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ANALYSIS OF ROYALTY PAYMENT TRANSACTIONS ON KNOW-HOW UTILIZATION TO AFFILIATED PARTIES: A CASE STUDY OF A TAX COURT DECISIONS

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ABSTRACT

Difficulties in determining fairness in know-how transactions often lead to disputes. This study aimed to analyze the problems and obstacles in royalty payment transactions to use know-how and provide solutions to prevent future disputes. It is a novel study that discusses the obstacles the parties experienced. The results showed that the main problem in paying royalties for know-how is its existence and reasonable price. These problems are caused by the difficulty of proving the know-how's existence, reasonable pricing methods, and limited comparative data on methods. Other obstacles are differences of opinion between taxpayers and tax authorities and inconsistent applicable guidelines. Therefore, taxpayers should prepare documentation that supports intangible property (IP), specifically know-how. They should use FAR analysis as a supporting document in determining the appropriate pricing method. Furthermore, taxpayers need to submit an Advance Pricing Agreement to avoid disputes in the future. DGT must update the guidelines regarding audits and audit procedures, specifically on Transfer Pricing transactions. These guidelines should be in line with those related to documentation and procedures for implementing transfer price agreements. DGT should also incorporate jurisprudence considerations in every regulation concerning IP to reduce the possibility of future disputes.

Keywords: Arm's Length Principle, Intangible Property, Know-How, Tax Dispute, Transfer Pricing

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1. INTRODUCTION

The survey conducted by EY (2010) showed that around 30% of holding companies' tax directors worldwide think that transfer pricing is the most crucial taxation issue. In another survey, EY (2019) stated that 82% of respondents had experienced problems regarding transfer pricing over the past three years. The survey also showed the factors causing transfer pricing problems and related future tax controversies. One tax controversy predicted to increase in the next two years is intangible property (IP) transfer pricing. The world's tax authorities focus on IP because the Organization for Economic Co-operation and Development (OECD) states that determining the arm's length requires considering certain factors. These include identifying the existence of an IP and the parties entitled to the profits generated, transactions regarding its use, and determining fair prices in IP-related cases. However, it is difficult to do these things because identification becomes problematic. Not all valuable IP is legally protected, registered, recognized, and recorded for accounting purposes. For instance, know-how is a form of IP rarely legally registered or recorded for accounting purposes.

Ngantung (2013) referred to paragraph 11 of the Commentary on Article 12 of the OECD Model that know-how includes undisclosed industrial, commercial, or scientific information from previous experience. This information has practical application in a company's operations. Economic benefits could also be obtained from the disclosure. This shows that know-how is information with economic benefits for its users but is not disseminated in general.

The difficulty in determining the arm's length in transactions related to know-how often leads to disputes between taxpayers and fiscus. Table 1 illustrates the disputes in tax court cases in Indonesia from 2016 to 2020. The disputes relate to the payment of royalties to affiliates for using know-how.

Table 1. List of Appeals Decisions on Tax Disputes Related to Royalties on Use Know-How

No.	No Verdict	Year	Point of Dispute	Verdict Results
1	PUT.69375/PP/M.XIIB/15/2016	2016	Pricing is fair	Partially Granted
2	PUT-7046/PP/M.XB/15/2016	2016	Existence of know-how IP submission	Granted Entirely
3	72763/PP/M.XVIII A/13/2016	2016	Existence of know-how IP submission	Rejected

4	Put-81509/PP/M.XVIII/15/2017	2017	Economic benefits over know-how IP	Granted Entirely
5	PUT-84904/PP/M.XIA/15/2017	2017	Existence of know-how IP, submission, and its economic benefits	Rejected
6	PUT-84903/PP/M.XIA/15/2017	2017	Existence of know-how IP, ownership, handover, and economic benefits	Partially Granted
7	PUT-089897.15/2011/PP/M.IIA/2018	2018	Economic benefits of know-how IP, submission, the form of business of the Appellant	Rejected
8	Put-096819.15/2012/PP/M.IA/2018	2018	Transactions related to the use of know-how IP	Rejected
9	PUT-116717.15/2014/PP/M.VIB/2019	2019	Existence of know-how IP, Economic benefits, and Reasonable pricing	Granted Entirely

