



## TAX TREATY IMPLEMENTATION ON INTRA-GROUP SERVICES: A NOTE TO TAX TRIBUNAL DECISIONS

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### ABSTRACT

Semakin berkembangnya transaksi lintas negara yang dilakukan oleh perusahaan multinasional menimbulkan konsekuensi atas penerapan harga transfer di antara perusahaan afiliasi yang merupakan bagian dari perusahaan multinasional. Studi ini bertujuan untuk mengeksplorasi pertarungan antara perusahaan multinasional dengan otoritas pajak Indonesia, Direktorat Jenderal Pajak, terkait konsekuensi pajak atas transaksi *intra-group services* sebagaimana tercermin dalam tiga kasus pajak yang dibawa ke Pengadilan Pajak dan telah diputus di tahun 2021 dan 2022. Penelitian ini menggunakan doktrin hukum dalam bentuk studi kasus sebagai metodologi dan menemukan bahwa masih terdapat kurangnya pengetahuan dari pegawai DJP akan kasus transaksi *intra-group services* dalam menerapkan aturan perpajakan domestik dan panduan internasional terkait transaksi *transfer pricing*. Dari perspektif hakim di Pengadilan Pajak, terdapat inkonsistensi dalam penerapan peraturan pajak, terutama terkait beban pembuktian administratif atas penerima manfaat dari transaksi *intra-group services* sesuai dengan pasal yang ada di perjanjian persetujuan penghindaran pajak berganda. Hasil penelitian ini turut berkontribusi dalam memberikan bukti adanya ambiguitas dalam peraturan pajak yang ada di Indonesia yang berakibat pada banyaknya interpretasi yang berbeda akan suatu hal antara petugas pajak, perusahaan multinasional, dan hakim pengadilan pajak.

*The growing trend of cross-border transactions conducted by multinational enterprises sheds new light on the consequences of transfer prices between affiliates among multinationals. This study aims to explore the battle between multinationals and the Indonesian tax authority, Directorate General of Taxes, concerning tax consequences of intra-group service arrangements as stipulated in three tax cases brought to the Indonesian tax court in 2021 and 2022. This study finds uses legal doctrine analysis as the methodology and finds that when scrutinizing the intra-group service transactions among members of multinationals, there was a lack of understanding from the Indonesian tax authority officers in applying the international transfer pricing guidelines and domestic tax regulations. From the tax judges' perspectives, there was an inconsistency in applying tax regulations, mainly dealing with the administrative burden of proof to benefit intra-group service provisions. This study contributes to the literature by establishing analysis that there is ambiguity in the provisions of the Indonesian tax legislation, which led to different interpretations from the tax officers, multinationals, and tax court judges.*

## 1. INTRODUCTION

In the current borderless transactions, global trade comes with consequences in economic development, growth, market integration, and taxation (de Wilde, 2015). Companies operating in different nations have consequences to share income tax from business profits derived from each jurisdiction they are located. This is because multinational corporations distribute tax burdens among foreign subsidiaries and affiliates to minimize the overall worldwide tax burdens; hence, corporate taxes are divided among tax jurisdictions where multinationals are operated (Pavone, 2020; Pieretti & Pulina, 2020). The concern is also driven by the fact that raising tax revenue is a

nation's domestic affair. Thus, there are issues of revenue distribution among countries, equal tax-base sharing, and taxing rights (Kaufman, 1997)

Multinationals are exposed to cross-border transactions between their associated enterprises. This arrangement is likely to be challenged by the tax authority because it is believed that the price charged for transactions under a similar group of multinationals is arranged under their fair market value (Rugman & Eden, 2017). This issue applies not only to the trading of goods but also to the rendering of services, which is found as the area where

multinationals are possible to be audited by the tax authorities (Plesner Rossing & Pearson, 2022).

In the Indonesian context, intra-group services are exposed to many tax disputes between the Indonesian tax authority, Directorate General of Taxes (DGT), and Indonesian taxpayers that eventually were brought to the tax court (Simamora & Hermawan, 2017). And yet, the trend seems to be growing because intra-group transactions relating to services are included as one of DGT's audit priority target lists. Thus, the magnitude of such issues in Indonesia's tax dispute is worth exploring. This paper aims to explore the implementation of domestic tax regulations and international guidelines concerning intra-group services from the perspectives of three cases decided by the Indonesian tax court in 2021 and 2022. All three cases were related to inter-company service fee payments among related enterprises. Tax court decisions are public documents that can be accessed through the official tax court directory and websites<sup>1</sup>. In addition, a framework for dealing with the deductibility of intra-group services, mainly for taxable income calculations, is also presented in this study. The framework provides procedural stages in determining tax deductions for service fees.

## 2. LITERATURE REVIEW

### 2.1. Arm's Length Price for Services

The arm's length price (ALP) stipulates the charge that does not violate open market forces (Eden, 2016, 2019; Eden & Smith, 2001). It means that the price or profit for intra-group transactions would be the same as if the parties were independent, and there is no mispricing on such charges. Thus, the probability of transfer mispricing among associated enterprises can be minimized by setting up the price according to this concept (Avi-Yonah, 2004). However, from the ALP perspective, determining the market price for intra-group services is challenging because services are unique based on the needs of the firms. Even under a similar group, each subsidiary and affiliate may need different services that are not available in the open market.

To address the issue of ALP for services, the Organization for Economic Co-operation and Development (OECD) determines two considerations related to intra-company services (OECD, 2022). According to the OECD Transfer Pricing Guidelines para 7.5, the first concern with service arrangement is whether such services have been rendered. It can be addressed using the concept of the benefits test, which means that such services need to bring economic or commercial benefits for the company to increase or maintain its market shares, boost sales, or reduce costs. However, linking the expected economic benefits within multinationals directly related to intra-group services might not be straightforward due to the complexity of their operations. Moreover, increased sales may not always be related to the services received

from affiliated parties. It needs the examination of the internal documentation justifying the transaction and cost of such services.

