follows:

a.	Ford Motor Company, USA	IDR	94,521,921,000.00
b.	Volvo Car Overseas Corp	IDR	11,769,525,000.00
c.	Ford Trading Company, LLC	IDR	5,327,470,000.00
	Total	IDR	111,618,916,000.00
	As a percentage of total operating expenses		60%

(Page 13, 24 of Put.30538/PP/M.V/15/2011-*ITA vs. Ford Motor*)

"Based on the corporate income tax return of 2004, which was received by the District Tax Office of Foreign Investment III on 12 December 2005 with the receipt of S-0296600/PPWB/WPJ.07/ KP.0403/2005, it was found that the taxpayer paid a distribution right fee in the amount of IDR111,618,916,000.00 when by the taxpayer calculated net income for fiscal purposes and no self-correction had been made. This fact was in accordance with page 12 of tax audit report number LAP-208/PSL/WPJ.07/KP.0400.I.4/2006 dated 08 December 2006 in which the tax auditor made a positive fiscal adjustment" (Page 14, 25 of Put.30538/PP/M.V/15/2011-*ITA vs. Ford Motor*).

The breakdown of the distribution right fee was as follows:

Breakdown Distribution Right Fee of PT. Ford Motor Indonesia

Date	Reference				Amount	Description
					(1,389,440,895)	Over accrue of DRF 2003
03/2004	APO40331001428	F00008	1828	V010906	866,574,819	40301289 DRF Q1-2004 FMC
04/2004	APO40416001467	F00004	1853	V011299	16,048,014,052	40401524 DRF Q1-2004 FMC
05/2004	APO40518001574	V00001	1926	V012459	4,378,780,749	40502014 DRF Q1-2004 VCC
07/2004	APO40708001680	F00008	2005	V013511	580,513,520	40703093 DRF Q2-2004 FTC
07/2004	APO40709001683	F00004	2015	V013575	23,962,681,740	40703094 DRF Q2-2004 FMC
10/2004	APO41004002084	F00004	2140	V015711	30,716,637,620	41004637 DRF Q3-2004 FMC
10/2004	APO41005002084	F00008	2140	V015716	1,937,173,288	41004698 DRF Q3-2004 FTC
12/2004	APO41229002257	V00001	2207	V017328	4,046,434,402	41206107 DRF Q2&Q3-2004 VCC
12/2004	RV050105000005		08/12/2004		24,297,923,217	DRF accrual for Q4 2004 Ford paid 25th
12/2004	RV050105000005		08/12/2004		1,961,729,184	DRF accrual for Q4 2004 Mazda paid
12/2004	RV050105000003		08/12/2004		4,211,893,583	DRF accrual for Q4 2004 Volvo paid 25th
					111,618,915,279	

(Source: Page 14 of Put.30538/PP/M.V/15/2011-*ITA vs. Ford Motor)*

"The non-arm's length transaction took place in the form of a distribution right fee which was accrued or paid by PT Ford Motor Indonesia to its affiliates overseas in the amount of 9.5% from net sales. That distribution right fee was charged because PT Ford Motor Indonesia was granted an exclusive right by its principal to market car products with the trade names of Ford, Volvo and Mazda in the territory of Indonesia. The tax auditor was of the opinion that the distribution right fee caused harm to PT. Ford Motor Indonesia and was not in arm's length condition because:

1. PT Ford Motor Indonesia should get fees or revenues for the services being conducted in order to market the product (car) of its principal located overseas, not the other way around. In this case PT Ford Motor Indonesia paid a distribution right fee to its principal overseas.
2. Other sole car distributors do not owe distribution right fees or other fees as compensation for the exclusive rights they receive from their principals" (Page 12, 23, 24, 35 of Put.30538/PP/M.V/15/2011-*ITA vs. Ford Motor*).