Sources: Website of the Secretariat of the Tax Court of the Ministry of Finance and the Decision of the DDTC Tax Court (processed)

The data shows the dispute case regarding royalty payments for using know-how related to existence, economic benefits, and determining fair prices. Therefore, tax disputes regarding royalty payments to affiliates for using know-how are an interesting issue to be investigated. The subject matter could be described in the following study questions:

- 1) What problems arise in the transaction of royalty payments to use know-how to affiliates?
- 2) What obstacles do taxpayers and DGT face in making royalty payment transactions to use know-how to affiliates?
- 3) What is the right solution for taxpayers and DGT to minimize disputes regarding royalty payment to affiliates to use know-how?

This study aimed to contribute to and improve previous literature by understanding royalty payment transactions to affiliates for using know-how and solving these problems. It is a case study with a qualitative approach and data were collected through interviews and documentation. Interview respondents were selected based on positions by the subject matter.

2. LITERATURE REVIEW

2.1. KNOW-HOW

Know-how is information that enhances commercial activity but is not registered for protection, such as OECD patents or trademarks (2022). It constitutes undisclosed industrial, commercial, or scientific information from

previous experience in the operation of an enterprise. For instance, one of the parties on a know-how surrender contract provides specific experience or knowledge undisclosed to the public to be used for their benefit. In such contracts, the licensor or know-how is not required to play any role in applying the formula given to the licensee. Also, the licensor does not guarantee the outcome of the OECD (2022). This contract differs from a service provision contract because one party uses its skills to work for the other party.

2.2. ARM'S LENGTH PRINCIPLES

The OECD defines the arm's length principle as an international standard approved by member states in determining transfer prices for taxation purposes. In 2022, it stated that the principle worked effectively in most cases. For instance, fair prices could be easily found under comparable circumstances in cases involving purchasing and selling commodities and loaning money. However, there are cases where the arm's length principle is difficult and complex to apply. This is common in multinational companies dealing with the integrated production of intangible or highly specialized goods and services. In Indonesia, the Director General of Taxes issued a Regulation of the Director General of Taxes Number PER-32/PJ/2011. It regulates taxpayers' application of fairness and business normality in conducting transactions with parties with a special relationship. These transactions are conducted with the following steps:

- a) Conducting a comparative analysis and determining the comparator
- b) Determining the suitable transfer pricing method
- c) Applying the principle of business fairness and normality based on the results of comparative analysis and determining the price of appropriate transfers into transactions between taxpayers with a special relationship
- d) Documenting every step in determining the fair price or profit

Comparative analysis should consider certain things, including:

- a) Transactions between taxpayers and parties having a special relationship are comparable to those with no special relationship. There is no material and significant difference in the conditions of the transactions. When there is a difference in conditions, adjustments are made to eliminate significant influences from the difference in confidence in internal and external comparison data with the same

comparison level. Taxpayers must use internal comparison data for pricing or fair profit.

- b) Available internal comparison data were only used in incidental transactions between taxpayers and parties with a special relationship.

3. RESEARCH METHODS

This problem-solving case study aimed to determine the causes of nine disputes over royalty payments to affiliates using know-how. It also intended to analyze and provide solutions to the problems faced by taxpayers and DGT in royalty payment transactions.

A qualitative approach was used to analyze a case to explore and understand specific problems (Creswell, 2009). This study analyzed nine tax court rulings related to royalty payments to affiliates to use know-how from 2016 to 2020.

Data were collected through interviews and document analysis of nine court decisions obtained from the secretariat of the Tax Court. The study reviewed Indonesia's and international (OECD Guidelines), as well as previous literature to prepare interview questions for respondents to obtain comprehensive results.

The data were validated through semi-structured interviews following the prepared question guidelines and responses from respondents. This study was conducted on five respondents, including two tax consultants, two DGT parties, and one academician. The respondents were selected to obtain a point of view appropriate for each group. The interview and analysis results are expected to be more comprehensive and not lean towards certain groups. A descriptive analysis was also conducted in the interview process to answer the study questions.