The second issue of the application of an ALP in services is determining the proper charge once the benefits tests have been proven. The OECD introduces direct and indirect charges to calculate acceptable prices for intra-group services. Direct charging relies on similar services available to independent parties comparably. On the other hand, indirect charging uses allocation keys such as the number of employees to represent human resource management fees and payroll services, and turnover to capture marketing services. However, the relationship between the price charged, the level of service provided, and the benefits received are difficult to measure and evaluate. Therefore, it might lead to transfer pricing disputes between multinationals and tax authorities due to different judgments on the reasonable basis for the allocation keys and price charged.

From the ALP point of view, market prices for services are seldom to be available as a means for comparability analysis (Wier, 2020). Services are unique for the company's needs; therefore, it is hard to find similar transactions under comparable facts and circumstances in the open market. Furthermore, what constitutes a service is also challenging to define. UNCTAD (2004) has noted this issue in its World Investment Report 2004, stating that it is challenging to come up with a specific description of services. Therefore, the definition of services is open to interpretation.

Moreover, international services transactions are blurred because they cannot be observed directly at the country's borders, unlike the movement of tangible goods transactions (Cooper et al., 2017). Hence, for tax purposes, it would be challenging to tax international services particularly when physical dependence and control are the main concerns of the administrations (IMF, 2011). In addition, dealing with international service transactions is not about the service alone. Another concern is to clearly identify the nature of services and other characteristics that might come with services, such as risk-sharing or risk-bearing.

### 2.2. Transfer Pricing in Indonesia – A Brief Explanation

Conceptually, the Indonesian tax regime incorporates a worldwide income approach, which means that tax payment is required from Indonesian residents for the income earned both from inside and outside Indonesia. Nevertheless, the laws will only apply if the residents meet the criteria under domestic statutes. It also implies that no matter where the sources of income are and how to get them, income is subject to tax for Indonesian taxpayers under certain circumstances. Subsequently, for such income, if received concerning the affiliated party transactions, the Indonesian tax authority may assess such income.

<sup>1</sup>It can be accessed through <https://setpp.kemenkeu.go.id/>.

Moreover, there is also a substance over form principle, which means transactions are essential to determine tax-related obligations instead of the legal form of documents. Furthermore, the substance over form principle is enacted clearly in the Director General of Taxes' circular letter number SE-04/PJ.7/1993 (SE-04) concerning guidance to handle transfer pricing cases states "In relation to the taxpayers' transactions with associated enterprises, this tax regulation stipulates the material principle (substance over form rule)". While the SE-04 has been amended by the circular letter number SE-50/PJ/2013 (SE-50), the basic principle is still relevant to the Indonesian tax system.

Furthermore, in relation to the prevention of tax avoidance practices, the substance over form rule is also stipulated in recently enacted Government Regulation Number 55 of 2022 Article 32 Section (4) which states that:

"In the event of tax avoidance practices [...] Director General of Taxes may reallocate the amount of tax that should be owed according to the principle of recognition of economic substance on top of its formal form".

As for the concept of the arm's length principle, it is stipulated in the Indonesian Income Tax Law Number 7 of 1983 as lastly amended by Law Number 7 of 2021 concerning Harmonization of Tax Regulations which states that:

"Director General of Taxes is authorized to reallocate income and deductions and to determine debt as equity for the computation of taxable income between associated enterprises to assure that the transactions would have been made between independent parties based on the arm's length principle using comparable uncontrolled price method, resale method, cost plus method, and other methods".

The criteria of associated enterprises are assessed based on these conditions:

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

Based on the explanation of specific regulations for the transfer pricing regime in Indonesia, there are pathways to enact tax regulations and adopt the OECD guidelines. The pathways can be described as follows. Firstly, it starts with the first phase, pre-1983, where there were no regulations for ALP and no transfer pricing disputes. Next, the second stage, where the Indonesian government enacted income tax laws in 1983, raised concerns about the arrangements the taxpayers made with their affiliated parties. The tax

authority noticed the arrangement techniques based on the transfer pricing concept. Also, this stage ended in 1993, when DGT stipulated transfer pricing for the first time.

Furthermore, the current development of transfer pricing regulations in Indonesia emerged with the enactment of the new regulations. The first one would be the Minister of Finance regulation number 172 of 2023 regarding the implementation of the ALP for associated transactions. Another regulation is Director General of Taxes regulation number PER-25/PJ/2018 concerning the implementation of the agreement on double taxation avoidance. While these two regulations may not be relevant to the cases explored in this study, their presence is worth mentioning that there is substantial development of transfer pricing and tax treaty regulations in Indonesia.

### 2.3. Research on Intra-group Services

With the growing scrutinization of intra-group service transactions, the tax dispute between DGT and the taxpayers is also increasing. According to (Simamora & Hermawan, 2017), most transfer pricing cases around intra-group services derived from the lack of supporting documents to provide the existence and benefit tests and to determine the arm's length price. This study provides interesting result in which most of cases around intra-group services were favourable for the taxpayers. Hence, there should be a comprehensive approach taken by DGT to scrutinize this issue.

Moreover, this trend aligns with the concern from the OECD that there are two main issues in intra-group services: whether a service was actually rendered and the compliance of the service pricing with the arm's length principle (Taborda et al., 2020). In addition, according to Nofita & Nuryanah (2022), the minimise dispute around intra-group services, it is critical to provide detail information on how to test benefit from services received by the Indonesian taxpayers. Also, a confirmation from DGT on how to define the concept of economic benefits is important issue to address.

On another note, Sihombing (2016) argued that one of the reasons for transfer pricing cases around intra-group services was the presence of different legal interpretation on transfer pricing regulations. As such, not only inter-group services are dealing with technical stream on the benefit and existence tests but also on legal interpretation. This could be the outcome of the broad definition around intra-group services in Indonesia's transfer pricing provisions (Wardhana, 2019).

From above explorations, this study aims to fill the knowledge gap by analysing the intra-group service cases regarding the formal requirement of documentation, as stipulated in the tax treaty. This is because to get the treaty benefit the taxpayers need to submit a document stipulating the residence of competing parties related to intra-group service payment.