"The tax auditor made a positive adjustment in the amount of IDR111,618,915,279.00 to the marketing expenses namely that Administrative Distribution Right Fee Expense Vehicle (royalty payment) paid by PT. Ford Motor Indonesia to its affiliates namely Ford Motor Company; Ford Trading Company, LLC; and Volvo Car International AB. Thus, the Distribution Right Fee Expense was treated as a nondeductible expense based on Article 18 paragraph (3) of the Income Tax Law number 7 Year 1983 as was amended by the Income Tax Law number 17 Year 2000 for the non-arm's length transaction with affiliated companies" (Page 23, 27 of Put.30538/PP/M.V/15/2011-*ITA vs. Ford Motor*).

"The tax auditors denied the arguments of PT. L'Oreal Indonesia which states that the exclusive right to use the technology and the licensed trademarks are attached to the 'licensed products,' so that for the sale of the those 'licensed products' PT. L'Oreal Indonesia was charged royalty payments by L'Oreal S.A. France as the owner of the technology and licensed trademarks even though those licensed products were not produced by PT. L'Oreal Indonesia" (Page 17, 18, 36 of Put.24631/PP/M.II/15/2010-*ITA vs. L'Oreal*).

"The tax auditors stated that technology and licensed trademarks were attached to the 'licensed products' as the 'licensed products' are produced by using the technology developed by the owner of that technology and then the outcome of the production will be given specific trade names or trademarks in order to differentiate with similar products produced by other parties" (Page 18, 36 of Put.24631/PP/M.II/15/2010-*ITA vs. L'Oreal*).

"The tax auditors stated that research and development expenses usually are classified and treated as part of the cost of goods sold. It can be observed from business practices that sold specific products generated from research and development with the multifold price compared to that of its low cost of goods sold" (Page 18, 36 of Put.24631/PP/M.II/15/2010-*ITA vs. L'Oreal*).

"Based on the facts and circumstances, the tax auditors concluded that the value of technology and trademarks developed by L'Oreal S.A. France was already attached to the price of the licensed products so that royalty payments charged by L'Oreal S.A. France for the sale of the licensed products could not be considered as deductible expenses by the tax auditors" (Page 18, 36 of Put.24631/PP/M.II/15/2010-*ITA vs. L'Oreal*).

"It is found in the 2005 income tax return of PT. L'Oreal Indonesia, its net sale reached IDR306,839,766,085.00. Of those net sales, PT. L'Oreal Indonesia claimed that IDR231,476,521,047.00 was subject to royalty payments of 6% with the breakdown as follows:

Royalty Payments of PT. L'Oreal Indonesia

Month	Sales (IDR)	% of Royalties	Royalty (IDR)
January 2005	20,015,224,750.00	6%	1,200,913,485.00
February 2005	18,408,225,390.00	6%	1,104,493,523.00
March 2005	19,292,780,914.00	6%	1,157,566,855.00
April 2005	16,646,859,037.00	6%	998,811,542.00
May 2005	19,443,412,128.00	6%	1,166,604,728.00
June 2005	19,116,906,006.00	6%	1,147,014,360.00
July 2005	19,783,527,863.00	6%	1,187,011,672.00
August 2005	20,673,055,426.00	6%	1,240,383,326.00
September 2005	24,729,429,586.00	6%	1,483,765,775.00
October 2005	17,616,407,375.00	6%	1,056,984,443.00
November 2005	17,547,420,779.00	6%	1,052,845,247.00
December 2005	18,203,271,793.00	6%	1,092,196,308.00
Total	*231,476,521,047.00*		*13,888,591,263.00*