The interview questions were drafted based on nine tax court disputes, applicable tax regulations, and previous studies. First, they were divided into three criteria according to the situational problem-solving theory. These criteria include problem recognition, involvement, and constraints. The questions were also divided into three sub-themes, namely problems in royalty payments to affiliates for using know-how, obstacles faced, and solutions to the problems.

4. RESULT AND DISCUSSION

Secondary and primary data were collected using the constant comparative method. A descriptive analysis was conducted to answer the study questions.

4.1 ANALYSIS RESULT

This study critically analyzed problems and arguments from the documents and interview results. Document analysis and interviews with tax consultants, DGT, and academics were conducted as data triangulation. This analysis was compared with applicable tax regulations in Indonesia and the OECD Guidelines. The results were presented based on the study questions.

4.1.1 PROBLEM ARISING IN ROYALTY PAYMENT TRANSACTIONS FOR USING KNOW-HOW AFFILIATES

The document analysis and interview results showed that the problem common in royalty payment transactions for using know-how is benefits and fair prices. The OECD Transfer Pricing Guidelines and Related Provisions (2022) highlighted that the existence and pricing of fair prices should be considered in applying the arm's length principles of the transfer or use of IP. The existence of know-how is a fundamental question in an IP transaction. Article 21 of the Financial Accounting Standard (PSAK) 19 states that IP are recognized when meeting the following elements:

1. The entity derives future economic benefits from the asset, and
2. The cost of acquiring such assets is reliably measurable.

In assessing the certainty of future economic benefits of using IP, the entity considers the external evidence available during the initial recognition of IP. Identifying know-how is difficult, where proof is defined by the OECD Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations (2022) as the knowledge that enhances commercial activities but is not registered for protection like patents or trademarks.

Know-how is information not disclosed in the company's operation. The non-disclosure of such information makes it challenging to prove IP (know-how). Therefore, the proof of know-how is usually the earliest correction made by the tax officials on the transaction of royalty payments. In line with this, the respondent of the tax officer stated:

"... some preliminary stages for royalty research its first existence, [...] When we imagine that there has been a correction regarding the existence, the bottom is not counted, it is not studied anymore, it is the person who is not there, yes, it is not enough to calculate the reasonableness of all corrections directly (DGT 1, 2022)."

This problem occurred in the appeal decision number PUT-116717.15/2-14/PP/M.VIB/2019, the difference of opinion between taxpayers and DGT regarding fair pricing. According to DGT, there was a problem with the existence, where the automatic price was unreasonable. Taxpayers stated that before considering the fair price unreasonable, the examiner (DGT) should conduct a test and not argue that the price is unnatural due to the problem of existence. The two tax consultant respondents also stated that the proof of existence was the earliest and easiest correction made by DGT, as follows:

"... related to the process, usually in proving the existence of the know-how by taxpayers, the data or evidence submitted by taxpayers cannot convince the Fiscus or the tax office (Tax Consultant 1, 2022)."

"... surely from taxpayers' side there are obstacles to prove it too, how do we know this exists or not, [...] for the examiner it is the easiest correction to make. Usually, the reason is quite simple, and the examiner cannot believe the evidence provided by taxpayers (Tax Consultant 2, 2022)."

The statement proof of existence is the earliest and easiest correction. The analysis of the appellate judges showed that the most common subject matter is about existence. Seven of the nine appeal decisions face the subject matter of the dispute regarding existence.

The second problem is determining reasonable prices. Following the Regulation of the Director General of Taxes Number PER-32/PJ/2011 on determining fair prices, five methods could be applied, including:

1. Comparable Uncontrolled Price (CUP)
2. Resale Price Method (RPM)
3. Cost Plus Method
4. Profit Split Method (PSM), or
5. Transactional Net Margin Method (TNMM)

These methods are not qualified to determine IP's fair value, specifically know-how. The reason is that the size used is a measure of tangible property.

"I think it is too risky because the main thing is that the size, we use the size of tangible assets, buying and selling, and so on. We can measure it easily when we look at it. A name, for example, CUP, is widely used. Therefore, there must be a comparison. At the

same time, intangible assets are unique between entities. It is a problem, and I think it will be a problem (Academics, 2022)."