**2.4. Tax Treaties and Domestic Tax Laws: A Harmonization Rule**

Tax treaties are the DNA of international tax regimes which stipulate the agreements or conventions between tax jurisdictions and confer the rights and obligations of such jurisdictions (refer as contracting states) (Arnold, 2013). There are two routes in which the taxpayers can get the treaty benefits. The first one is a self-executing regime which means the treaties can be applied directly once they are signed by contracting states. Another approach requires an additional stage to incorporate treaty provisions into domestic tax regulations in order for the taxpayers in contracting states to get the treaty benefits.

Indonesian tax system confirms the application of tax treaty after the provision is enacted in domestic legislations. This concept is accommodated in PER-25/PJ/2018 concerning procedures for the application of a double taxation avoidance agreement. According to this regulation, in order for foreign taxpayers to benefit from the tax treaty between Indonesia and contracting states, they need to fulfil the requirement, as regulated in the provision. As such, there is self-executing determination to apply the treaties.

The legal status of the tax treaty can be seen as a customary law to harden the concept of a soft law issued by the OECD and the UN (West, 2017). Also, the tax treaty is on the continuum of the hard law ties the corresponding states and should be used for certain tax policy goals (Christians, 2007). Theoretically, tax treaty and domestic tax laws are designed to work in harmony (Han, 2011). The treaty is arranged to protect the national interest, to support revenue, and to grow business and trade relations. Therefore, it is critical to understand the issue around the harmonization between the tax treaty and domestic legislation, as this study intends to apply.

**3. RESEARCH METHODOLOGY**

In a broad sense of the research community, this study is regarded as legal research because it is concerned with interpreting the law and legal decisions. According to Barkan et al. (2015, p.1), legal research refers to all phases of a procedure that ranges from the examination of the facts of a situation through the implementation and dissemination of the findings of the investigation.

Essentially, legal research relates to identifying and finding the laws which may appear in the codes, statutes, and court opinions and applying them in the cases observed (Trubek, 1984) and supporting legal decision-making (LexisNexis, 2021). The coded laws are known as law-on-the-books, and the application of such laws is named law-in-action.

In addition, from the perspective of social science research, legal research is one of the branches of the multidisciplinary aspect of social science along with the disciplines of sociology, economics, statistics, psychology, and anthropology (McCrudden, 2006).

Also, it presents the interpretivism approach, which involves the interrogation of the authoritative legal proposition and tries to explain the laws conceptually and practically. Thus, as Varuhas (2022) states, “interpretivism is the highest form of doctrinal method”. Also, legal research and interpretative social science aim to engage in the same endeavor; to exercise interpretation (Murphy 2004).

Next, this study incorporates the legal case study as a research method. Saunders et al. (2009, p.4) stipulate research methods as the methods and tools used to collect and analyze data. It includes both quantitative and qualitative analyses. Further, case studies are generally used to examine contemporary phenomena of a single or limited number of instances within real-life (Yin 1981; Yin 2012). Such studies aim to improve existing social theories (Babbie, 2020). As such, case studies in legal research address questions related to the legal phenomenon of a case or multiple cases (Miller, 2018).

In this study, legal tax case analysis is more qualitative and tries to explain the phenomenon of tax base erosion in Indonesia, particularly in intra-group services disputes between MNCs and DGT. Also, the legal reasoning in this research is on the continuum of deductive rather than inductive because general rules and legislations on the tax base erosion are posed (Hutchinson & Duncan, 2012; Webley, 2010). Later, such laws are examined in the tax cases observed in this study.

Moreover, this research incorporates legal case studies relating to tax case law, such as how Indonesian tax judges interpret the tax laws and OECD or UN guidelines on transfer pricing and tax treaty in relation to intra-group service arrangements. Case law refers to using cases to interpret statutes, conduct legal analysis, and how judges apply the law (Hsieh, 2012; Levi, 1948). In the context of this research, case law is used in how legal reasoning is applied in tax cases, which has already been explored in other studies (Franklin & Myers, 2016; Padhi & Bal, 2015; Pinto & Sadiq, 2016).

Moreover, the elements of the brief in each case will be analyzed using a case brief framework by Makdisi and Makdisi (2009), which consists of four elements, as shown in Table 1.

**Table 1.** Elements of a Case Brief

Elements	Description
Facts	Case name and parties, facts and proceedings, and the verdict
Issues	what kind of tax issues
Holding	Laws governing taxation in the issues
Rationale	Defining the reasoning behind a decision or holding

**Source:** How to write a case brief for law school: Excerpt reproduced from *Introduction to the Study of Law: Cases and Materials* (Makdisi and Makdisi 2009)

## 4. RESULTS AND FINDINGS

### 4.1. Determination of the Cases

This study aims to incorporate three tax cases related to intra-group services resolved in the Indonesian tax court in 2021 and 2022 using a case brief framework. Further, cases are derived from the tax court website that is open to the public to access according to the Indonesian Public Information Disclosure Act number 14 of 2008. Under such an Act article 14, tax cases are considered legal matters open as public information. Hence, the Indonesian tax court provides court decisions on its websites and is available to download for the public (Wardhana, 2019).

Moreover, the research examines only tax cases that are contested in tax courts; it does not address judicial review cases before the Indonesian Supreme Court. The reason is that taxpayers can challenge DGT's findings about the objection result of the tax notice at the Indonesian tax court. Also, it has procedural law and the power to investigate such problems (Isipriyarso et al., 2021). The cases are selected based on the author's exploration of the tax court decision directories as follows:

1. Filter the decision that contains Article 26 and Article 25 of the income tax laws because these two taxes are related to issues explored in this study.
2. Select the decisions that were resolved in the years 2021 and 2022.
3. Pool the cases contain intra-group service transactions because Article 26 and Article 25 might also be connected to other arrangements such as royalty, dividend, and interest payments.
4. Choose the cases having transactions with related entities outside Indonesia because intra-group services could also be arranged with domestic affiliated companies and independent parties.

Finally, after reading the chosen cases, the author decided to use three relevant issues for this study (HSBC, Honda, and Shangri-La cases). Additionally, in the case of the tax court's findings are consisted of intra-group and other transactions, the analysis in this study would be more focused on the intra-group services.

