

## Transfer Pricing, A Tax Avoidance Tool (A Review of Literature)

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### ABSTRACT

The purpose of the work presented in this paper is to capture the current state of Transfer Pricing as well as to document the current practices of Transfer Pricing Abuse through a systematic literature review to extend and update the previous work. The approach to this paper is to answer the questions such as “what is Transfer Pricing?”, “How is it progressing?”, “what are the driving factors?” and “what are the emerging trends?”. These questions are used to guide the search of papers from various publication databases even if it is expected that existing literature might not be sufficiently developed to translate each question directly into a finding. The literature is then analyzed and the major emerging themes are presented. Four key findings (topics on which the views of the authors converged) and two issues (topics on which authors had differing views) have been established. These include the interpretation of Transfer Pricing, Arm’s Length Price Principle, Transfer Pricing methods, and Transfer Pricing as a tax avoidance technique. The systematic literature review approach used in this paper allows emerging trends and issues in Transfer Pricing to be highlighted in a structured and thematic manner. These findings also open up information about transfer pricing issues so that they can be used as reference material for further research.

*Keywords: Transfer pricing, tax management, tax avoidance*

### Introduction

To carry out business practices both domestically and internationally, the company will not be separated from conducting sale and purchase transactions with related parties. Currently, 60% of world trade is intra-group trade (Addo et al., 2017; Arslan, 2019). The calculation of prices, returns, terms of trade, financing, and business implementation between them is determined based on the determination of Transfer Pricing. Transfer Pricing is one of the international regulations because of its involvement in intra-group transactions that continue to dominate international trade today (Guvemli et al., 2017; Beebeejaun, 2018).

Transfer Pricing is a methodology used to determine prices and conditions in transactions between entities to comply with the principle of a fair relationship. Transfer Pricing is a useful tool in moving profits from one company to another, through a third company (Padhi, 2019). Companies, in general, will take every opportunity available to increase profits and maintain power, one of which is to set transfer prices (Arslan, 2019; Arham et al., 2020). Transfer Pricing can result in reduced potential state revenue from the tax sector of a country because companies tend to shift their tax obligations from countries that have high tax rates to countries that apply low tax rates (Wu & Lu, 2018). Global tax authorities have raised concerns about tax advantages caused by granting transfer pricing (Klassen et al., 2016). The Organization for Economic Corporation and Development (OECD) revealed in research that more than 60% of global trade is carried out by multinational companies, which means that transfer pricing is a crucial issue. In Indonesia, the practice of transfer pricing has become an issue of concern for the Directorate General of Taxes because this practice has been abused and as a result, state tax revenue has decreased (Hosiana & Tjen, 2018). In other words, the transfer policy is implemented as an exploitation of the price-setting policy for goods and services transferred between related parties, not

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based on market value with tax rules paid by all affiliated parties (Barker et al., 2017; Asongu et al., 2019; Nguyen et al., 2020). Because of the distribution of disguised income through transfer pricing to increase profitability, multinational companies threaten the country's taxation system (Arslan, 2019). Transfer pricing develops with various calculation methods (Nguyen et al., 2020).

The work presented in this paper aims to capture the current state of transfer pricing as well as to document transfer pricing abuse practices through a systematic literature review to expand and update the previous literature review work.

### **Transfer Pricing Concept**

Transfer Pricing is defined as determining the price of services and goods exchanged within a company (Klassen et al., 2016; Barker et al., 2017; Cugova & Cug, 2019). Transfer Pricing is used for services and goods transferred between related companies located in different countries (Cugova & Cug, 2019). Transfer Pricing is a common tax avoidance method for multinational companies (Beebeejaun, 2018) and an important vehicle for international tax planning (Guvemli et al., 2017). In a broader context, Transfer Pricing can be used as a method for allocating pre-tax profits to countries where multinational companies do business, in short, a process that is related to the price determined between affiliates in the same group (Asongu, 2016). Transfer pricing involves setting prices for goods and services that make transactions from a company affiliated with another (Arslan, 2019). A country has the potential to lose tax revenue because multinational companies tend to shift their tax obligations to other countries (Huda et al., 2017). Through the determination of Transfer Pricing, companies located in high tax jurisdictions can process a Transfer Price to a low tax jurisdiction to avoid taxation. These transfers are accomplished by selling goods and services to affiliates in low tax jurisdictions at a lower cost which generates low income for high tax jurisdictions and vice versa. All of these transactions will result in income tax evasion (Barker et al., 2017).

