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Evaluation of Capacity Adjustments for Transfer Pricing Disputes: A Case Study of Tax Court Decisions

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ABSTRACT
This study evaluates the implementation of capacity adjustment using the transactional net margin method (TNMM) on two appeal decisions of transfer pricing dispute based on the tax consultant's point of view. Capacity adjustment is one of the techniques described in the OECD transfer pricing guidelines (OECD TPG) for transfer pricing analysis of companies that have not yet reached their optimal production capacity. However, in practice there are differences in interpretation between the Indonesian tax authorities and the OECD TPG. The study uses a qualitative approach which consists of document analysis of the two appeal decisions and semi-structured interviews. Based on the results of the study, the implementation of capacity adjustment requires rational commercial reasons and the basis for proper calculations.

Keywords: *transfer pricing, capacity adjustment, tax dispute.*

1. INTRODUCTION

Recently, the number of tax disputes related to transfer pricing has increased from year to year. One of these cases is the application of the TNMM as the most widely used method in transfer pricing analysis [1]. Based on the research on transfer pricing disputes in India, it stated that a comparability adjustment must be made to increase the comparability between the tested party and the comparable companies in the application of the TNMM [2]. Research specifically on capacity adjustment using the TNMM has never been carried out in Indonesia. In fact, companies in Indonesia, especially manufactures that have affiliated transactions, have certainly experienced non-optimal capacity conditions [3].

This study evaluates the implementation of capacity adjustment in a manufacturing company operates in the under- capacity condition. This evaluation will be specifically carried out on the results of the tax court decision on the transfer pricing dispute of the company in the 2012 and 2013 fiscal years. This dispute will be decided by the panel of judges in 2020.

Transfer pricing documentation which is prepared by the taxpayer [4] stated that capacity adjustments have been made in accordance with the guidelines from the appendix of 2010 OECD Transfer Pricing Guidelines (OECD TPG) because there are no specific regulations in Indonesia regarding capacity adjustments [5]. In practice, there are different interpretations with the tax authorities [6] regarding the use of capacity adjustments in determining the arm's length value of the taxpayer's affiliated transactions.

In the previous study, it revealed the implementation of capacity adjustment in transfer pricing analysis in India. Furthermore, similar research in Indonesia regarding adjustments related to transfer pricing analysis is limited to analysis using working capital adjustments [7]. The study stated that the working capital adjustment was well received by the tax authorities even though the technical guidance was only found in the OECD TPG in 2010 [8] and the tax regulations in Indonesia have not explained in detail how the mechanism is [9].

This research is of significant value because it can not only be applied to one company in the unit of analysis of this study, but there is also the possibility that it can be applied to the case of other companies with non-optimal capacities that use the TNM method to analyse the arm's length price of their business. Although the IBFD states that in the early stages of business establishment, companies are usually given tax write-offs or reductions, but non-optimal capacity conditions can not only occur in companies in the early stages of establishment [10]. Cases of capacity adjustment can occur in many companies, both caused by internal and external factors of the company in the form of declining economic conditions or special conditions such as the Covid-19 pandemic that can trigger capacity adjustments as described in the OECD guidelines released at the end of 2020 [11].

2. THEORETICAL FRAMEWORK

In the international consensus written in the OECD TPG in 2010 and 2017 [12], there are five transfer pricing methods including the Comparable Uncontrolled Price (CUP), Resale Price (RP), Cost Plus (CP), Profit Split (PS) and Transactional Net Margin (TNM) methods. Since 2010, the implementing regulations in Indonesia, stated in the Director General of Taxes Regulation No. 43 of 2010 (PER-43) which was later updated with the Regulation of the Director General of Taxes No. 32 of 2011 (PER-32) adopted these five methods to conduct an analysis of the arm's length price of affiliated transactions.

In practice in Indonesia, the TNM method is most widely used in the transfer pricing documentation carried out by taxpayers because the comparison is easier and limited to financial indicators [13]. This is in line with research which states that the TNM method is the most frequently applied method to perform transfer pricing analysis. Beside the low comparability factor, the simplicity for obtaining data is one of the practical reasons for applying the TNM method in many transfer pricing documentations compiled by taxpayers.

However, the TNM method has a fundamental weakness. The application of the TNM method assumes that the level of profitability between companies that have similar products or services is at the same level. In practice, the assumptions underlying the TNM method may be invalid, for example because the differentiation of similar products and services is getting bigger.