### 4.2. Analysis of the Cases

#### 4.2.1. HSBC Case

##### a) Facts:

In November 2017, Bank HSBC Indonesia (HSBC), an Indonesian corporate taxpayer registered in Large Taxpayer Office One (LTO 1), paid a global service fee to its related party, HSBC Global Services Ltd (HSBC Ltd). The amount paid from HSBC to HSBC Ltd was Rp139.201.210.

The Indonesian tax authority, DGT, imposed a 20 percent withholding tax with some additional penalties for such transactions under domestic tax regulations. According to DGT, HSBC failed to submit the Certificate of Domicile (COD) on its November 2017 Article 26 income tax return. COD is needed to claim the treaty

benefits of Indonesia and the UK and prove that HSBD Ltd is a UK resident.

Thus, because no substantiation showed HSBC Ltd is a UK resident for tax purposes, HSBC needs to withhold income tax for its service fee payment to HSBC Ltd. On the other hand, HSBC disagrees with DGT and argues that the tax treaty prevails over domestic tax rules according to the principle of "*lex specialis derogat legi generali*". This means that specific laws take precedence over general laws. Tax treaties take precedence over domestic tax laws applicable at the time of their implementation. Tax treaties are equal to special statutes (*lex specialis*) compared to general domestic tax legislations (*lex generalis*).

As such, according to HSBC, the service fee is aligned with the natural business process of HSBC Ltd and is considered as business profits. Thus, according to Article 7 of the Indonesia – UK treaties, the profits shall be taxable only in the UK except if there is a permanent establishment (PE) in Indonesia. So, HSBC concluded that DGT has no right to withhold income tax from such fees because PE was not an issue in this case.

Furthermore, concerning COD, HSBC showed such a document during the audit and objection processes. According to the COD issued by the HMRC, a UK tax authority, HSBC Ltd is a UK resident; therefore, it could claim treaty benefits. The fact that HSBC did not attach COD on its November 2017 Article 26 tax return, as DGT stipulated, could not be used as a basis to withhold tax due to the *lex specialis* meaning of the tax treaty. Also, Indonesia adopts a substance over form rule in its tax system, which means that the substance of transactions is more important than the formality of substantiation.

The judgment: judges affirmed the appeal of HSBC.

##### b) Issues:

Can HSBC claim a treaty benefit for intra-group service payment to its affiliated enterprise, HSBD Ltd, a UK resident, under Indonesia – UK tax treaty even though HSBC failed to submit COD on its Article 26 income tax return?

##### c) Holding

In accordance with the tax court decision, relevant tax regulations for this case are:

1. Article 26 concerning 20 percent rates of withholding by the party obliged to pay the remunerations in connection with services.
2. Article 32A concerning the government's authorization to establish and/or implement treaties and/or agreements with the governments of other jurisdictions.
3. Articles 1, 7, and 25 of the Indonesia – UK tax agreement.
4. Article 24 (1) of government regulation number 94 in 2010 concerning Certificate of Domicile as evidence of approval to claim treaty benefits.

##### d) Rationale

During the trial, HSBC claimed that they had submitted documents regarding the dispute, such as the DGT-1 form, COD, and an invoice for intra-group service from HSBC Ltd. The tax court judges agreed with HSBC that even though the HMRC's COD was not reported on HSBC's Article 26 tax return, it does not diminish the right to get benefits from Indonesia – UK treaties. In addition, during the trials, HSBC showed such documents along with the DGT-1, which HMRC authorizes.

According to the judges, if DGT officials suspect HSBC Ltd is not a UK resident, they can use an instrument of Exchange of Information (EOI). DGT may ask for such information formally from the HMRC according to the Tax Information Exchange Agreements (TIEAs).

Nevertheless, such procedures to look for the truth of the residency status of HSBC Ltd were failed to address by DGT. As such, the judges, according to their beliefs and substantiations during the trials, decided that HSBC Ltd is a UK resident; therefore, intra-group service fees paid from HSBC to HSBC Ltd are subject to the Indonesia – UK tax treaty. DGT should consider such transactions as income from the normal course of business and are subject to tax in the UK. In conclusion, DGT has no right to withhold any income tax from HSBC Ltd.

#### 4.2.2. Honda Case

##### a) Facts:

The issue in the Honda case is similar to HSBC regarding the administrative burden to obtain treaty benefits. However, the timeline is different; as such, consistency in judgment is critical to explore.

In April 2016, Honda Lock Indonesia (Honda) paid technical support and assistance service fees to its affiliated party Honda Lock Manufacturing Co Ltd (Honda Ltd), a company registered in Japan. The amount paid was Rp566.741.700. Similar to the HSBC case, Honda did not submit the Certificate of Domicile (COD) on its April 2016 Article 26 income tax return. Both HSBC and Honda cases stipulated taxpayers' interpretation of tax regulations that submitting COD in the Article 26 IITL was not compulsory to prove residency status because such regulations were not addressed in the tax treaty provisions.

Hence, DGT imposed a 20 percent withholding tax with additional tax fines. Honda argued that they provided the COD issued by the Japanese tax authority during the objection and trial processes; therefore, the taxing rights for such services belong to Japan. This argument was based on Article 7 (1) Indonesia – Japan tax treaty, which stipulated that services are taxable in Japan. Honda argued that the *lex specialis* approach of treaties prevails formal submission of COD on the tax return.

The tax court's judgment: the judges affirmed the decision by DGT with an adjustment. They stipulated that Honda Ltd was Japan resident according to the COD. Nevertheless, payment from Honda to Honda Ltd could not be considered a technical service fee; instead,

it was a form of royalty payment. Hence, according to the Indonesia – Japan treaties, Honda should withhold a ten percent income tax on such amounts.

##### b) Issues:

Do technical support and assistance service fees from Honda to Honda Ltd subject to a twenty percent withholding income tax according to Article 26?

##### c) Holding:

According to the tax court, the relevant tax regulations for this case are:

1. Article 26 concerning 20 percent rates of withholding by the party obliged to pay the remunerations in connection with services.
2. Article 32A concerning the implementation of treaties.
3. Articles 1, 4 (1), 7 (1), and 12 of the Indonesia – Japan tax agreement.
4. Articles 1 (10) and 55 of government regulation number 74 released in 2011 concerning the obligation to obey the treaty agreement for the Indonesian government.
5. Article 24 (1) of government regulation number 94 in 2010 concerning Certificate of Domicile as evidence of approval to claim treaty benefits.
6. Articles 2 and 3 of tax regulations number PER-24/PJ/2010 concerning the administrative requirement to apply avoidance of double taxation agreement is the presence of COD.