The five methods also require comparative data, though perfect comparisons are often unavailable due to the unique nature of IP (Ngantung, 2013).

Know-how is an IP that is difficult to identify, making it challenging to obtain commensurate comparison data to determine a fair price. According to Ngantung (2013), the transaction nature should identify before looking for a comparison of IP transactions. Although such know-how could be identified, it is impossible to obtain comparative data matching related transactions. This is because know-how is industrial, commercial, or scientific information from previous experience in the operation of an enterprise.

The issue of fair prices occurred in four of the nine appeal rulings. The two problematic appeal decisions regarding comparison data were PUT.69375/PP/M.XIIB/15/2016 and PUT-089897.15/2011/PP/M.IIA/2018. In the appeal decision, it is challenging to select companies to be comparisons. This is because not all companies experience the same circumstances faced by taxpayers. It is also challenging to find comparable companies from various assessment aspects.

Differences of opinion among taxpayers and fiscus in determining the fair price (arm's length) are common problems. In decision numbers PUT.69375/PP/M.XIIB/15/2016 and PUT-116717.15/2-14/PP/M.VIB/2019, differences of opinion between taxpayers and DGT caused disputes. The discrepancy occurred due to differences in views regarding data and circumstances when the dispute occurred.

The interview results showed that the difference of opinion was caused by differences in interests from the fiscus side, which prioritized legality.

"... because we are legal, examination, research will produce legal products (DGT 2, 2022)."

Taxpayers' side prioritizes economic problems.

"Yes, the dispute occurs because of differences of opinion between taxpayers and Fiscus. It occurs when the tax inspector or office thinks there should be no need to pay royalties, while taxpayers consider that the payment must be made when the company's business is running (Tax Consultant 1, 2022)."

The misalignment of the applicable law causes a difference of opinion between taxpayers and Fiscus. IP is not an exact science and has not been stated in the applicable regulation in the transactions and examinations.

"There is nothing about it, and it has to be like this, yes, hence, it is creative to look for interviews of the people, dig up the facts that are benefits, how can we show it to the judge in an easy way. [...] the point is that intangible property for TP is not an exact science, hence, it can cause double taxation in many countries (Tax Consultant 2, 2022)."

This is further complicated by the misalignment of regulations governing examinations and documentation.

"... in my opinion what is necessary is a more comprehensive regulation, it is just a regulation that is one for example between transfer pricing regulations, especially the examination is still at the level of Regulation of the Director General of Taxes, yes [...] while the documentation itself has entered the Regulation of the Minister of Finance level. (Tax Consultant 1, 2022)"

There are differences of opinion and treatment between taxpayers and Fiscus on royalty payment transactions for using know-how. The analysis showed that the problems in royalty payment transactions to use know-how are caused by five obstacles. These include the difficulty of proving the existence of know-how, appropriate pricing methods, limited comparative data, differences of opinion between Fiscus and taxpayers, and uncertainty and alignment of applicable legal regulations.

4.1.2 OBSTACLES FACED IN MAKING ROYALTY PAYMENT TRANSACTIONS FOR UTILIZING KNOW-HOW TO AFFILIATES

Five obstacles caused the problems in royalty payment transactions for using know-how to affiliates. These obstacles are explained in the following section.

1) THE DIFFICULTY PROVING THE EXISTENCE OF KNOW-HOW ON ROYALTY PAYMENTS TO AFFILIATED PARTIES

In transactions related to IP, the fundamental question considers the existence of an IP itself, specifically know-how. Although know-how is

confidential, unlike other intangible properties such as patents or trademarks, it is usually not registered with the relevant legal entity.

The non-registration of the know-how is the difficulty of proving its existence. The company requires internal documents relating to know-how to prove its existence. However, sometimes these documents are not available.

These documents are unavailable because the know-how is usually applied to a formula or production process that uses written documents. However, know-how is sent by experts who provide information regarding its application.