"PT. L'Oreal Indonesia argued that of the amount of IDR75,363,245,038.00, [IDR306,839,766,085.00 minus IDR231,476,521,047.00] is not subject to royalties as that amount represents sale of luxury products. According to the license agreement between L'Oreal S.A. France and PT. L'Oreal Indonesia, PT. L'Oreal Indonesia shall pay royalties in amount of 6% for sales of 'mass market products' (L'Oreal, Maybelline, Dralle & Redken, etc.) and 'professional products' (Kerastase, etc.). However 'luxury products' (Lancome, Ralph Lauren, Giorgio Armani, etc.) are not subject to royalties. These conditions are in accordance with Article 1 point 1.2 of the Licensed Agreement as follows: 'Licensed trademarks shall mean the L'Oreal, Maybelline, Dralle and Redken trademarks as well as all other trademarks and any and all names, abbreviations, symbols, and other distinctive signs including the designs, which are used at the present time or which will be used later on, in combination or in association with one and/or another of the main abovementioned trademarks on L'Oreal initiatives, or any other trademarks that the parties will

decide by common consent to exploit in accordance with this agreement" (Page 19, 36 of Put.24631/PP/M.II/15/2010-*ITA vs. L'Oreal*).

"Based on the tax audit, PT. L'Oreal Indonesia sells cosmetics products which were bought previously from both local and overseas affiliates. Based on the income tax return and audit report, its buying transactions with related parties are as follows:

Related Party Purchases of PT. L'Oreal Indonesia

No.	Supplier	Transaction Amount (IDR)
1	PT Yasulor Indonesia	26,676,356,211.00
2	Marly	13,952,758,549.00
3	Lancome Parf Et Beautecie	10,666,064,902,00
4	Beautycos International	16,765,208,987.00
5	Prestige at Collections Int	7,272,627,031.00
6	Biotherm Distribution Et Cie	2,152,983,355.00
7	L'Oreal US Ralph Laurent Int	3,213,288,152.00
8	L'Oreal Singapore	1,580,996,450.00
9	L'Oreal US Maybelline	455,407,641.00
10	Others	1,491,463,670.00
	Total	*84,227,154,948.00*

(Source: Page 19, 20, 37 of Put.24631/PP/M.II/15/2010-*ITA vs. L'Oreal*)

"If it [related party purchase] is compared with the value of total purchases (IDR98,494,473,902.00) reported on Form 1771-II in the income tax return, it can be concluded that most of the products sold by PT. L'Oreal Indonesia originated from related parties of the L'Oreal group because other parties do not have licenses to produce cosmetic products under the trade name L'Oreal" (Page 20, 36 of Put.24631/PP/M.II/15/2010-*ITA vs. L'Oreal*).

"The products purchased by PT. L'Oreal Indonesia from affiliates of the L'Oreal Group were received in packages in which trademarks of L'Oreal were already printed on those packages, so the tax auditors argued that those kinds of transactions were no different to other transactions conducted by other general merchandisers in which the seller receives goods and sells those goods to consumers without any additional process. Thus, the tax auditors concluded that in 2005, PT. L'Oreal Indonesia never produced 'licensed products' owned by L'Oreal S.A. France, and instead only a performed distribution function" (Page 20, 36 of Put.24631/PP/M.II/15/2010-*ITA vs. L'Oreal*).

"Research and development expenses are usually put under the cost of goods sold, which could be observed from business practices in which products are sold as an outcome of research by multifold prices compared to those of its cost of goods sold. The value of technology and trademarks developed by L'Oreal S.A. France were already attached to the price of the 'product licensed.' Thus invoices for royalty payments for the sale of the 'licensed product' could not be treated as deductible expenses by the tax auditors because the royalty payments were not in accordance with arm's length condition. This non-arms length condition could take place because L'Oreal S.A. France and PT. L'Oreal Indonesia are related parties in which 99% of shares of PT. L'Oreal Indonesia are owned by L'Oreal S.A. France" (Page 20, 37 of Put.24631/PP/M.II/15/2010-*ITA vs. L'Oreal*).

