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The Effect of Thin Capitalization, Tunneling Incentive, Exchange Rate, Foreign Ownership, and Effective Tax Rate on Transfer Pricing

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Abstract

This research aims to test and find empirical evidence of the influence of Thin Capitalization, Tunneling Incentive, Exchange Rate, Foreign Ownership, and Effective Tax Rate on transfer pricing. The type of data used is secondary data in the form of annual reports of companies listed on the Indonesia Stock Exchange. The population in this study were manufacturing companies listed on the Indonesia Stock Exchange in 2016-2023, and the sampling technique used was the purposive sampling method and obtained a total of 128 manufacturing companies listed on the Indonesia Stock Exchange in 2016-2023. The analysis technique used is panel data regression analysis, previously a panel data estimation test, Chow test, Hausman test and Lagrange Multiplier (LM) test will be carried out to determine the model approach that will be used between common effects, fixed effects and random effects. Next, a hypothesis test is carried out to answer the hypothesis that has been formulated using the Partial Test and Coefficient of Determination (R2).

Keywords: Thin Capitalization, Tunneling Incentive, Exchange Rate, Foreign Ownership, Effective Tax Rate, Transfer Pricing.

INTRODUCTION

Globalization has driven rapid development in the economic sector, especially through multinational companies that expand their business reach to various countries. The aim is to strengthen the export and import market targets of products in various countries (Hidayat et al., 2019). Special relationships arise due to sales transactions of goods and services of multinational companies (Ayshinta et al., 2019). One of the impacts of this expansion is the emergence of transfer pricing practices, namely determining prices in transactions between companies that have special relationships including subsidiaries or branches in other countries. Transfer pricing can carry the risk of tax losses in a country, companies try to reduce their profits because the main tax imposed by the government is on the profits obtained by the company (Wijaya & Amalia, 2020).

The Indonesian government has regulated special relationships in Law No. 7 of 2021 Article 8 concerning the Harmonization of Tax Regulations, which states that direct or indirect ownership of another company's capital of 25% or more will form a special relationship between corporate taxpayers.
(Philanthropy & Widya, 2021).

Transfer pricing cases involving multinational companies in Indonesia, such as PT Adaro Energy Tbk and PT Toyota Motor Manufacturing Indonesia, show that this practice can reduce state tax revenues. Coaltrade Services International, ADRO's branch in Singapore, is suspected of carrying out transfer pricing practices through the sale of coal mined in Indonesia at a lower price. The coal was then sold to other countries at a higher price. ADRO accounted for more than 70% of the coal sold by Coaltrade between 2009 and 2017 and only paid less than US$ 125 million in taxes than it should have paid in Indonesia (Nabila et al., 2020)

To avoid paying Rp1.2 trillion in taxes, TMIN uses a buy-sell system, namely selling to its subsidiary Toyota Asia Pacific Singapore at a price below the market price, then the subsidiary Toyota Asia Pacific Singapore resells it at a higher price. Indonesia has a tax rate of 25%

compared to Singapore, which has a lower tax rate of 15%. As a result, the tax paid to the state is reduced (Solihin & Utami, 2022).

One factors that influence a company's decision to carry out transfer pricing is thin capitalization which is a series of company capital structures with a combination of debt ownership that is greater than capital (Akhadya dan Arieftiara, 2017). Thin capitalization is carried out by using loan interest to subsidiaries or other companies that have special ties through interest-bearing debt to many companies compared to using additional capital.

*Tunneling incentive*s are actions taken by transferring company assets and profits to controlling shareholders with the aim of making money for themselves, but the costs are borne by minority shareholders (Yumna, Sumiati, 2021). This happens because majority shareholders can control the organization, which causes majority shareholders to have greater control in decision-making, thus benefiting them more than minority shareholders (Prabaningrum et al., 2021).