The matter occurred in dispute number PUT-116717.15/PP/M.VIB of 2019, and one of the disputes was the existence of know-how. According to the Appeal (DGT), the Appellant (taxpayers) could not prove the existence of know-how submission from the affiliated party. However, the Appellant had provided evidence of the submission by:

1. Sending employees for training in Japan
2. Bringing in experts from affiliated parties in Japan for in-house training
3. Recruiting local employees who participated in internships located at affiliates in Japan through the Indonesian-Japanese government cooperation program
4. Providing knowledge through correspondence

The Appellant of the know-how's existence was not convinced because there is no physical evidence of the technical assistance agreement.

There is a written document when know-how is given as a formula. However, the formula uses a foreign language, forcing the company to translate. This problem occurred to disputes PUT-84903/PP/M.XIA/15/2017 and PUT- 84904/PP/M.XIA/15/2017. According to the Appeal (DGT), the Appellant (taxpayers) could not prove the existence of know-how provided by the affiliate party. This holds even when the Appellant presents a design document for a unique product with instructions for raw materials using the language of the afflic in Japan. The Appeal stated that the evidence could not prove the know-how submission because the documents provided are instructions for use. The documents are not confidential because they are known to the employees in charge of handling the production.

Tax officials often correct royalty payments due to doubts and suspicion. In this case, giving back on technical know-how to parties with a special relationship reduces the company's profits. This problem occurs in disputes 72763/PP/M.XVIII/13/2016. According to the Appeal (DGT), the Appellant (taxpayers) could not prove the existence of the technical know-how received.

This occurred even when the Appellant provided a Technology Know-How and Brand License Agreement. The evidence included using a technology license and know-how supported by patent rights issued by the Ministry of Justice. However, the Appeal rejected the evidence because the Appellant could not prove to the research team the form of use of IP over technology and know-how in its business processes.

In line with the legality and existence of questionable royalty payments, the concern considers a company established decades ago and the technology used as the know-how since the company was founded. However, subsidiaries or parties receiving know-how must pay royalties for the technology.

These issues become challenges, where companies must prove they need know-how about related technologies to run their production. Therefore, the proof requires time and proper means to convince tax officials that the know-how exists and that the related transactions are actual.

2) FAIR PRICING METHODS ON ROYALTY PAYMENT TRANSACTIONS ON KNOW-HOW PAYMENTS

The difficulty of proving the existence of the know-how brings questions regarding the fair value paid for the related transactions. The respondents also thought that the difficulty after proving existence is determining the reasonableness of the transfer price. According to one respondent, no suitable method was used to calculate the fairness of the transfer price related to IP. This was because of the available methods used to measure tangible assets. The interview results showed that the CUP method is often used to calculate transactions related to IP, specifically know-how.

This statement is in line with Ngantung (2013) that the choice of transfer pricing method refers to the conformity aspect. The CUP/CUT method takes precedence compared to other existing methods. In the context of IP, this method is flexible and implicit. A perfect comparison is often unavailable because IP is unique. However, the CUP method causes difficulties when IP analyzed has high-value. This also occurs when the assets lack market comparison because they require commensurate comparison data. Therefore, CUP often gives less reliable results and must be supported by other methods.

Some respondents stated that several methods could still be considered to calculate fair prices in transactions concerning IP, specifically know-how. The method to be considered is stated in the Regulation of the Director General of Taxes Number PER-32/PJ/2011. In this case, the Profit Split method calculates the fairness of transactions related to know-how.

Article 11 of the Regulation of the Director General of Taxes Number PER-32/PJ/2011 states that the Profit Split method determines the price of transfers based on Transactional Profit. It involves identifying the combined profit on affiliated transactions shared by parties having a Special Relationship. The method uses an economically sufficient basis that estimates reasonable profit sharing. This estimate is reflected in the agreement between parties with no Special Relationship, using the Contribution or the Residual Profit Split method.

The Profit Split method causes problems because it could be applied without comparison, requiring a compromise between state parties. The compromise is determining multinational profit sharing that requires agreement between countries, which could be complicated. This problem is what is being carried out at the G20 BEPS. In this case, some parties were pessimistic that the project could be completed quickly. Therefore, the Profit Split method could be suitable for calculating fair prices in transactions related to know-how in agreements between countries.