##### d) Rationale:

The judges decided that domestic tax regulations did not rule out the exercise of the agreement for residents of treaty partners, which is proven by the COD. The burden of proof of such documents is in the hand of the Indonesian taxpayer, Honda. As such, during the objection process, Honda submitted COD signed by the Japanese tax authority to DGT. For this reason, the judges believed that Honda Ltd was a Japanese resident. Therefore, treaty provisions could be applied.

In connection with the nature of transactions, the judges explored the Technical Assistance Agreement between Honda and Honda Ltd. The judges believed such agreements showed the spirit of licensee agreement rather than technical services to some extent. Licensor (Honda Ltd) provides information and technical assistance to the Licensee (Honda), and Honda needs to exploit the intangible property provided by Honda Ltd. For this arrangement, Honda shall pay Honda Ltd a royalty of 2 percent of the total sales each year.

According to Article 12 of Indonesia – Japan treaties, royalty costs of Indonesian taxpayers that are paid to Japan's citizens are taxed in Indonesia. The rate of such payments is a maximum of 10 percent. Therefore, tax court judges decided that payment from Honda to Honda Ltd substantially was not technical support and assistance service fees; instead, it was a form of royalty payment. In conclusion, DGT's adjustments on such fees were affirmed, but with a 10

percent royalty withholding tax according to the Indonesia – Japan tax treaty.

In this case, the judges expanded the interpretation of treaties and agreements between parties (Honda and Honda Ltd), which initially did not address by the DGT's tax auditor and the taxpayer (Honda).

#### 4.2.3. Shangri-La Case

##### a) Facts:

Swadharma Kerry Satya (PT SKS) has the right to use, operate, and manage the Shangri-La Hotel Jakarta based on the license agreement signed on 30 December 1993 and amended on 24 April 2014. The agreement is between PT SKS and Shangri-La International Management Limited, located on British Virgin Island (SLIM BVI). Hence, SLIM BVI is the owner of the "Shangri-La" brand. Subsequently, SLIM BVI gives the rights of exploiting the "Shangri-La" brand to Shangri-La International Management BV (SLIM BV), registered in the Netherlands. SLIM BVI and SLIM BV are wholly owned subsidiaries of Shangri-La Asia Limited, incorporated in Bermuda.

In 2016, PT SKS paid marketing, communication, and reservation fees to SLIM BV amounted to Rp17.538.805.886,00 based on the Reservation and Marketing Consultation Agreement between PT SKS and SLIM BV signed on 30 December 1993. The payment was for marketing, communication, and reservation services conducted by SLIM BV to PT SKS regarding the Shangri-La Hotel Jakarta customer reservations. The fees paid to SLIM BV depend on 3,25 percent of yearly gross sales or USD 350,000, which one is greater.

DGT argued that SLIM BV is a conduit company for some reasons. Firstly, it has only one employee based on the search from [www.bloomberg.com](http://www.bloomberg.com) and [www.graydongon.com](http://www.graydongon.com). Second, according to the 2016 Shangri-La Asia Limited annual report on page 212, the nature of the business of SLIM BV is not a marketing business; instead, it is only for utilizing the brand of Shangri-La. Last, according to the ORBIS database, SLIM BV has only two directors; one of them also served as a director in Shangri-La Asia Ltd. Also, PT SKS could not provide documents concerning the realization of marketing activities conducted by SLIM BV as stipulated in the agreement.

Therefore, DGT concluded that marketing fees payment from PT SKS to SLIM BV was not a deductible expense for tax purposes. DGT believed such marketing activities do not exist due to SLIM BV acting as a conduit company, and PT SKS failed to prove the benefits test of such intra-group services. As such, DGT adjusted the marketing fees as non-deductible expenses. In contrast, PT SKS challenged DGT's conclusion and asserted that PT SKS used marketing services provided by SLIM BV. In this case, one of such service was PT SKS incorporated a hotel reservation system developed by SLIM BV, so 90 percent of customers' reservations were made through such systems and only 10 percent through an online travel

agent. Hence, according to PT SKS, the benefits test of the marketing services can be proven.

The tax court's judgment: the judges affirmed the appeal of PT SKS.

##### b) Issues:

Do marketing, communication, and reservation service fees paid from PT SKS to SLIM BV constitute deductible expenses?

##### c) Holding:

According to the tax court, the relevant tax regulations for this case are:

1. Article 6 (1) concerning deductible expenses.
2. Article 9 (1) concerning non-deductible expenses.
3. Articles 18 (3) and 18 (4) concerning ALP for inter-company transactions and the criteria of associated enterprises.
4. Article 1, 28(3), 28(4), 28(5), and 28(11) General Provisions and Tax Procedures Law (GPTPL) concerning the bookkeeping requirements.
5. Article 12(1), 12(2), and 12(3) GPTPL concerning tax assessment.
6. Regulation number 74/2011 concerning taxpayers' obligation to retain books or documents for intra-group transactions.

##### d) Rationale:

According to tax court judges, DGT's argument that SLIM BV was a conduit company based on the search from websites and commercial databases was flawed. Such sources were unreliable evidence that SLIM BV acted as a special purpose entity. Instead, DGT could benefit from the bilateral mechanism of EOI to prove their arguments, which they did not conduct. The judges concluded that DGT's proposition that PT SKS exercises treaty abuse was backed by minimum efforts to sustain such statements.

In addition, the judges also considered that PT SKS withheld Article 26 income tax concerning such payments according to the Indonesia – Netherlands tax treaties. Further, during the trials, PT SKS showed the transfer pricing document (TP Doc) in relation to intra-group transactions. The document described that the marketing fees paid by PT SKS to SLIM BV are within ALP. In conclusion, such expenses are deductible for tax purposes.