"Based on those facts and circumstances, the tax auditors made a positive adjustment to the royalty payment paid by PT. L'Oreal Indonesia to L'Oreal S.A. France. That royalty payment was treated as a hidden dividend (profit sharing). Thus, all of the royalty expenses in the amount of IDR13,888,591,263.00 reported by PT. L'Oreal Indonesia in its income tax return were adjusted to nil. However, the tax auditors did not make a positive adjustment to the base of withholding tax of Article 26 of the Income Tax Law reported by PT. L'Oreal Indonesia in its tax return because dividend payments are also subject to Article 26 of the Income Tax Law" (Page 16, 37 of Put.24631/ PP/M.II/15/2010-*ITA vs. L'Oreal*).

b.Tax auditors seek for evidence of the existence of intangible property owned by taxpayers

"From the general ledger account Technical Assistance Fee Cost, Account Number 610300, it is stated as follows:

Technical Assistance Fee Paid by PT. Halliburton Indonesia

No.	Month	Description	Amount (USD)
1	January 2005	TP Duncan: Invoice ERP 200508	254,377
2	February 2005	TP Duncan: Invoice TAF 200508	254,377
3	March 2005	TP Duncan: Invoice TAF 200509	(154,394)
4	April 2005	TP Duncan: Invoice ERP 200509	(154,394)
5	May 2005	TP Duncan: Invoice ERP 200510	489,713
6	June 2005	TP Duncan: Invoice TAF 200510	489,713
7	July 2005	TP Duncan: Invoice TAF 200511	293,828

No.	Month	Description	Amount (USD)
8	August 2005	TP Duncan: Invoice ERP 200511	293,828
9	September 2005	TP Duncan: Invoice ERP 200511 Correction	(202,550)
10	October 2005	TP Duncan: Invoice TAF 200511 Correction	(202,550)
11	November 2005	TP Duncan: Invoice TAF 200512	1,144,457
12	December 2005	TP Duncan: Invoice ERP 200512	818,387
Total			*3,324,791.62*

(Source: Page 15, 38 of Put.32485/PP/M.I/15/2011-*ITA vs. Halliburton*)

"Based on further investigations on invoices of the technical assistance fee, it was found that those expenses are invoices from Halliburton Energy Services Inc. for performing special projects" (Page 15, 38 of Put.32485/PP/M.I/15/2011-*ITA vs. Halliburton*).

"Based on examination of the general ledger and respective invoices, it was found that the payments were paid to Halliburton Energy Services Inc. Based on the audit report, Halliburton Energy Services Inc. is majority shareholder of PT. Halliburton Indonesia (80%), so that a related-party relationship between two companies exists based on Article 18 of the Income Tax Law number 7 Year 1983 as lastly amended by the Income Tax Law number 17 Year 2000" (Page 15, 38 of Put.32485/PP/M.I/15/2011-*ITA vs. Halliburton*).

"Due to the existence of the related-party relationship between PT. Halliburton Indonesia and Halliburton Energy Services Inc., tax auditors, by referring to Article 18 paragraph (3) and paragraph (4) of the Income Tax Law, claimed that the validity of the transactions between the two abovementioned companies was under question and no real work was performed. Thus, the tax auditors made a positive adjustment based on Article 18 of the Income Tax Law Number 7 Year 1983 as lastly amended by the Income Tax Law Number 17 Year 2000" (Page 16, 38 of Put.32485/PP/M.I/15/2011-*ITA vs. Halliburton*).

"In addition, during the objection process, PT. Halliburton Indonesia could not prove or explain the existence of expenses incurred or in other words PT. Halliburton Indonesia could not explain or prove which activities were conducted by the service provider that led to the royalty (technical assistance fee) expense" (Page 19, 38 of Put.32485/PP/M.I/15/2011).

"From the general ledger account Royalty Expenses, Account Number 800600, royalty expenses of PT. Halliburton Indonesia are stated as follows:

Royalty Expenses Paid by PT. Halliburton Indonesia

No.	Document Number	Date of Document	Amount (USD)
1	93015201	01/16/2005	1,050
2	93046748	01/31/2005	1,050
3	93116913	03/14/2005	420
4	93211395	04/29/2005	130
5	93233612	05/16/2005	420
6	4300098049	07/21/2005	1,730
7	93372294	07/28/2005	225
8	93372294	07/28/2005	90
9	93372294	07/28/2005	113
10	93372294	07/28/2005	45
11	93372294	07/28/2005	225
12	93487062	09/28/2005	1,836
13	93487062	09/28/2005	41
14	93487062	09/28/2005	18
15	93487063	09/28/2005	1,836
16	93487063	09/28/2005	27
17	93487063	09/28/2005	10
18	93487068	09/28/2005	1,836
19	93487069	09/28/2005	1,836
20	93487070	09/28/2005	1,836
21	93510695	10/09/2005	1,836
22	93513014	10/11/2005	1,836
23	93517985	10/14/2005	1,836
24	93557812	10/31/2005	1,050
25	93608632	11/29/205	1,764
26	93615807	11/30/2005	1,836
27	93644935	12/20/2005	38
28	93656228	12/26/2005	1,229
Total			*26,196.54*

(Source: Page 18, 19, 48 of Put.32485/PP/M.I/15/2011-*ITA vs. Halliburton)*

“Based on further investigation of invoices on royalty expenses, it is found that those expenses are invoices from Halliburton Energy Services Inc. for performing special projects” (Page 19, 48 of Put.32485/PP/M.I/15/2011-*ITA vs. Halliburton*).

“Based on examination of the general ledger and respective invoices, it was found that the payments were paid to Halliburton Energy Services Inc. who is, according to the audit report the majority shareholder of PT. Halliburton Indonesia (80%). A related-party relationship exists between the two companies based on Article 18 of Income Tax Law number 7 Year 1983 as lastly amended by the Income Tax Law number 17 Year 2000” (Page 19, 48 of Put.32485/PP/M.I/15/2011-*ITA vs. Halliburton*).

“Due to the existence of a related-party relationship between PT. Halliburton Indonesia and Halliburton Energy Services Inc., tax auditors, by referring to Article 18 of the Income Tax Law, claimed that the validity of the transactions between the two abovementioned companies was under question and no real work had been performed. Thus, tax auditors made a positive adjustment to the royalty expense in accordance with Article 18 of the Income Tax Law number 7 Year 1983 as lastly amended by the Income Tax Law number 17 Year 2000” (Page 19, 48, 49 of Put.32485/PP/M.I/15/2011-*ITA vs. Halliburton*).

“In addition, during the objection process, PT. Halliburton Indonesia could not prove or explain the existence of expenses incurred or in other words PT. Halliburton Indonesia could not explain or prove which activities were conducted by service providers that led to the royalty expense” (Page 19, 49 of Put.32485/PP/M.I/15/2011-*ITA vs. Halliburton*).

Appendix 12

AUT UNIVERSITY
TE WĀNANGA ARONUI O TAMAKI MAKAU RAU

A U T E C
S E C R E T A R I A T

25 February 2013
Zahir Ahmed
Faculty of Businness and Law

Dear Zahir
Ethics Application: **13/18 Tax audit of transfer pricing cases derived from intangible assets: A case study in Indonesia.**
Thank you for submitting your application for ethical review. I am pleased to advise that the Auckland University of Technology Ethics Committee (AUTEC) approved your ethics application at their meeting on 18 February 2013, subject to the following conditions:

1. Reconsideration of the level of confidentiality that may be offered to participants. AUTEC considered that given the context and recruitment process it may be possible to offer limited confidentiality only;
2. Consideration of offering the participants an opportunity to review their interview transcripts, particularly in relation to whether any identifiable information is included;
3. Provision of the indicative interview questions;
4. Revision of the Information Sheet as follows;
    a. Provision of a clearer time frame by which participants need to consider the invitation to participate;
    b. Inclusion of information relating to points 1 and 2 above.