The uncertainty in determining the method for calculating fair prices in transactions related to know-how causes differences of opinion between parties.

3) LIMITED COMPARATIVE DATA ON ROYALTY PAYMENT TRANSACTIONS ON KNOW-HOW PAYMENTS

The difficulty in determining fair prices is due to the unavailability of commensurate comparison data on transactions related to know-how. This problem has led to the absence of an appropriate method to calculate fair prices in such transactions. The OECD Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations 2022 mention factors affecting comparability for an accurate comparison. These factors include:

- a. The transaction's contractual terms
- b. The functions performed by the parties to the transaction
- c. The assets used and risks assumed, including how those functions relate to value generation by the MNE group to which the parties belong, the circumstances surrounding the transaction, and industry practice
- d. The characteristics of property transferred or services provided
- e. The economic circumstances of the parties and the market in which they operate, and their business strategies

These five factors are challenging in transactions related to IP, specifically know-how. It also requires significant funding to obtain comparison data from the database.

Know-how is the knowledge arising from previous experience in a company's operation. Each company has different experiences in operational processes, even in the same industry. Obstacles related to comparative data occurred in the decision number PUT-08987.15/2011/PP/M.IIA/2018. Taxpayers were companies engaged in the MSG and flavoring industries, but it is difficult to obtain comparable companies in Indonesia. Companies engaged in the same industry have different product manufacturing processes. Therefore, taxpayers choose a comparison company with a product manufacturing process similar to taxpayers, even from different industries. This was not approved by the DGT because the comparison data were not comparable.

All respondents agreed that there was no perfect comparison data, especially on transactions related to know-how. The difficulty in obtaining internal comparison data makes companies go for external sources. However, external comparison data is often not recognized for its comparability. This is in line with Ngantung's statement that tax authorities in Indonesia, the Netherlands, and Italy reject comparisons from external commercial databases, such as RoyaltyStat. Commercial databases often give biased and incorrect results caused by improper considerations of the brand or other IP values.

Taxpayers encounter challenges finding comparative data commensurate with IP, specifically the know-how. When they find commensurate comparative data, it is rejected by Fiscus because of differences of opinion and provisions. Differences of opinion between taxpayers and Fiscus regarding determining the comparison data often cause disputes.

4) DIFFERENCES OF OPINIONS BETWEEN TAXPAYERS AND FISCUS

Differences in opinion between taxpayers and Fiscus constitute a significant obstacle to royalty payment transactions for using know-how and often cause disputes. The problem often argued is fair value because taxpayers and Fiscus have standards.

When taxpayers prove that their fair value is under the applicable market value, it is not under the market in Fiscus's opinion. Fiscus views this as tax avoidance carried out by taxpayers. For instance, taxpayers feel that their

payment for royalties is at arm's length, even when they charge high royalty fees. Fiscus still states that taxpayers charge high royalty fees to reduce profits.

The problem occurred in the appeal decision number PUT.69375/PP/M.XIIB/15/2016. Taxpayers filed disputes based on calculations proving the arm's length principle using the Transactional Net Margin Method (TNMM) performed by DGT using only financial statement data for 2011. According to taxpayers, the calculation of fair prices using financial statements for one year only without considering the 2008-2011 period is invalid. No provision in tax laws and regulations governing the determination of fair prices requires using financial statement data for one year tax.

Differences of opinion between taxpayers and Fiscus are caused by several factors. One cause for this discrepancy is the misalignment of laws applicable to transactions regarding IP, specifically know-how.

5) NON-COMPLIANCE OF LAWS APPLICABLE TO ROYALTY PAYMENT TRANSACTIONS ON KNOW-HOW

Misalignment of applicable regulations is also a problem faced by taxpayers. The regulations on examination and documenting are often conflicting. In this case, the examinations and self-documentation are regulated by the Regulations of the Director General of Taxes and the Minister of Finance level, respectively.

The Regulation of the Minister of Finance of Indonesia Number 213/PMK.03/2016 concerning Types of Documents and Additional Information That Must Be Kept by Taxpayers who Make Transactions with Parties who Have a Special Relationship and Procedures for Their Management refers to three documents. These are master and local documents, or CbC report, and how they are managed. The Regulation of the Director General of Taxes Number PER-22/PJ/2013 concerning Guidelines for Examination of Taxpayers who Have a Special Relationship does not refer to the three documents listed in PMK 213/PMK.03/2016. This misalignment creates difficulties for taxpayers in preparing documents.