## 4.3. Discussions

### 4.3.1. Law on the books and law in action

In the HSBC and Honda cases, which share a similar concern of the administrative burden to get the benefits of tax treaty provisions regarding intercompany services, the summary of the tax laws incorporated by DGT and tax court is presented in Table 2.

According to Table 2, one critical concern is that DGT ignores the authoritative legislation (law-on-the-book) concerning the rights of the Indonesian government to build mutual agreements with other jurisdictions as stipulated by government regulations,

which is relevant to the issues of treaty benefits regarding COD criteria. This information is derived directly from tax court decision documents regarding these two cases. A tax treaty is a specialized law written and agreed upon between two competent authorities that must be put first when dealing with taxing rights under an international tax regime (Vogel, 2006). As such, it shall be stipulated by DGT as a legal basis to adjust taxpayers' arrangements if taxing rights issues are addressed.

**Table 2.** The authoritative legislation under HSBC and Honda cases

Statutes	DGT	Tax Court (HSBC case)	Tax Court (Honda case)
Article 26 income tax laws	√	√	√
Article 32A income tax laws	X	√	√
Tax treaty	X	√	√
Government regulation number 74 of 2011	X	X	√
Government regulation number 94 of 2010	X	√	√
PER-61/PJ/2009 as amended by PER-24/PJ/2010	√	X	√

√ means the statutes have been incorporated in the decision, while X signs the opposite. For DGT, the regulations are shown in the audit and objection reports, and for tax court, they are presented in the ruling decisions.

Further, the omission of treaty legal bases shows that DGT officials, mainly the tax auditors, are not well-informed about international tax issues and lack of technical capacity on how to interpret tax treaties. As such, DGT needs to strengthen the capacity of its officials to handle contentious administrative and judicial aspects of the tax administration (Esteban, 2021).

The challenges of DGT to protect its tax bases for cross-border services are linked with legislation issues, as mainly addressed in many developing nations (McNair et al., 2010). From this view, it can be concluded that legislation and administrative procedures concerning intercompany services, specifically in addressing treaty benefits of such transactions, should be continuously reviewed. Also, DGT needs to regularly increase the effectiveness of treaties' implementation and understanding from its tax officers because interpretation matters in the application of tax treaties. Thus, the absence of rules

regarding treaty provisions in the HSBC and Honda cases shows a lack of understanding by DGT's officers of international tax regimes.

Furthermore, from the tax court perspective, there is an inconsistency in applying government regulation number 74/2011 and tax regulation number PER-24/PJ/2010. In the HSBC case, which was resolved in 2022, the judges did not incorporate such legislation. While in previous disputes of the Honda case, the judges completely corroborated the statutes. The two rules are essential in explaining the administrative requirement of COD to benefit the treaty for intra-group services. Indonesia follows civil law mechanism which judges need to interpret and apply a body of statutes and administrative regulations (Anderlini et al., 2020). Hence, in general, court decision is more inconsistent under civil law due to different judge's interpretation of regulations.

In addition, despite judges having their perspective according to the law in deciding the cases, such consistency would bring legal certainty for the taxpayers and DGT when dealing with the same issues in the future. Thus, the inconsistency problem does not appear only in the tax court's decisions, but also in applying legal bases to support the conclusions. Also, there should be a similar interpretation of the written and action laws concerning COD, treaty provisions, taxing rights, and withholding aspects of intra-group service transactions. Hence, laws on the books will be equally implemented in practice.

Next, in the Honda case, tax court judges expanded the elucidation of the tax laws by re-classifying the kind of transactions conducted between Honda and Honda Ltd from services to royalty payments. The judges, according to the facts and circumstances during the trials, concluded that substantially Honda paid a royalty, instead of service, to its associated enterprise, Honda Ltd. This argument was based on the legal bases cited by judges in the decisions, Article 26 and the Indonesia - Japan tax treaty, and provisions under a formal agreement between Honda and Honda Ltd.

The judges mainly referred to the written agreement between parties to support the definition and calculation of the royalty paid from Honda to Honda Ltd and did not address domestic tax laws in the decision. The definition of royalty appears in the elucidation of Article 4(1)(h) domestic tax laws, which describes royalty as:

"An amount paid or payable in any means or calculation, whether periodically or not, in return for the use of rights over tangible and intangible property, intellectual property, industrial rights, and transfer of knowledge and information in the field of scientific, technical, industrial, or commercial".

This definition serves as authoritative legislation for the taxing rights of royalty under the Indonesian tax regime and, to some degree, aligns with the meaning stipulated in the OECD Commentaries on the Articles of the Model Tax Convention (OECD, 2010). While this

definition is defined in statutes, the judges in the Honda case did not corroborate it as a legal basis.

As such, in this case, the law in the book is not strictly enforced and differs from the law in action. This is apparently showing a slight lack of capacity and understanding of tax provisions among Indonesian tax court judges. While the HSBC and Honda cases dealt with an administrative issue of the withholding tax of intra-group service payment, the Shangri-La case was concerned with the deduction aspects of such fees.

In the Shangri-La case, from the perspective of the written laws, one critical aspect worth noting was the absence of authoritative legislation of Articles 18(3) and 18(4) from the DGT lens. Article 18(3) serves as DGT's authorization to apply methods for transfer pricing arrangements in the intercompany scenario, and 18(4) defines related enterprises criteria. However, such rules were omitted as legal bases according to DGT's official audit report.

Additionally, there was no description of the use of such legislation by DGT auditors based on tax court decisions. It shows the need for capacity-building improvement for Indonesian tax officers, mainly those dealing with audits, to properly understand and apply the legislation hierarchy. Building capacity for the tax agencies is essential, not only in relation to the tax administrations but also in the judiciary and legal framework, as any challenged tax issue would end up in the courts.

Furthermore, on the tax judges' side, there was inconsistency with the law on the books regarding the requirement for EOI and the ALP charge for services in the case. For EOI, the judges concluded that DGT failed to prove that SLIM BV was a pass-through entity. In addition, the judges mentioned that DGT officers did not use their authoritative rights to conduct EOI with the Netherlands to explore information related to SLIM BV. However, in the Indonesian tax system, no single tax regulation obliges tax auditors or examiners to explore taxpayers' information using the EOI mechanism.