The use of profit indicators in the analysis of the TNM method can be influenced by how big the affiliate transaction factor is on the margin. This can be a bias in making conclusions to determine whether the determination of fairness is really obtained from affiliated transactions or mixed with independent transactions in terms of, for example, losses experienced by the company because the company is in a start-up condition or capacity is not optimal.

Comparability analysis is also referred to as the heart of transfer pricing analysis because it is useful for determining methods as well as comparisons that can be used to determine the fairness and prevalence of business [14]. Comparability analysis finds the challenge at the end of the comparison stage to find a reliable comparison. Being comparable means that there is no difference in conditions between an affiliated transaction and an independent transaction that could materially affect the situation under analysis (price or profit margin). Alternatively, if there is a difference in conditions, the difference can be eliminated through accurate adjustment.

Generally applicable guidelines state that adjustments should be made to match comparability. In the process, adjustments in the comparability analysis can be made by several methods [15]. Some of the methods described in the study include adjustments for asset and working capital intensity, risk-based adjustments, adjustments for accounting consistency, and adjustments for economic conditions including geographic areas. All these methods lead to an increase in comparability to improve the results of transfer pricing analysis.

Transfer pricing adjustments can also be done qualitatively through a qualitative analysis model of prices or margins for affiliated transactions that cannot obtain reliable comparisons [16]. However, in practice there are two drawbacks to this adjustment. First, companies tend to have difficulty obtaining reliable information regarding qualitative information to match affiliate transactions. Second, tax authorities generally do not accept qualitative adjustments because companies cannot provide sufficient data to support their arguments.

Furthermore, transfer pricing adjustments to improve the comparability of companies and their comparable data can be made under special conditions [17]. For example, in a financial crisis that occurred due to the Covid-19 outbreak, the company's profitability adjustments can be made using regression analysis or cost structure analysis. Regression analysis establishes a relationship between changes in sales and the level of profit. Cost structure analysis performs an analysis of changes in sales-driven profitability by adjusting for variable costs and fixed costs [18]. Other adjustments that can be made include adjustments to working capital and adjustments to contracts and payment terms that change due to the Covid-19 outbreak. This is due to the one-year lag time from comparison company data which is generally provided by commercial databases.

The adjustments that are illustrated in detail in the OECD TPG 2010 and 2017 are related to the sensitivity of the gross profit margin and the net profit margin. The illustration describes quantitatively the effect of the difference in capacity for manufacturing companies operating at full capacity and non-optimal capacity on the company's profitability. It explains that the comparison at the level of net income which is analogous to the application of the TNM method can be more sensitive to the non-optimal capacity of manufacturing companies. The sensitivity also depends on the proportion of fixed costs and variable costs as well as the proportion between the company and its comparators at a certain level of capacity.

In tax regulations in Indonesia, capacity adjustments are not specifically regulated. The regulation only covers the need for reliable adjustment for certain condition. The application of the transfer pricing method should consider the level of comparability between affiliated transactions and independent transactions, including the reliability of adjustments made to eliminate material effects of existing differences [19].

3. RESEARCH METHODS

This study uses a qualitative approach because it performs an in-depth analysis of a case and a process to explore and understand a particular problem. This research explores the main source documents which are two appeal decisions for the fiscal year 2012 and 2013.

Data collection techniques consist of document analysis and interviews. The document analysis stage is carried out by analysing the two appeal decisions [20]. Semi-structured interviews that follow the predetermined question guidelines are used to conduct interviews with related parties in this case study. This semi-structured approach was chosen because it is expected that can meet research objectives and allow flexibility to respond to participants' answers and follow up on problems that arise.

In the analysis of interview results, descriptive analysis is used to answer research questions and will be revealed during the interview process. The interview questions are attached in the appendix and were conducted with a semi-structured method.

This research involves an interview process to six respondents who have at least ten years of professional experience. Respondents consist of six consultants who have at least a bachelor's academic background. Respondents come from tax consultants from the big four and tax consultants from second tier of transfer pricing firms in Indonesia. Based on professional positions, there are two consultants are managers, senior managers, partners respectively.

The interview process was conducted online with zoom media which was recorded based on the consent of each respondent. Prior to the interview, confirmation was made regarding the respondent's willingness. The interview process lasted from one hour to two hours. After the interview was completed, the research continued by manually transcribing the interview results and agreeing on the interview results to each respondent. The next step is to analyse the results of the interview by quoting the respondent's questions that are closely related to the research analysis points so that they can answer the research questions well.