### **Arm's Length Price Principle**

If the government cannot regulate transfer pricing, multinational companies can divert most of their profits from their country to low tax jurisdictions. Therefore, the government has imposed a regulation on transfer pricing to be controlled (Choi et al., 2020). To avoid transfer pricing errors, a principle known as the Arm's length price principle is needed (Asongu et al., 2019; Choi et al., 2020). Arm's length price principle is the principle that stipulates that the conditions of transactions between related parties are proportional to conditions of transactions between non-related parties. Prices and profits must be the same (Hosiana & Tjen, 2018). By adhering to this principle, prices are under control (Cugova & Cug, 2019). The application of the Arm's length price principle can be very easy for tax authorities and other regulatory agencies to determine whether related party transactions are appropriate when the intended transaction is for goods and services, meaning that a fair market price is already available for other markets. Multinational companies that conduct transactions between companies must comply with the Arm's length price principle to prevent tax evasion (Barker et al., 2017). There are several things to consider, particularly intra-group loan transactions. These are:

1. Analysis of debt requirements
2. Make sure the loan from the affiliate is correct
3. Fairness test with debt to equity ratio
4. Test the reasonableness of interest rates for intragroup loans.

### **Transfer Pricing Method**

The transfer pricing determination method is used to assist companies in determining and controlling transfer prices. In transactions made by taxpayers with related parties (Rahmiati & Sandi, 2016; Guvemli et al., 2017; Hosiana & Tjen, 2018; Amidu et al., 2019; Arslan, 2019) shows that there are several methods to determine transfer pricing (Beebeejaun, 2017; Cugova & Cug, 2019). This method is based on the arm's length principle that has been established internationally.

*Based on price*

## a. Comparable Uncontrolled Price Method (CUP)

Transfer Price = Independent Price

Companies may use the comparable uncontrolled pricing method (CUP) in the case that the price specified in a transaction is compatible with a similar transaction for which the price in the transaction is fair. This approach is based on direct comparisons with prices and can only be accepted if the goods are available on the free market. The guidelines state that if it were possible to apply the CUP method, it would be the most appropriate regarding the arm's length principle.

## b. Resale Price Method (RPM)

Transfer Price = Independent Price - Dealer's Gross Margin

The Resale Price method refers to the gross profit or the difference between the price at which a product is obtained and the price based on unrelated parties. It suits distributors and re-sellers.

## c. The Cost Plus method (COST +)

Transfer Price = Independent Price + Reasonable Margin from Dependent Retailers

The cost-plus method is used to adjust the fair price for transfers of tangible, intangible, or services. The gross profit markup is added to the cost of goods or services to adjust for a fair price. The mark-up of crude oil profits is adjusted based on the function performed by the tax-payer or by considering comparators' uncontrolled transactions. Manufacturing companies for resale related goods distributors usually choose this method. The cost-plus method is the gross profit method of net income, therefore; markups are applied to indirect and direct costs of production.

*Based on profit*

## a. Profit Sharing Method (PSM)

Profit-sharing operating profit-sharing method, which occurs because the transaction is related in a way that reflects the revenue sharing in the arm arrangement. It is used in the business case when it is divided into many related interactions and it becomes difficult to understand each transaction separately

## b. Transactional Net Margin Method (TNMM)

The transactional net margin (TNMM) method examines the net profit indicator, i.e. the ratio of net income to the corresponding baseline (e.g. expenses, sales, assets), which tax-payers are aware of from controlled transactions (or from transactions that are suitable to agree) with net income obtained in comparable uncontrolled transactions. This method is useful in practice for providing inter-party services, for example, product management and distribution costs for which the re-pricing method cannot be applied adequately.

The selection of the right method is very important because the suitability of the method chosen must be accounted for and must be based on analysis (Cugova & Cug, 2019). If there is an error in using the method it will result in an incorrect result, which in turn can result in fines and additional tax evasion.