According to regulation 125/PMK.010/2015 concerning exchange of information procedures, EOI is used when there is a strong allegation that the audited taxpayers intentionally avoid and evade the tax payment or abuse the tax treaty benefits. Another criterion is that such information cannot be observed from Indonesia and only be derived from the partner country or jurisdiction. In the Shangri-La case, DGT stipulated the conclusion based on the trusted commercial data, audited financial statement, invoice, and COD signed by the director of SLIM BV. All these documents can be explored without the need to conduct EOI. Therefore, the laws did not support the judge's conclusion that DGT needed to assign the EOI formally.

Next, the regulations for ALP prices for intra-group services were absent in the tax judge's ruling. The judges disagreed with DGT and concluded that PT SKS received benefits from the assistance given by SLIM BV in the form of marketing services to support

the sales of PT SKS. Moreover, the price charged by SLIM BV was under the ALP approach.

This conclusion is aligned with the procedures dealing with intra-group services, in which, after considering that services have been rendered and benefits are received, the next step is determining whether the price or charge is following the ALP. However, the judges did not mention the domestic Indonesian rules to support such claims and decisions. Instead, they mainly relied on the transfer pricing document (TP doc) that PT SKS showed during the trials. TP doc is not a form of legislation; it refers to the transfer pricing policy through price-setting presented to the tax institutions that sets out taxpayers' compliance (Hemling et al., 2022).

In fact, under the Indonesian tax regime, the need to incorporate ALP for intra-group service after determining the benefits test is stipulated in letter number SE-50 of 2013 concerning technical guidance for associated enterprises. According to this regulation, steps that need to be taken in dealing with intra-group services are: (1) determine the benefits tests, and (2) calculate the ALP charge of such services. This regulation is an authoritative rule for assessing the ALP in the intra-group service transaction that the tax court judges omitted to corroborate in the Shangri-La case.

#### 4.3.2. Intragroup Services: Redrafting Regulations

From the HSBC, Honda, and Shangri-La cases, two aspects need to address concerning intercompany services: withholding and deductibility. From a withholding perspective, as a lower-middle income country, under the current World Bank country classification, Indonesia needs to protect its tax bases and receive a fair share of tax revenue. However, under most treaty provisions, intercompany services are considered business profits; therefore, the taxing rights are on the treaty partners.

The Indonesian tax authority, DGT, could only impose withholding tax if the Indonesian taxpayers failed to submit the COD of the competing entity or in the existence of a permanent establishment. This concern raises the issue of administrative and formal burdens, leading to the dispute between DGT and taxpayers, as in the HSBC and Honda cases, in which DGT failed to uphold its position regarding the legal requirements of COD.

Additionally, tax treaties have a higher hierarchy compared to domestic tax laws. Hence, the only way to preserve the withholding taxing right is to renegotiate the tax treaty provisions. It is essential to allow such payment for services of any kind, including consultancy services arising in Indonesia, which may also be taxed in Indonesia with an agreed charge tax rate. As Indonesian taxpayers mainly act as recipients of the intra-group services from their associated enterprises, the treaty provisions are far from fostering the interest of Indonesia by not permitting withholding income tax from such services.

The provider of intra-group services mostly comes from high-income or industrialized countries

with the capacity and resources to render technical, management, marketing, and other intra-group services. In this study, the provider comes from the UK (HSBC case), Japan (Honda case), and the Netherlands (Shangri-la case).

Renegotiating the treaty provisions regarding Indonesia's taxing right to withhold income tax from intra-group services is an act to share the tax revenue. As most of the world's bilateral tax treaties mainly consisted of agreements between low and high-income nations, developing countries, such as Indonesia, have a less desirable negotiating position. It can be reflected in treaty provisions, which may result in the imbalance sharing of tax revenue. Renegotiation process can be addressed using Multilateral Convention to Implement Tax Treaty Related Measures to Prevent Base Erosion and Profit shifting (MLI) between Indonesia and other countries. Coordination, harmonization, and inclusiveness through MLI regarding intra-group services must be addressed equally to develop effective solution and interest among countries (Livio Gomes, 2019)

In the intra-group service cases, Indonesia might lose tax revenue because payment for services might be subject to a deduction in the income tax calculation for the Indonesian taxpayers and, at the same time, free from withholding requirements. Hence, renegotiations are critical in aligning views of contracting countries sharing the tax revenue (Bruggen, 2002) and reducing the opportunity for companies to avoid paying taxes. If it is accepted that Indonesia reserves the right to withhold tax from services, several factors must be addressed in setting the withholding rate (Brooks, 2007).

- 1) The applicable rate should be moderate, so it will not discourage service arrangements, mainly for services directly related to revenue generation, as in the Shangri-La case. Based on tax treaties between Indonesia and Switzerland, Germany, India, Luxembourg, and Venezuela, a 5 percent – 10 percent withholding tax for intra-group services would suffice.
- 2) The rate should be set to a standard that minimizes another attempt to categorize other forms of payment as a service to avoid taxes. For example, in the Honda case, the service fee is a form of royalty payment. Thus, the percentage for intra-group service might be set similarly to other withholding tax rates in payment of royalty, dividends, and interest.

Furthermore, concerning the deductibility aspect of intra-group service fees, many tax authorities may allow a deduction for such expenses to calculate taxable income if the expenses are paid exclusively for the business purposes of the taxpayer. However, while DGT has adopted the benefits test and determination of ALP price for intra-group service in its domestic tax regulations, there is not yet precise regulation on what documents need to prepare by the taxpayers regarding their intra-group service arrangements. Under current tax regulations, such as PMK-172 of 2023, PER-

32/PJ/2011, and SE-50/PJ/2013, DGT mentions that concerning service arrangements between related parties, the tax officers must review the agreement of such services and invoice. As such, there is no clear information or explicit comment on what specific documentation is necessary and the nuances of documenting taxpayers' intra-group services for transfer pricing purposes. In addition, under PMK 172 of 2023, a preliminary analysis for intra-group service transactions should be conducted beforehand to analyze the existence and benefit of such services. However, there is no further explanation on what kind of documentation or substantiation needed to prove intra-group services.