In analysing and discussing the results of the interviews, the questions were grouped including evaluation of the application of adjustments to improve comparability analysis and recommendations related to the regulation for application of adjustments to improve comparability.

4. RESEARCH OBJECT

The research object is a manufacturing company which changed the company's business characteristics from contract manufacturing to fully-fledged manufacturing or in the business restructuring process. Business restructuring resulted in the need for adjustment time in entering the market, production activities that could not be carried out normally, and sales efficiency which affected the product cycle or the company's business cycle. Prior to the restructuring, each of the company's products was purchased by a business group as part of a contract manufacturing agreement. However, after the restructuring of the business, the company had to sell its own products so there were significant promotional costs that the company had to incur.

Based on the tax appeal decision for fiscal year 2012, the appellant's Net Cost Plus (NCP) value is below the interquartile range of the comparable company. There were several reasons as follows: whereas the appellee rejects the adjustment to the financial statements of the appellant which is presented in the transfer pricing documentation regarding the production capacity level, which is still below normal capacity. The Appellant uses the comparison method of the appellant's single year data (2012) with the multi-years data of the comparison companies (2010-2012). Furthermore, based on the data in the tax returns for the July, August and September 2012, there were still significant sales, even though according to the appellant at that time there was no production because it was still in the process of restructuring.

According to the appellant, the arguments related to transfer pricing analysis are as follows for 2012: the adjustment in the transfer pricing analysis carried out by the Appellant is in accordance with the applicable provisions since the appellant made an adjustment for increasing level of comparability of the tested party (appellant) with the comparable companies, by eliminating the impact of different economic conditions on the level of profitability. This adjustment is necessary to produce comparable economic conditions experienced by the appellant to the economic conditions experienced by the comparable companies. Another argument is as stated in the paragraph 2.71 OECD TPG 2010, the net profit indicator can be directly affected by industry strength, one of which is the level of business experience of the appellant.

Due to the lack of similar companies having the same operational conditions as the appellant, for the purpose of transfer price analysis, the profit and loss statement of the appellant is normalized to eliminate the impact of operations below normal production capacity. Several adjustments were made to sales and variable cost of goods (material costs and labour costs) to reflect the normal conditions of the company. This is stated in the paragraph 2.72 OECD TPG 2010. If there is no adjustment made by the appellant, the results of the analysis will be distorted and unreliable.

The profit and loss statement data after the adjustment is made by recalculating the total sales in 2012 using the sales volume in 2014. Sales adjustments must be made because the appellant's production is carried out below normal capacity while comparable companies generally produce at normal capacity. Practically speaking, the appellant has just reached its normal production capacity in 2014.

The tax court judges are of the opinion that because in the trial the appellee was proven not to do adjustments to the PLI-NCPM being tested. In the other hand, the appellant could prove abnormal conditions due to changes in functions, assets and risks which caused the appellant to have to adjust the conditions in 2012 against normal conditions carried out by the appellant in accordance with the provisions of Article 3 paragraph (2) letter a PER-43/PJ/2010 jo. PER-32/PJ/2011 and in accordance with the guidelines in the paragraph 2.71 and 2.72 OECD TPG 2010.

However, for the year 2013, the panel of judges had a conclusion that the calculations made by the judges are not significantly different from those made by the appellant and the adjusted NCPM is below the interquartile range. The judges believed the correction of the appellee has complied with the arm's length principle and rejected arguments from the appellant.

5. ANALYSIS

Regarding the evaluation of adjustments for comparability analysis, regulations in Indonesia state that in the application of the TP method, it is mandatory to pay attention to the level of comparability between affiliated and independent transactions, including the reliability of adjustments to eliminate material effects of existing differences.

In practice, adjustments are required if there is an identifiable disproportionate effect on prices or profits. On the other hand, if the disparity has no effect, then no adjustment is needed.

> "*Actually, this comparability adjustment can and needs to be done. It is solely to improve the quality of comparability. So the regulations actually suggest both in terms of regulations in Indonesia and OECD TP guidelines*" (R6,J1)

Appropriate adjustment criteria require strong commercial reasons, quantitative calculations, and supporting data including detailed mapping of fixed and variable costs to support adjustment calculations.

> "*To make these adjustments, we need data, including breakdown, costing or recording of costs from the taxpayer from the cost of goods sold and operating expenses, where we need to figure out which costs are variable and which costs are fixed.*" (R1,J2)

In terms of comparison of the implementation of TP adjustments between Indonesian regulations and the OECD TPG, it can be concluded that based on the literature review, there is no detailed description of how to implement adjustments to increase comparability in Indonesian regulations [21]. However, the OECD guidelines provide some illustrations of how incomparable conditions can affect pricing or profits.