The exchange rate has two functions in accounting, including being used to enter foreign currency values and disclosure of profits and/or losses that can affect the company's overall profits. Multinational companies will request the exchange of one currency for another to make payments which results in the overall currency of the country of origin required to pay for raw materials from abroad changing even though the supplier does not change the price (Azhar & Puspitasari, 2023).

Foreign ownership can increase tax revenues without any international taxation policies. The greater proportion of shares owned by foreign majority shareholders means that foreign shareholders have greater control over important decisions in the company (Azhar & Puspitasari, 2023). The amount of ownership in Indonesia is a minority which causes conflict between minority shareholders and majority shareholders (Utami, MF, & Irawan, F, 2022).

Effective Tax Rate(ETR) is a high tax payment, a weakening exchange rate, concentrated share ownership, and profit engineering to get high bonuses. Effective Tax Rate (ETR) is a proxy for tax. Tax is a mandatory contribution to the state that is mandatory and does not receive direct compensation which is used for state needs (Mineri, MF, & Paramitha, M. 2021).

Previous studies have been conducted in relation to the variables used in this study. A study entitled the influence of effective tax rates, exchange rates, and tunneling incentives, on transfer pricing concluded that effective tax rates have an effect on transfer pricing, while exchange rates and tunneling incentives have no effect on transfer pricing (Prabaningrum, et al., 2021). A study entitled The Influence of taxes, Foreign Ownership, bonus plans, and company size on companies conducting transfer pricing stated that taxes have an effect on transfer pricing, while foreign ownership, bonus plans, and company size have no effect on transfer pricing (Prabaningrum, et al., 2021).

In order to provide the latest information from the companies studied, this study uses variables for the period 2016-2023 so that this study is different from previous studies. Several previous studies have shown that even though they use the same variables, the research results are still diverse and inconsistent. This diversity of findings encourages re-research with the aim of exploring and explaining the differences in existing results.

The Impact of Thin Capitalization on Transfer Pricing

Thin capitalization is a condition where the company prioritizes debt financing over capital financing. Usually, companies have budget procedures from an efficient tax perspective. Companies can choose equity or debt to use in determining the financial structure (Azhar, MF, & Puspitasari, 2023)

The research conducted states that thin capitalization is a framework for avoiding taxes by making debt a dominant source of funding when compared to capital. The company's decision to invest in terms of funding business operations prioritizes debt funding compared to the capital

in its capital structure or what is commonly called Thin Capitalization so this practice creates tax incentives.

According to the trade-off theory, companies that use debt to fund their business operations benefit from taxation because the interest expense arising from debt is not taxed but must consider the problems that will arise in the future. This can maximize the profits obtained and reduce the tax burden. The effect of thin capitalization based on previous research has obtained results that have a positive effect on transfer pricing (Utami, MF, & Irawan, F, 2022)
H1: Thin Capitalization has an effect on Transfer Pricing.

The Impact of Tunneling Incentives on Transfer Pricing

*Tunneling incentiv*ously the majority shareholders take action, namely sending company assets and profits for personal gain (Mineri, MF, & Paramitha, M., 2021). One example of a Tunneling incentive is by sending company profits through sales or purchase transactions with related companies and implementing transfer pricing. Of course, these transactions use unfair prices for the benefit of the majority shareholders, resulting in the company's profits being smaller.

The case that arises is caused by the majority shareholder forcing the manager's will to meet the personal needs of the shareholders. This tunneling has an impact on dividends from minority shares and minority shareholders will be burdened by this tunneling activity (Mineri, MF, & Paramitha, M., 2021). This is supported by previous research which states that tunneling incentives have a significant effect on transfer pricing (Mineri, MF, & Paramitha, M., 2021). Based on this, the second hypothesis can be formulated, namely:
H2: Tunneling Incentive has an effect on Transfer Pricing.