Please provide me with a response to the points raised in these conditions, indicating either how you have satisfied these points or proposing an alternative approach. AUTEC also requires copies of any altered documents, such as Information Sheets, surveys etc. Once your response is received and confirmed as satisfying the Committee's points, you will be notified of the full approval of your ethics application. Full approval is not effective until all the conditions have been met. Data collection may not commence until full approval has been confirmed. If these conditions are not met within six months, your application may be closed and a new application will be required if you wish to continue with this research.
To enable us to provide you with efficient service, we ask that you use the application number and study title in all correspondence with us. If you have any enquiries about this application, or anything else, please do contact us at ethics@aut.ac.nz.
I look forward to hearing from you,

Dr Rosemary Godbold
Executive Secretary
Auckland University of Technology Ethics Committee
Cc: Abdul Haris Muhammadi abdulharis.muhammadi@gmail.com

Appendix 13

AUT UNIVERSITY
TE WĀNANGA ARONUI O TAMAKI MAKAU RAU

AUTEC SECRETARIAT

4 March 2013

Zahir Ahmed
Faculty of Business and Law

Dear Zahir
Re Ethics Application: **13/18 Tax audit of transfer pricing cases derived from intangible assets: A case study in Indonesia.**
Thank you for providing evidence as requested, which satisfies the points raised by the AUT University Ethics Committee (AUTEC).
Your ethics application has been approved for three years until 4 March 2016.
As part of the ethics approval process, you are required to submit the following to AUTEC:

- A brief annual progress report using form EA2, which is available online throughhttp://www.aut.ac.nz/researchethics. When necessary this form may also be used to request an extension of the approval at least one month prior to its expiry on 4 March 2016;
- A brief report on the status of the project using form EA3, which is available online throughhttp://www.aut.ac.nz/researchethics. This report is to be submitted either when the approval expires on 4 March 2016 or on completion of the project.

It is a condition of approval that AUTEC is notified of any adverse events or if the research does not commence. AUTEC approval needs to be sought for any alteration to the research, including any alteration of or addition to any documents that are provided to participants. You are responsible for ensuring that research undertaken under this approval occurs within the parameters outlined in the approved application.
AUTEC grants ethical approval only. If you require management approval from an institution or organisation for your research, then you will need to obtain this. If your research is undertaken within a jurisdiction outside New Zealand, you will need to make the arrangements necessary to meet the legal and ethical requirements that apply there.
To enable us to provide you with efficient service, please use the application number and study title in all correspondence with us. If you have any enquiries about this application, or anything else, please do contact us at ethics@aut.ac.nz.
All the very best with your research,

Dr Rosemary Godbold
Executive Secretary
Auckland University of Technology Ethics Committee
Cc: Abdul Haris Muhammadi abdulharis.muhammadi@gmail.com

Appendix 14

KEMENTERIAN KEUANGAN REPUBLIK INDONESIA
DIREKTORAT JENDERAL PAJAK
DIREKTORAT PENYULUHAN, PELAYANAN, DAN HUBUNGAN MASYARAKAT

JALAN JENDERAL GATOT SUBROTO KAV. 40-42 JAKARTA 121 90 KOTAK POS 124
TELLPON (021)5250228. 5251509: FAKSIMILE ;02[1]) 573608EL SITUS pEijak :Jp ■1.1
LAYANAN INFORMASI DAN KELL:HAN KRiNG PAJAK (321:500200:
EMAIL pengaduanDilpajak do.,d

Nomor : S-330/PJ.09/2013 25 Maret 2013
Sifat : Biasa
Hal : Pemberian Izin Penelitian

Yth. Sdr. Abdul Haris Muhammadi
Auckland University of Technology
55 Wellesley Street East Auckland Central 1010,
New Zealand

Sehubungan dengan surat Saudara tanggal 2 Januari 2012 hal Permohonan Ijin Wawancara dan Surat dan i Dr. Rosemary Godbold, *Executive Secretary of Auckland University of Technology Ethics Committee* tanggal 4 Maret 2013 hal *Ethics Application,* dengan ini diberikan izin kepada Saudara untuk melakukan penelitian (riset) pada KPP Penanaman Modal Asing Tiga, Direktorat Pemeriksaan dan Penagihan, dan Direktorat Peraturan Perpajakan II, sepanjang bahan-bahan keteranganidata yang didapat hanya digunakan untuk keperluan akademis dan tidak menyangkut rahasia jabatan/negara sebagaimana diatur dalam ketentuan Pasal 34 Undang-undang Nomor 6 Tahun 1983 tentang Ketentuan Umum dan Tata Cara Perpajakan sebagaimana telah diubah terakhir dengan Undang-Undang Nomor 16 Tahun 2009.