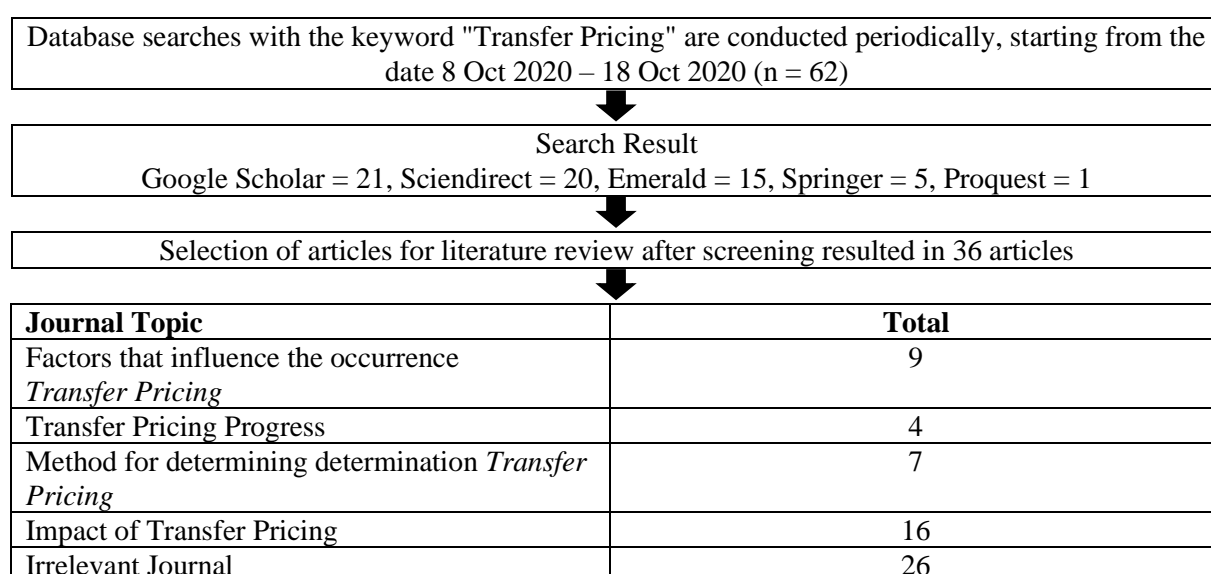
***Transfer pricing as a tax avoidance technique***

Avoidance of relationship tax with multinational companies because cross-border transactions carried out by multinational companies will be obtained by the national tax system (Sari et al., 2018). Amidu et al., (2017) and Irawan et al, (2020) revealed that tax avoidance occurs because of differences in tax views for the government and taxpayers. Tax avoidance is not always an act against the law but is an ethical act that results in lowering state revenues so this issue is very important for tax authorities. Tax avoidance by multinational companies by providing transfer pricing. (Contractor, 2016) summarizes five types of tax avoidance techniques commonly used by companies by taking advantage of the loopholes provided by the countries involved, namely deferral of affiliate income, transfer fees, cost absorption by the parent company, commuting, and relocation of the head office. The negative side of Transfer Pricing One of which is the provision of transfer pricing which has been associated with tax avoidance

and wealth retention. This practice has become a tax problem when parties have begun to notice that multinational companies are abusing transfer pricing to make a profit with their proper tax obligations (Contractor, 2016).

### Material and Methods

The stages of the literature review process started from searching data, doing a simple search on the word "Transfer Pricing", which resulted in +3,000 articles from various national and international journals through the Google Scholar, Emerald, ScienceDirect, and Springer pages so that they became several articles relevant to the selected topic. that. Reference articles are only taken for the last five years (2016-present). The next stage is data processing using the Microsoft Excel application. The data that has been collected will then be entered into a table and will become a database. The process illustrated by the article is illustrated in the diagram:



Of the 62 selected articles, the author re-chooses the article with a screening process so that it fits the reference and the topic is relevant to the theme raised. In the screening process, the authors found 9 articles describing the influence factors of transfer pricing (Contractor, 2016; Wang et al., 2016; Choi et al., 2018; Susanti & Firmansyah, 2018; Asongu et al., 2019; Padhi, 2019; Arham et al., 2020; Choi et al., 2020; Nguyen et al., 2020), 4 articles describing the development of transfer pricing (Cooper et al., 2016; Wang, 2016; Guvemli et al., 2017; Rathke et al., 2020), 7 articles describing transfer pricing methods and 16 articles providing conclusions about the impact of the transfer price (Klassen et al., 2016; Marques et al., 2016; Addo et al., 2017; Amidu et al., 2017; Barker et al., 2017; Holzmann, 2017; Huda et al., 2017; Beebeejaun, 2018; Hosiana & Tjen, 2018; Irawan et al., 2020; Agana et al., 2018; Gjorgieva, 2018; Panjalusman et al., 2020).