Therefore, detailed exploration of documents needed as proof of services are critical. Such documents are not exhaustive according to taxpayer's business process. The example of these documents could be business communication through mail and email, breakdowns of outgoing calls, signed document of a meeting, lists of service activities, service notes and certificates, reports describing service rendered by the parties provide such services, material for meetings, printed document directly from the systems, a printout of electronics schedule showing date and time of service activities, printouts of the deliverables of such services, and a list of associated enterprises' and taxpayers' employees contributed to such service arrangements.

Based on the concern about documentation, DGT needs to address this issue in domestic tax regulations. In addition, most DGT adjustment regarding intra-group service is due to insufficient supporting evidence by the taxpayers. Nevertheless, this is not merely the taxpayers' fault, nor they are not well informed, but because such regulations do not yet exist in the Indonesian tax regime. A uniform approach in the evidence-based formation for intra-group service documentation is essential as tax control measures due to the increasing number of disputes between DGT and the taxpayers regarding such services.

Another concept that has not yet been regulated in the Indonesian tax system is the low value-adding services (LVAS) and safe harbour concepts. The services that qualify as LVAS are supporting functions, do not fall under the main businesses of multinational corporations, do not create valuable and unique assets, and have no significant risks for the service provider within the multinational enterprises' group. Examples of LVAS are accounting and auditing services, credit control checking, assistance in financial audits, human resources activities, legal services, public relations support, the information system support.

Furthermore, in the early development of a new concept of LVAS, domestic tax regulations may follow the simplified charge mechanism, namely the safe harbour rule. The safe harbour objective is to simplify taxpayers' obligations and provide certainty under domestic transfer pricing regulations. The rule, to some extent, allows taxpayers to get the exemption from detailed scrutiny by following simple guidelines

(Chugan, 2014). The enactment of safe harbour concept in domestic tax regulations may also promote Indonesia as a service-hub location, and thus, attract more multinationals to invest their money in Indonesia.

## 5. CONCLUSIONS

It is believed that service transactions under the same group is one of the most explored and celebrated areas of transfer pricing that tax authorities seek to assess (Rossing & Rohde, 2010, 2014). This trend is also increasing in the Indonesian tax system (Simamora & Hermawan, 2017). Also, in Indonesia, intercompany services are possibly challenged by DGT and end up in the litigation process in the tax court. However, intra-group services have not been researched intensively, mainly from a legal case law perspective. Hence, this dissertation develops further exploration of this area.

The results indicate that from the three cases explored, DGT's officers need an intensive capacity improvement around the regulation regarding intra-group services, mainly dealing with the interpretation of treaties and understanding the tax laws' spirit enacted in Indonesia. For example, while it is relevant and essential, the tax treaty is not corroborated as a legal basis in HSBC and Honda cases. According to the *lex specialis* nature of the tax treaty, it should be stipulated as one of the authoritative legislations when dealing with cross-border transactions and taxing rights between Indonesian taxpayers and their counterparties. Yet, treaty provisions are not stipulated in HSBC and Honda cases.

In addition, Article 18 (3) and 18 (4) domestic tax laws as the authoritative legislation when dealing with associated enterprises were omitted in the Shangri-La case. On the other hand, despite having the right to interpret laws, there was inconsistency among the tax court judges, specifically in the HSBC and Honda cases, concerning the administrative requirement of COD to benefit the treaty for intra-group services. Furthermore, in the Honda case, the judges omitted domestic regulation regarding the definition of royalty.

The omittance of domestic tax regulations was also happened in the Shangri-La case, in which the tax court judges do not explore such rules to stipulate the ALP concept for the intra-group services. Hence, the inconsistency in applying tax regulations concerns subjectivity and different treatment in deciding what type of laws the judges use as a source of their decisions. Also, it may raise an issue of legal uncertainty in the Indonesian tax dispute regime. As such, it is recommended to harmonize the tax regulations and judges' interpretation to provide certainty and synchronization among tax courts.

To overcome the issues around intra-group services, particularly dealing with the international tax regime and its applications, increasing human resources' capacity is critical, both in the Indonesian tax authority and tax court. There should be basic training and regular training on international taxation

for the tax auditor, account representative; tax objection/appeal reviewer. By doing so, international tax issue will be circulated in every level of tax officer. Also, regular meetings among judges to broaden their point of view on similar cases are critical to address.

As such, raising awareness of international tax concepts and cross-border transactions are urgent development for DGT to combat tax base erosion behaviour by multinational enterprises. Also, the tax court needs to deepen the judges' understanding to concur with their opinions and decisions in providing legal tax certainty in Indonesian tax dispute resolutions.

## 6. LIMITATIONS AND IMPLICATIONS

The limitations of this study are acknowledged. Firstly, this study explores only three cases to generalize the legal case law approach. The number of case studies might not sufficiently capture the growing concern of intra-group service disputes in Indonesia. Secondly, due to time constraints and ethical bureaucracy in DGT and the tax court, the study only uses documentary analysis of the cases without further exploring the implementation of law in action in DGT and tax court. Lastly, despite the timeliness of cases resolved in 2021 and 2022, the period could be extended to the cases ruled in a couple of years, not only 2021 and 2022, to capture better the inconsistency in applying tax regulations.

Next, there are suggestions for future studies. Researchers can elaborate on other qualitative methods such as interviews and focus groups to investigate and explore the written laws' implementation concerning intra-group services in Indonesia. The methods can be done by interviewing DGT officers, auditors, and tax court judges. Also, a future study can give more detail on the safe harbour rule proposal to the Indonesian tax system regarding intra-group services. Another suggestion is the comparison analysis between Indonesia and other countries in addressing intra-group services to draw detailed attention to Indonesia's tax regulations compared to other tax jurisdictions.

To conclude, as business and cross-border transactions grow, tax system is also evolving. Hence, legislative arrangements should cope with the growing and evolution of the tax system and taxpayers' business models, particularly when dealing with intra-group transactions. Also, legislations should provide certainty and clarity to minimize tax disputes between tax authorities and taxpayers and to support fair taxing rights among tax jurisdictions.

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