Surat izin ini berlaku selama 6 (enam) bulan sejak tanggal diterbitkan dan dapat diperpanjang paling lama 3 (tiga) bulan dengan mengajukan perpanjangan secara tertulis yang disampaikan paling lambat 1 (satu) minggu sebelum berakhirnya masa berlakti surat ini.

Setelah selesai melaksanakan penelitian (riset), Saudara wajib menyerahkan salinan basil penelitian (riset) tersebut dalam bentuk *hard-copy* ke Perpustakaan Kantor Pusat DJP dengan alamat Gedung Utama, Lantai 3 Jl. Jenderal Gatot Subroto Kay. 40-42 Jakarta Selatan 12190 dan dalam bentuk *soft-copy* melalui email: perpustakaanpajak@gmail.com dan/atau perpustakaanpajak.go.id.

Demikian surat ini dibuat agar dapat dipergunakan sebagaimana rnestinya.

Dire tur,

Kis afit o Petrus
NI 1 404071983031001

Kp.: PJ.091/PJ.0913

Appendix 15

KEMENTERIAN KEUANGAN REPUBLIK INDONESIA
DIREKTORAT JENDERAL PAJAK
DIREKTORAT PENYULUHAN, PELAYANAN, DAN HUBUNGAN MASYARAKAT

JALAN JENDERAt GATOI SU6R0TC KAV 40-42. JAKARTA '2100, KOTAK POS 124
TELEPON11.021) 5250208 525˙50P: FAKSIMII E (021(5735085: Si1US y.w...!.˙T12t■Dt!._;p !ci
LAYANAN INFORMASI DAN KELUHAN KRING PAJAK (02" 500200,
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Nomor S-527 /PJ.09/2013 10 April 2013
Sifat . Biasa
Hal Pemberian Izin Wawancara

Yth. Abdul Haris Muhammadi
55 Wellesley Street East Auckland Central 1010,
Auckland, Selandia Baru

Sehubungan dengan surat Saudara tanggal 2 Januari 2013 ,dengan ini diberikan izin kepada Saudara untuk melakukan penelitian (riset) pada KPP Minyak dan Gas Burni, sepanjang bahan-bahan keterangan/data yang didapat hanya digunakan untuk keperluan akademis dan tidak menyangkut rahasia jabataninegara sebagaimana diatur dalam ketentuan Pasal 34 Undang-undang Nomor 6 Tahun 1983 tentang Ketentuan Umum dan Tata Cara Perpajakan sebagaimana telah diubah terakhir dengan Undang-Undang Nomor 16 Tahun 2009.

Surat izin ini berlaku selama 6 (enam) bulan sejak tanggal diterbitkan dan dapat diperpanjang paling lama 3 (tiga) bulan dengan mengajukan perpanjangan secara tertulis yang disampaikan paling lambat 1 (satu) minggu sebelum berakhirnya masa berlaku surat ini.

Setelah selesai melaksanakan penelitian (riset), Saudara wajib menyerahkan salinan hasil penelitian (riset) tersebut dalam bentuk *hard-copy* ke Perpustakaan Kantor Pusat DJP dengan alamat Gedung Utama, Lantai 3 JI. Jenderal Gatot Subroto Kay. 40-42 Jakarta Selatan 12190 dan dalam bentuk *soft-copy* melalui email: perpustakaanpajak@gmail.com dan/atau perpustakaan@pajak.go.id.

Demikian surat ini dibuat agar dapat dipergunakan sebagaimana mestinya.

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Direktur,

Kismantoro Petrus
NIP 19840407198303100 1

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