### Results and Discussion

#### Results

Prices are often influenced by the fact that they are not negotiated in the market, but are regulated by positions of power (Cugova & Cug, 2019). This happens because there is a relationship between multinational companies. Transfer pricing can be defined as the fixing of transaction prices between company members in developed and developing countries. Of particular concern are cross-border transactions between parent and subsidiary. The transaction includes the sale of tangible goods, the sale of intellectual property for the provision of property (Abiodun, 2020). The determination of transfer pricing

can be used as a method of allocating profits to attribute profits to multinational companies. Transfer pricing has been implemented by most multinational companies to optimize their profit after tax (Irawan et al., 2020). Transfer prices play an important and strategic role in income shifting by multinational companies (Wang et al., 2016). Multinational companies are legally allowed to use the transfer pricing method to allocate revenue among the various subsidiaries and affiliated companies that are part of the parent organization. However, companies can also carry out transfer pricing abuse by changing their taxable income so that it reduces their overall tax. Transfer prices are particularly emphasized in multinational companies when group members come from different countries with different tax systems. Overall, transfer pricing can be used to generate profits for companies in the group in countries with the least tax burden. Transfer pricing may be market-based, referring to prices that are equivalent to prices charged on external markets for similar goods and services. The alternative can be on a non-market basis, goods or services transferred below or above prevailing market prices often based on aggressive tax avoidance schemes. Transfer pricing schemes are designed to determine the amount of profit or loss that can be attributed to the activities of the company's decentralized sub-unit (Addo et al., 2017).

Recent years have seen public scrutiny of unprecedented problems over the tax practices of multinational groups of companies. In this context, inappropriate transfer prices pose a major risk to the direct tax bases of many developing economies. Transfer pricing rules are instrumental because they will support existing anti-tax reviews in the country (Guvemli, et al., 2017) conducted a study in several Balkan countries in Southeast Europe to see the development of transfer pricing compared to the Arm's length principle, new OECD, documentation requirements, tax audit procedures and transfer pricing. Some countries are still not integrated with transfer pricing policies that are guided by the OECD. However, not all countries apply the same transfer pricing rules and policies (Rathke & Rezende, 2020) revealed that of the 44 countries studied, there were four different transfer pricing systems. The largest group of countries with transfer pricing rules consistent with the latest OECD, and three groups of countries with domestic provisions that differ from OECD standards (Rathke & Rezende, 2020). Things like that can happen because there are countries that have policies according to their own countries and different transfer pricing methods, for example, Brazil, China, India, and South Africa.

The development of the transfer pricing method in China did not become a concern until it began its disclosure reform process in the early 1980s. Foreign investment that comes not only discusses advanced technology and management skills but also tax planning that can reduce tax obligations. In 2014, China had been the largest recipient of foreign direct investment in developing countries for 23 consecutive years. This made China's state tax administration require most companies to report their income tax obligations. Two-thirds of companies reported abnormal losses, they deliberately made losses and avoided taxes by manipulating transfer prices as a way to divert Chinese profits to other countries. However, regulation of transfer prices has been drawn up in a short time and has increased progress in Chinese taxation. The substance resembles OECD but is more concise (Wang, 2019).

In Indonesia, the problem of transfer pricing is not new because the General Board of Taxes has issued various tax regulations related to transferring pricing issued by the Director-General of Taxes Number PER-29 / PJ / 2017 concerning procedures for managing reports and the minister of finance regulation number PMK-213 / PMK.03 / 2016. This is done for the transparency of taxpayers in conducting affiliated transactions to uphold justice for other taxpayers who are obedient in carrying out their obligations (Irawan et al., 2020).

Transfer pricing practice is used as a business tool to achieve company goals, namely profit. Foreign direct investment requires products that can be profitable so that it encourages misuse of transfer pricing to improve social welfare (Choi et al., 2020). Most multinational companies implement transfer pricing schemes at arbitrary prices and profits are reported in countries with low tax rates, thereby reducing the amount of income tax paid by multinational companies (Addo et al., 2017; Franklin & Myers, 2016) looked at several factors from transfer pricing practice. In his research, it shows that transfer pricing can provide benefits for a division within a company. It can be said that the factors that influence the company's performance to carry out transfer pricing are due to tax differences. Reinforced by Susanti and Firmansyah (2018), the main factor affecting a company's decision to carry out transfer pricing is the