The Influence of Exchange Rates on Transfer Pricing

The Financial Accounting Standards Board(FASB) exchange rate is a ratio where one currency unit with a number of other currencies can be exchanged at a certain time. A high exchange rate reflects the price of domestic products that are relatively lower than other products (Mineri, MF, & Paramitha, M., 2021). According to agency theory, the exchange rate is related to the emergence of a problem caused by cash flow conditions, namely changes in the exchange rate, where the principal emphasizes uncertain future cash flow conditions, while management tends to emphasize things related to their work.

The results of the study prove that the exchange rate has an effect on transfer pricing. The results of the study obtained are also in line with the research conducted, namely stating that the exchange rate has an effect on the decisions of companies that carry out transfer pricing (Mineri, MF, & Paramitha, M., 2021).
H3: Exchange Rate has an effect on Transfer Pricing.

The Effect of Foreign Ownership on Transfer Pricing

Foreign ownership is the amount of share ownership owned by foreign entities, both individually and institutionally. Control over the company and transfer pricing increases if the share ownership is also large (Mineri, MF, & Paramitha, M., 2021). Foreign majority shareholders will use their power to order management to carry out the orders they want. This is called expropriation, which uses control to gain as much personal gain as possible from the wealth of other parties. The results of previous research and research conducted by researchers state that the foreign ownership variable has a significant effect on transfer pricing.
H4: Foreign ownership has an effect on transfer pricing.

The Influence of Effective Tax Rate on Transfer Pricing

The most effective tax measurement uses the effective tax rate (Effective Tax Rate).
Tax Rate). Companies conducting transactions with affiliated companies and located abroad tend to minimize the tax burden that must be paid by the amount of tax so that the effective tax amount can decrease (Mineri, MF, & Paramitha, M., 2021). Multinational companies will be faced with different tax rates in terms of exports and imports. This difference is common so countries with

less developed companies will be subject to lower tax rates compared to countries with developed companies. With this difference, it can be a reason for developed companies to think about reducing their taxes because taxes can reduce profits and if taxes are reduced, it will affect the company's costs so that it can reduce the Effective Tax Rate. Previous research states that taxes proxied by the Effective Tax Rate have an effect on Transfer Pricing (Mineri, MF, & Paramitha, M., 2021). H5: Effective Tax Rate has an effect on Transfer Pricing.

RESEARCH METHODS

The research method is a scientific method carried out to obtain data. Researchers conduct research using strategies associative. Researchers chose this strategy because it was in accordance with the objectives associative research, namely describing and testing the hypothesis of a relationship between two variable or more Sugiyono, (2018).

In this research the associative method used to find out about the influence of independent variables (variables that influence) namely Environmental Performance, Green Accounting, And Corporate Social Responsibility (CSR) with the dependent variable (variable that is influenced) namely financial performance.

The research method used in this research is quantitative. Quantitative methods are research methods that are based in the philosophy of positivism, it is used to research populations or samples specific, data collection using research instruments, data analysis quantitative statistics in order to describe and test existing hypotheses determined by Sugiyono, (2017).

This study uses secondary data taken from financial reports and/or annual reports of manufacturing companies listed on the Indonesia Stock Exchange (IDX) in 2016–2023 and conducted in Palembang City. This data is accessed through the official IDX website www.idx.co.id. The population in this study is all manufacturing companies listed on the IDX during the period 2016–2023 and there are 16 companies used as research samples. The dependent variable in this study is transfer pricing, while the independent variables include thin capitalization, tunneling incentive, exchange rate, foreign ownership, and effective tax rate. The sampling technique uses the purposive sampling method.

This study uses quantitative analysis techniques, namely panel data (pool data) so that the regression is called the Panel Data Regression Model. Panel data is a combination of inter-temporal data (time series) with data between individuals or spaces (cross-section). The regression model is used to test the effect of each independent variable on transfer pricing. Data analysis was carried out using descriptive statistical tests, panel data regression analysis consists of model estimation tests (chow test, Hausman test, Lagrange multiplier test) and uni hypothesis (t-statistic test and coefficient of determination R2). Furthermore, the data is processed using statistical data processing tools, namely E-Views 12.