4.1.3 SOLUTIONS FOR TAXPAYERS TO MINIMIZE THE DISPUTE IN ROYALTY PAYMENT TRANSACTIONS FOR USING KNOW- HOW TO AFFILIATED PARTIES

An analysis was conducted to produce solutions to help taxpayers and DGT prevent and overcome tax disputes related to royalty payments using know-how. The solution resulted from comparing the literature review and the results of interviews of all respondents.

1) COMPILING DOCUMENTATION SUPPORTING THE EXISTENCE OF IP, SPECIFICALLY KNOW-HOW

The initial problem in paying royalties for the know-how to affiliates is the existence of the know-how. It is difficult to prove its existence due to its non-registration and submission form. The form usually given is an undocumented formula or production process. According to the tax consultant, the language in a documented formula or process is only understood by certain people. Therefore, it becomes difficult or takes a long time to prove existence because companies sometimes need other parties to help prepare documents to convince Fiscus.

Article 2 of PMK 213/PMK.03/2016 states that the documents to be prepared are the master file, local document, and CbC Report. Taxpayers must consider the ex-ante principle when preparing the TP-doc document. According to Kristiaji et al. (2013), the arm's length principle or ex-ante approach requires taxpayers to apply fairness when making transactions with affiliation. Information related to comparison transactions used in the fairness principle is obtained during the transaction. This is information available in the years when the transaction with the affiliate was conducted. It is related to changes in economic conditions anticipated during the transaction. This information is expected to affect the price agreed upon by the independent parties. Taxpayers are asked to pre-determine the fair market price used in the next few years. Since DGT prioritizes this ex-ante principle, taxpayers must apply it to prevent problems in royalty payment transactions for know-how.

2) USING FUNCTION, ASSET, AND RISK ANALYSIS (FAR) TO SUPPORT TRANSFER PRICING METHODS

The OECD (2010) states that the determination of the transfer pricing method upholds the aspect of "*The Most Appropriate Method*". The parties

must determine the advantages and disadvantages of each method recognized by the OECD according to the nature of the controlled transaction. Such considerations are specifically determined through functional analysis. Therefore, this FAR analysis is fundamental to convince the tax officials regarding the method used in pricing the transfer.

Following PER-22/PJ/2013, the tax officials need information on comparability factors to the affiliate transaction in assessing the transfer pricing method. This is specifically information about the functions, assets, and risks of all affiliate parties transacting with taxpayers, including those from abroad. Therefore, the FAR analysis conducted with information reliability is used in selecting tested parties in the examination. Those selected as tested parties have a more straightforward function with no unique or valuable IP. Additionally, the tax inspector could select two parties tested in affiliated transactions, including taxpayers being examined or audited and its counterparties.

The FAR analysis is also used in selecting comparative data, following PER-32/PJ/2011 Article 3 Paragraph 2 (a) in implementing the arm's length principle of fairness and business normality. The first step is conducting comparative analysis and determining the comparison. Article 7 states that comparative or function analysis must identify and compare significant economic activities and responsibilities. The main answer would be taken by the parties with and without a Special Relationship. Therefore, the FAR analysis has fulfilled PER-32/PJ/2011 to determine the company for use as a comparison.

The FAR analysis is essential as data supporting why a transfer pricing method is used to pay royalties for *know-how* to minimize disputes.

3) APPLY FOR AN ADVANCE PRICING AGREEMENT (APA)

Taxpayers with difficulties carrying out royalty payment transactions on know-how should apply for an Advance Pricing Agreement (APA). Respondents from DGT suggested that taxpayers with a yearly royalty payment transaction for using know-how to affiliates should apply for APA.

Taxpayers could use APA for previous years even when its submission is only set due to a Roll-back provision. Article 1 Paragraph 12 of PMK-22/PMK.03/2020 states that the roll-back is a notification of the agreement in the APA for tax years before the APA period. This period is the year covered in the APA per the domestic taxpayers to a joint decision no later

than five tax years after submitting the APA application. It means that taxpayers could enforce APA in the past five years.