tax borne by the company. The difference in tax burden borne by the company performs transfer pricing to obtain the minimum tax. Things like that can happen because there are no explicit formal rules regarding transfer pricing in countries that do business with transfer price misappropriation. A special law is needed to prevent multinational companies from committing transfer pricing abuse (Beebeejaun, 2018). In the US the government has proposed closing the transfer pricing loophole by tightening its tax laws and by imposing a new minimum tax on outside income that multinational companies use to evade taxation and shift income to low-tax jurisdictions (Barker et al., 2017). Another most important factor in the misuse of transfer pricing is the increase in profits for multinational companies (Padhi, 2019). Multinational companies have increased profitability by lowering the tax base through methods such as shrouded capital, restructuring, treaty shopping, investment tax heaven, and transfer pricing (Arslan, 2019).

The current transfer pricing practice is always associated with tax issues. From a taxation point of view, this transaction can be significant as multinational companies shift and reallocate revenue from one tax jurisdiction to lower tax jurisdiction. When income and losses are reallocated, countries will fight for what they believe to be taxable income that is the right of their respective countries make a statement in their paper that the current trend of transfer pricing in India is shown by the lack of government expertise to solve these problems because the problems are so complex that tax authorities lack the knowledge to understand taxation and other related transactions. A significant transfer pricing problem is the fixing of fair prices on intangible assets. As there are no comparison prices, it is very difficult to compare with fair transactions. The findings study revealed (Wang et al., 2016), transfer pricing manipulation of related transactions involving intangible goods has become popular as a way to escape tax obligations. This has led the tax authorities to take firm steps in the regulation of transfer prices.

Transfer pricing has increased the subject of attention in several countries. Transfer prices are a global phenomenon and multinational companies are influential in transfer pricing regulations. Tax authorities must pay special attention to these tax avoidance methods (Guvemli et al., 2017). China's tax policy on transfer pricing and tax administration affects a very large number of cross-border transactions between China and other countries. China has suffered heavy revenue losses from transfer price manipulation. Since 2008, China's tax authorities have paid particular attention to this method of tax avoidance.

Taxation provisions have comprehensively regulated transfer pricing and its implementation. However, there are still many abusive practices that harm state finances. This is due to the limited resources in the Directorate General of Taxation in understanding transfer prices as multinational companies increase each year. So, the government needs to determine what to do to minimize the risk of income loss from the abuse of transfer pricing (Huda et al., 2017).

The problem of Transfer Pricing in the country of Mauritius has been highlighted by Finance Uncovered (2016), a global network of investigators carrying out cross-border investigations into southern Africa and uncovering how multinational subsidiaries in several African regions have shifted revenue to subsidiaries in Mauritius. Further investigations revealed that the workers in the transaction were limited. Developing countries must balance the needs of investment and trade across borders with laws regulating activities to combat transfer pricing abuse. At that time the laws and provisions regarding transfer pricing only had brief provisions (Beebeejaun, 2018).

As a result of the abuse of transfer pricing, countries such as Ghana lose large tax revenues (Addo et al., 2017). The proxy used to measure tax avoidance is the difference between STR and ETR. The results of this study support the evidence at that time, the government suffered a loss of 2 billion from the misuse of Transfer Pricing (Amidu et al., 2017). The government in Mauritius (tax heaven) expressed deep concern over the fact that multinational companies in their country do not pay the appropriate tax (Beebeejaun, 2018). This is due to a lack of legal function, regulatory authority, and technical knowledge. Transfer Pricing irregularities in Mauritius are uncontrollable as the government does not have the necessary resources to effectively control and monitor transfer pricing between parties concerned. Research in Vietnam reveals that there is a strong relationship between the transfer pricing law

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and transfer pricing decision-making for foreign direct investment (Nguyen et al., 2020). The government needs to have a special law on transfer pricing, a good transfer pricing document is also expected to introduce more training on transfer pricing to companies. By adopting lawful transfer pricing in Vietnam, it will help the government better deal with abusive transfer practices.

### ***Discussion***

From several articles that were used as references, there were many similarities in the results which showed that the practice of misuse of Transfer Pricing had a bad impact on the government. Since multinational companies are actively involved in transactions between intra-group companies, they have the initiative to manipulate transfer pricing to avoid taxes (Choi et al., 2020). This practice is the main mechanism used by multinational companies to divert their profits resulting in tax avoidance (Amidu et al., 2019). Transfer Pricing manipulation results in tax revenue losses for the state (Susanti & Firman-syah, 2018; Amidu et al., 2019; Abiodun, 2020).