Transfer pricing is calculated using the following formula:

$$\text{Transfer Pricing} = \frac{\text{Receivables from related parties}}{\text{Total Receivables}} \text{ x } 100$$

Thin capitalization can be measured using the following formula:

$$\text{DER} = \frac{\text{Total Debt}}{\text{Total Equity}}$$

Tunneling incentive using the following proxy:

$$\text{Tunneling Incentive} = \frac{\text{Largest Number of Share Ownership}}{\text{Number of Outstanding Shares}}$$

The exchange rate is calculated using the following formula:

$$\text{Exchange Rate} = \frac{\text{Exchange Rate Difference Profit and Loss}}{\text{Profit and Loss Before Tax}}$$

Foreign ownership uses the following formula:

$$\text{Foreign Ownership} = \frac{\text{Total Foreign Ownership}}{\text{Total Shares Outstanding}}$$

Effective Tax Rate (ETR) uses the following formula:

$$\text{ETR} = \frac{\text{Tax Burden}}{\text{Profit before tax}}$$

RESULT AND DISCUSSION

Overview of Research Object

This study uses a population of manufacturing companies listed on the Indonesia Stock Exchange in 2016-2023 and the purposive sampling method is the sampling technique used. The following are details of the samples used in this study.

No.	Company Criteria	Amount
1.	Manufacturing companies that have been listed on the IDX in 2016-2023.	164
2.	Manufacturing companies that did not publish financial statements and annual reports for the period 2016-2023.	(32)
3.	Manufacturing companies that experienced losses during 2016-2023.	(38)
4.	Manufacturing companies that are not controlled by foreign companies with a percentage of 20% or more.	(10)
5.	Manufacturing companies that do not experience foreign exchange gains/losses.	(14)
6.	Manufacturing companies that do not provide financial reports in foreign currency.	(14)
Number of companies that meet the sample criteria		16
Research period 2020-2022		8 years
Number of research samples		**128**

Source: data processed by Eviews 12, 2024

Table 1. Descriptive Statistical Analysis

	X1	X2	X3	X4	X5	Y
Mean	7386,207	6225,495	-2.718378	6979,153	2614,486	1768,276
Median	6168,000	5833,000	0.020000	6682,000	2442,000	157,1100
Maximum	51600.00	9984,000	28,16000	9984,000	8146,000	90627.91
Minimum	1218,000	1768,000	-174,2400	4234,000	1225,000	0.000000
Std. Dev.	7095,926	2299,970	22.72095	1730,883	962,6661	8694,756

Source: data processed by Eviews 12, 2024

X1, X2, X3, X4, X5 shows that the greater the debt to creditors, the amount of interest expense that the company must pay will be directly proportional.

Table 2. Panel Data Regression Estimation Test Results

Variables	*Common Effect Model*	*Fixed Effect Model*	*Random Effect Model*

Prob.	X1	0.0253	0.1043	0.0237
	X2	0.0064	0.0657	0.0058
	X3	0.9082	0.7187	0.9071
	X4	0.0660	0.6372	0.0630
	X5	0.7463	0.2024	0.7435
Constant		0.7984	0.0542	0.7961
Adj R-Square		0.074336	0.095801	0.074336
Prob(F-Statistic)		0.021767	0.069453	0.021767

Source: data processed by Eviews 12, 2024

From all the results of the regression model estimation, the next step is to re-test to determine the best model, namely the Chow Test, Hausman Test, and Lagrange Multiplier Test.

Model Selection Test Results

Table 3. Chow Test

Redundant Fixed Effects Tests			
Effects Test	*Statistics*	*Df*	*Prob.*
Cross-section F	1,178049	(14.91)	0.3056
Cross-section Chi-Square	18.488522	14	0.1854

Source: data processed by Eviews 12, 2024

Based on the Chow Test results table, the Chi-Square Probability value is 0.1854 > 0.05. The conclusion is that H0 is rejected H1 is accepted and the selected estimation model is the Common Effect Model.