Regarding the transfer pricing problem in royalty payment transactions to use know-how, the APA has included material testing by applying the Principles of Fairness and Business Normality. The test helps taxpayers know when they make a mistake in determining the transfer price. This enables them to negotiate and correct the disagreement. Moreover, taxpayers are more efficient in compiling TP-doc.

The APA application is strongly recommended for taxpayers with royalty payment transactions to use know-how to affiliates. It increases taxpayers' effectiveness in preparing TP-doc and fulfills the *ex-ante* aspect.

4.1.4 SOLUTIONS FOR DGT TO MINIMIZE DISPUTES IN ROYALTY PAYMENT TRANSACTIONS FOR USING KNOW-HOW TO AFFILIATED PARTIES

The analysis showed that several obstacles from DGT burdened taxpayers. These constraints were compared with the opinions of other respondents and analyzed with the literature. The analysis results are regulations for DGT to help taxpayers overcome the obstacles and minimize tax disputes in royalty payment transactions using know-how.

1) UPDATING REGULATIONS GOVERNING THE EXAMINATION GUIDELINES

One obstacle causing problems in royalty payment transactions to use know-how is the misalignment of applicable regulations. This misalignment makes it difficult for taxpayers at the examination stage. The treatment necessary during documentation differs from the one conducted by the Fiscus at the examination stage.

It is necessary to update the guidelines regarding the examination and how the examiner carries out the inspection procedure, specifically in Transfer Pricing transactions. These guidelines should be consistent with PMK 213/PMK.03/2016 and PMK 22/PMK.03/2020 regarding documentation and transfer price agreements, respectively.

2) INCLUDE JURISPRUDENCE CONSIDERATIONS IN EVERY REGULATION ON IP

The repeated examinations and disputes in royalty payments to use know-how are included in the risks that taxpayers must face. Corrections and repeated disputes are detrimental because the royalties paid by taxpayers cannot be charged fiscally in the Corporate Income Tax.

DGT should consider jurisprudence in the applicable regulations to avoid such incidences. According to Simanjuntak (2018), jurisprudence is the decisions of judges or courts fixed and justified by the Supreme Court (MA). It is a judge's decision or previous case not regulated by law and used as a guideline by other judges in resolving similar disputes or cases. This jurisprudence should be considered to address the future recurrence of disputes.

5. CONCLUSION AND RECOMMENDATION

This study concluded several problems concerning the existence and pricing of fair prices in royalty payment transactions to affiliated parties. According to the OECD Transfer Pricing Guidelines and Related Provisions (2022), the existence and reasonable pricing should be considered in applying the arm's length principle in transferring or using IP. However, taxpayers and DGT experienced problematic obstacles in royalty payment transactions for using know-how to affiliates.

Five obstacles caused the problems in royalty payment transactions for using know-how to affiliates. These were difficulty proving the existence of know-how, fair pricing method, limited comparative data, differences of opinion between taxpayers and Fiscus (DGT), and non-compliance with applicable laws.

Taxpayers should take certain steps to overcome obstacles to royalty payment transactions to use know-how. They should compile documentation supporting the existence of know-how, use Function, Asset, and Risk Analysis (FAR) to determine transfer pricing methods, and apply for an Advance Pricing Agreement (APA).

DGT should also take some actions to overcome obstacles to royalty payment transactions to use know-how. They should update regulations governing inspection guidelines and include jurisprudence considerations in

regulations on IP. The four actions could minimize disputes in royalty payment transactions to use know-how of the affiliation party.

This study only focused on the use of know-how in discussing obstacles to royalty payment transactions for IP. Observations were also not conducted on each taxpayer. Additionally, speakers directly involved in disputes were not interviewed due to limited information and pandemic conditions.

Future studies could discuss the constraints of paying royalties on IP in addition to know-how. Due to digitization, disputes regarding IP are expected to increase in the future. Therefore, studies should direct observations to taxpayers and resource persons involved in disputes in royalty payments on IP.

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