> "*As far as I know, the regulations in Indonesia that cover the TP adjustment are not enough. However, the laws and regulations in Indonesia are quite oriented towards the OECD TPG. in the OECD TPG and there are no points in the laws and regulations in Indonesia that are directly contradictory to the contents of the OECD TPG.*" (R1,J4)

It is necessary to improve the regulation of TP in Indonesia. For example, it can be done by providing illustrations that are not binding. In the regulation, it is necessary to state an exception that the illustration is not binding. If it is binding, it will be difficult to apply in practice.

"*So back to the question, is there a need for regulations that need to be perfected that to what extent, if you want to give examples of comparability, you can, but does it immediately become standard? Well that is what I am worried about. Standardizing a business condition is a bit difficult. Because every company has a story that has different problems*." (R6,J6)

Taxpayers have a strong argument that non-optimal capacity can justify implementing capacity adjustment in TP analysis. It is to prove that the decrease in profit is not directly justified as an abuse of TP.

"*So the reason for the unfulfilled capacity is one reason that is sufficient for me. I mean accountable in terms of analysing TP. But again, the issue of data reliability needs to be taken into consideration as well in making comparability adjustments*." (R6,J7)

Regarding the evidence for capacity adjustment, taxpayers need to prepare data on the capacity of the installed machines as well as other legal evidence that can be verified and strengthen the argument that the capacity is not full. Internal data is more reliable than external data to make capacity adjustments.

"*Of course, internal data will be better, meaning that in this case capacity adjustment is more about how we can identify and reveal that our capacity adjustment has not yet reached the optimal stage. Of course, you need data, such as the capacity of the machine that has been installed, how many lines are there. If in this dispute we use the investment license permit data to strengthen it, to show the panel of judges that there are indeed figures that serve as benchmarks. But, from the installed machine data it can be calculated, and the document is to strengthen the taxpayer's reasons*." (R5,J7)

Respondents stated some issues related to TP disputes on comparability adjustment and capacity adjustments. First, respondents stated that in the tax audit and objection stage, the tax authorities were usually not easy to accept the adjustments made by the company. This condition can be justified by the absence of regulations or examples in regulations that regulate capacity adjustment.

"*Again, if at the stage of tax audit and objection because the regulation or adoption of TPG which contains adjustments regarding this matter is not contained in the existing regulation, then the possibility of being accepted is small, because we can also understand that tax officers, both at the tax audit and the tax objection level, are rather difficult. to accept it, because on the legal basis in the regulations it is not found.*" (R5,J11)

The factors that can strengthen the taxpayer's argument according to some respondents are related to the right business reasons and the condition of the taxpayer which is supported by strong evidence and quantitative calculations. The taxpayer's argument can also be strengthened by good disclosure in the TP documentation to help explain to the tax authorities or prove when the dispute is in the tax court.

"*Why do we make any (comparability or capacity) adjustments, why are the adjustments needed and how do we make the adjustments. So if it is explained in the TP Doc, it means that there is nothing we want to cover up on the business process.*" (R4,J13)

6. CONCLUSION

The evaluation of comparability adjustment in this study states that in practice there are differences between the regulations and the OECD guidelines and the practice of capacity adjustment. In practice, the comparability adjustments made by the taxpayer are not always acceptable. The most influencing factors include whether there are appropriate commercial reasons, how quantitative calculations are carried out, and supporting evidence regarding the adjustments made.

Specifically, the evaluation related to capacity adjustment to increase comparability is evidence related to the significant decrease in capacity experienced by the company. This can be proven by documents in the form of technical calculations of engine capacity, the investment license permit or the optimal capacity achieved by the company in the previous period.

Regarding the recommendations, this study concludes that regulations in Indonesia need to state in more detail the comparability adjustments that can be made by taxpayers. Regulations need to state the attached case examples to provide education to Taxpayers. To avoid disputes over binding cases, an example of a case can be denied that the case is not binding to be applied in the TP analysis by the audit but depends on the details of the case faced by the taxpayer. In the end, this provides an understanding to the taxpayer how the comparability adjustment can be done and reduces the potential for transfer pricing disputes in the future.

This study limits only a company for the case study. Another limitation is the number of respondents who were interviewed. This research can be developed on several tax court decisions and more respondents from the tax authorities or the judges at the tax court and the supreme court.

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