Table 4. Hausman test

Correlated Random Effects – Hausman Test			
Test Summary	*Chi-Sq. Statistic*	*Chi-Sp. df*	*Prob.*
Random cross-section	14.675529	5	0.0118

Source: data processed by Eviews 12, 2024

The results of the study stated a probability value of 0.0118 < 0.05. H0 is rejected and H1 is accepted, this means that the selected estimation model is the Fixed Effect Model.

Table 5. Legrange Multiplier Test

***Lagrange* multiplier Tests for Random Effects**			
	Hypothesis Testing		
	Cross section	*Time*	*Both*
Breusch Pagan	0.505115 (0.4773)	0.562707 (0.4532)	1.067822 (0.3014)

Source: data processed by Eviews 12, 2024

Based on the Lagrange Multiplier test results table, states that the Breusch-Pagan probability value is 0.4773 > 0.05. H0 is accepted and H1 is rejected so that the selected model is the Common Effect Model.

Classical Assumption Test Results

Table 6. Multicollinearity Test

	X1	X2	X3	X4	X5
X1	1	0.06897	0.06709	0.11862	0.09501
X2	0.06897	1	0.22619	0.79397	-0.04947
X3	0.06709	0.22619	1	0.06566	-0.75247
X4	0.11862	0.79397	0.06566	1	0.12990
X5	0.09501	-0.04947	-0.75247	0.12990	1

Source: data processed by Eviews 12, 2024

Based on the table, it is known that the correlation between variables X in this study as a whole is <0.85. It can be concluded that this research model passes the Multicollinearity Test.

Table 7. Heteroscedasticity Test

Prob. (F Statistic)	**0.021767**
Durbin-Watson	1.146021
dU	1,79322
4-DW	2.853979

Source: data processed by Eviews 12, 2024

Based on the prob. value of 0.021767 < 0.05, it means that this research model is free from heteroscedasticity problems. This research model passes the Heteroscedasticity Test because it produces a 4-DW value of 2.853979 > dU of 1.79322.

Table 8. Panel Data Regression Analysis Results

Variable	*Coefficient*	*Std. Error*	*t-Statistics*	*Prob.*
Constant	1055,284	4121,799	0.256025	0.7984
X1	0.262938	0.115876	2,269128	0.0253
X2	-1.661857	0.597108	-2,783175	0.0064
X3	6.565968	56.78798	0.115622	0.9082
X4	1.471088	0.791947	1.857558	0.0660
X5	-0.433104	1.335423	-0.324320	0.7463
Adj. R-Squared			0.074336	
F-Statistic			2,766719	
Prob. (F-Statistic)			0.021767	

Source: data processed by Eviews 12, 2024

From the table above, the panel data regression analysis equation is obtained, namely:

$Yit = \alpha 0 + \beta 1it X1it + \beta 2it X2it + \beta 3it X3it + \beta 4it X4it + \beta 5it X5it + \varepsilon it$

Y = 1055.28 + 0.262*X1 - 1.661*X2 + 6.565*X3 + 1.471*X4 - 0.433*X5

Hypothesis Test Results

T-Test (Partial)

The T-test is used to examine how the dependent variable is partially influenced by the independent variable. If the sig. Value is ≤0.05, it indicates that the hypothesis is accepted.H1 shows that Thin Capitalization has an effect on Transfer Pricing. The results of the hypothesis test showed that the Thin Capitalization variable has a value of 0.0253 and H1 is accepted.H2 states that Tunneling Incentive has an effect on Transfer Pricing. The results of the hypothesis test state that the Tunneling Incentive has a value of 0.0064 and H2 is accepted.H3 shows that

the Exchange Rate has no effect on Transfer Pricing. The results of the hypothesis test show that the Exchange Rate has a value of0.9082 then H3 is rejected.H4 shows that Foreign Ownership has no effect on Transfer Pricing. The results of the hypothesis test showed that the Foreign Ownership variable has a significance value of 0.0660 and H4 is rejected.H5 states that ETR has no effect on Transfer Pricing. The results of the hypothesis test state that ETR has a value of 0.7463 and H5 is rejected.