In the research conducted (Hosiana & Tjen, 2018), transfer pricing is a price set in a business transaction between two parties, based on fair pricing to minimize taxes. The results studied indicate that Company X has a special relationship in terms of ownership or equity participation, meaning that the lending and borrowing transactions carried out by the two companies can be categorized as related party transactions. The condition that occurs is a lending and borrowing transaction where Company X gets a loan but lends it to Company Y, which should use an interest rate according to a fair interest rate. However, Companies X and Y do not pay interest on their loans, this provision has deviated from Government Regulation No. 94 of 2010. Company X should have started paying interest charges on lending and borrowing transactions with related parties so that the company does not have to pay a tax burden that is greater than tax expense with interest expense. If the company continues to run the interest-free scheme, in the future the company will suffer losses. Applying the appropriate method can minimize these problems. The correctness of the method used and the detection of market price differences will be verified by the tax administrator in the tax audit based on the principle of independent relations. Findings from (Wu & Lu, 2018) reveal that 78% of multinational companies apply two appropriate methods, namely the cost-plus method and the resale price method.

In some countries, the Transfer Pricing arrangement holds multinational companies from tax evasion, namely the United States, France, Canada and Japan, Korea, Australia, and Italy claiming to be less interested in the Transfer Pricing process, while Ireland and Puerto Rico are not committed to this issue even though they are very interested in foreign investors who have lower tax rates (Arslan, 2019). Judging from this statement, it can be concluded that several countries are strong with policies that are made so that they can make multinational companies that are established and built-in their regions obey and obey the rules for not evading taxes. Tighter regulations lower the difference in tax rates from reported profits, meaning that they can prevent multinational companies from shifting profits from high tax countries to low tax countries (Marques & Pinho, 2016). Transfer Pricing is used as a tool for decision-making for international companies by shifting profits from one company to another to get tax advantages. The use of transfer pricing can avoid crisis conditions such as bankruptcy (Cugova & Cug, 2019).

The appropriate application of Transfer Pricing can be done if the company implements a good tax strategy (Rahmiati & Sandi, 2016). Following the regulations, transactions of a business entity with related parties must be realized at fair prices and this must be proven. There are no legal rules that allow the state to manipulate Transfer Pricing to avoid paying taxes (Beebeejaun, 2018). The nature of tax competition can depend on the strict transfer pricing regulations (Choi et al., 2020). Transfer Pricing irregularities can be overcome with sophisticated tax rules and regulations (Beebeejaun, 2018). The

government must produce a good tax law, enabling it to enforce the transfer pricing regulations in the country (Abiodun, 2020) so that companies avoid tax avoidance practices. Tax authorities need to implement laws that encourage domestic investment and close loopholes used by multinational companies for tax evasion (Barker et al., 2017; Asongu et al., 2019). It is also necessary to ensure that the provisions of national and international flows regarding Transfer Pricing are understood by the parties or agencies concerned to comply with this regulation (Arslan, 2019).

## Conclusion

One of the most common forms of international tax avoidance is transfer pricing by multinational companies. The practice of transfer pricing has received attention in various fields, especially economics and taxation. The determination of Transfer Pricing is an issue that needs to be considered carefully by tax authorities because it affects the amount of tax to be paid by a company. From this research, it can be concluded that the implementation of transfer pricing is still not appropriate. There is a manipulation process in practice so that it hurts the government which reduces tax revenue. Multinational companies, which have subsidiaries, must be able to change their tax management rules so that transfer pricing in practice can be implemented properly and not deviating from it. Companies must be able to measure their business performance properly to carry out all of their series of processes properly.

From the overall results of the study, the authors want to conclude that the practice of transfer pricing manipulation can drain tax receivers. The negative impact of transfer pricing manipulation is a large loss from direct tax revenue to the state. The implementation of Transfer Pricing following the rules tends to reduce shareholder rights because the income of a company is reduced. Abuse of Transfer Pricing is motivated by the reason that companies can improve social welfare. Multinational companies can increase their profitability by implementing Transfer Pricing.

There are still many cases of misuse of transfer pricing that researchers have not explored extensively. This research has limitations, including the implementation time to review more articles is very limited, the number of reference articles used as a source is not large. From the above limitations, the next writer should be better at explaining in more detail the development of Transfer Pricing practices and many of his studies on the transfer pricing issue. The results of this literature review are expected to help further researchers to improve the quality of research.

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