F-Test (Simultaneous)

Thin Capitalization, Tunneling Incentive, Exchange Rate, Foreign Ownership, and ETR significantly affect Transfer Pricing. The calculated F value of 2.766719 is greater than the F table value of 1.416268, supporting the results of the significance value.

Coefficient of Determination Test

Adjusted R Square has a value of 0.074336. This shows that 74.3 percent of Transfer Pricing is influenced by Thin Capitalization, Tunneling Incentive, Exchange Rate, Foreign Ownership, and ETR. The remaining 25.7 percent is influenced by other factors outside the study.

Discussion

The Effect of Thin Capitalization on Transfer Pricing

The results of this study state that when Thin Capitalization increases, the Transfer Pricing efforts that will be carried out by the company will increase. The results of this study also support the agency theory which states that Thin Capitalization is a management step (agent) in fulfilling the desires of shareholders (principals) to obtain the highest possible income, which results in management having good performance because it has succeeded in optimizing profits by minimizing the tax burden that should be paid by the company.

The Impact of Tunneling Incentives on Transfer Pricing

The results of the study show that when Tunneling Incentive increases, Transfer Pricing efforts that will be carried out by the company will increase. Tunneling occurs because of agency problems between majority shareholders and minority shareholders. The greater the percentage of shareholder ownership, the greater the chance of Tunneling Incentive. The majority shareholders tunnel to their subsidiaries or relations through transfer pricing which aims to temporarily transfer their personal assets.

The Influence of Exchange Rates on Transfer Pricing

The results of the study stated that when the Exchange Rate increases, the efforts made by the company will decrease towards Transfer Pricing practices. The amount of the price of products or services produced by the company can be influenced by the exchange rate which continues to fluctuate, so that the amount of company cash available can be used to make transactions, and management will carry out Transfer Pricing.

The Effect of Foreign Ownership on Transfer Pricing

The results of the study stated that Foreign Ownership has increased, and the efforts that will be made by the company to carry out Transfer Pricing will decrease. Expropriation is the right of control to be used to maximize personal gain through the wealth of other parties, this can occur through transfer pricing. Based on the Financial Accounting Standards Statement (PSAK) No. 15 Concerning Investments in Associated Entities and Joint Ventures, controlling shareholders are those whose share ownership is 20% or more of an entity, whether the ownership is direct or indirect to another party, which can have a significant influence in controlling the entity.

The Influence of ETR on Transfer Pricing

The results of the study show that if ETR increases, the company's efforts to carry out Transfer Pricing will decrease. Some countries have high tax rates, while other countries have low tax rates (Tax Haven Country). The difference in tax rates is utilized by companies in tax

management, namely tax planning to minimize the tax burden borne by the company through Transfer Pricing.

CONCLUSION

Based on the results of this study, it was found that H1 states that Thin Capitalization has an effect on Transfer Pricing and H1 can be accepted. H1 shows that the higher the Thin Capitalization carried out, the higher the Transfer Pricing. H2 states that the Tunneling Incentive has an effect on Transfer Pricing and H2 can be accepted so that the higher the Tunneling Incentive, the higher the Transfer Pricing. H3 states that the Exchange Rate has no effect on Transfer Pricing so H3 is rejected. H4 states that Foreign Ownership has no effect on Transfer Pricing so H4 is rejected. H5 states that ETR has no effect on Transfer Pricing because ETR has no effect so H5 is rejected.

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