

## IMPLEMENTATION OF THE ARM'S LENGTH PRINCIPLE IN RELATED PARTY RELATIONSHIPS AT PT S INDONESIA

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**Abstract:** This study aims to analyze the implementation of Arm's Length Principle by PT S Indonesia in affiliated transactions with SF Co., Ltd, a parent company from Japan. The focus of the study is to assess the suitability of determining fair prices with tax regulations in Indonesia. The research method used is descriptive qualitative through interviews with tax consultants who handle the company's transfer pricing. The analysis is carried out based on Transfer Pricing documentation and applicable tax provisions. The results of the study indicate that the use of the Transaction Net Margin Method (TNMM) is in accordance with the business characteristics of PT S Indonesia. Testing using the Profit Level Indicator (PLI) with the Berry Ratio method shows that the company's position is within the fair range, especially in the lower interquartile. In conclusion, PT S Indonesia has implemented tax obligations in accordance with the fairness principle without any indication of tax avoidance practices, although there are obstacles in finding comparable comparisons.

**Keywords:** *Transfer Pricing, Arm's Length Principle, Transaction Net Margin Method*

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### 1. Introduction

Globalization has precipitated transformative changes across various facets of society, notably in the realm of international trade, fostering economic interdependence among nations and giving rise to the concept of economic globalization. The main role of economic globalization is played by multinational companies, which operate across multiple countries, engaging in cross-border transactions under the oversight of a centralized corporate entity that thrives in the global marketplace. Their activities encompass production, distribution, and investment (Panglaykim, 1983).

Multinational companies frequently establish special relationships in their cross-border transactions, termed affiliated transactions, as delineated in Article 18, paragraph (4) of Income Tax Law No. 36 of 2008. This legislation also prescribes the criteria for identifying parties with special relationships. This condition requires corporations to comply with applicable tax regulations in Indonesia, including implementing appropriate transfer pricing practices. Darussalam, Septriadi, and Kristiaji (2013) explain that transfer pricing practices often result in unreasonable transfer prices, which are considered an attempt to avoid paying taxes that should be paid to the state.

The Indonesian government has attempted to address issues related to transfer pricing by enacting Ministerial Regulation No. 172/PMK.03/2023, which regulates the Arm's Length

Principle (PKKU), Mutual Agreement Procedure (MAP), and Advance Pricing Agreement (APA). These articles serve as an Anti-Avoidance Rule. The application of the Arm's Length Principle in transactions between taxpayers and related parties must be based on the actual conditions and characteristics of the company, as regulated by the Directorate General of Taxes in Regulation No. 32/PJ/2011.

S Indonesia Firm is a furniture manufacturing company based in Indonesia and has entered into a transaction with SF Co., Ltd., based in Japan. The two companies share a special relationship, as SF Co., Ltd. owns 90.06% of S Indonesia Firm. This relationship constitutes a special relationship. Therefore, the company is required to apply the Arm's Length Principle to achieve a fair price for the transfer pricing transaction between the two companies.

This article aims to analyze the methods that can be used by S Firm Indonesia in determining transfer pricing in related-party transactions, by evaluating the appropriateness of the transaction value applied by S Firm Indonesia with comparable companies, and assessing S Indonesia Firm's compliance with transfer pricing regulations in Indonesia.

Several studies related to the application of fair pricing using the Arm's Length Principle have been conducted by various researchers, including Suryana (2021), Saraswati, Saifi, and Dwiatmanto (2014), and Januariza & Retnani (2021). Suryana's (2021) research applied the Transactional Net Margin Method (TNMM) to RB Firm, a company providing marketing and technical services, specifically web services. Reebonz Limited, an affiliated party, has a special relationship with RB Firm due to its majority share ownership. Fair pricing was tested using Gross Markup as the profit level indicator. Saraswati, Saifi, and Dwiatmanto's (2014) study applied the TNMM to Mertex Firm because the company's transactions were complex, as Mertex Firm produces goods based on custom orders, resulting in different treatments for different parties, and used Mark on Total Cost as the profit level indicator. Januariza and Retnani's (2021) research examined the special relationship between X Firm Indonesia and X Inc Japan due to 50% share ownership. X Firm Indonesia performed limited functions, as all activities were fully managed by the affiliated party, with goods ordered based on customer demand. X Firm Indonesia applied the TNMM as its transfer pricing method and used Net Cost Plus as the profit level indicator, as it is a manufacturing company with multiple cost functions. These studies demonstrate the application of fair pricing methods tailored to the characteristics of each company.

## **2. Literature Review**

### **Special Relationship**

Based on Law No. 36 of 2008, Article 18, Paragraph (4), a special relationship is characterized by a relationship between taxpayers where one holds, directly or indirectly, a capital participation of 25% or more in another taxpayer, one taxpayer controls another taxpayer either directly or indirectly, or there is a family relationship by blood or marriage in a direct or collateral line of descent. The policy established by the Directorate General of Taxes regarding transfer pricing is outlined in Regulation PER-43/PJ/2010, as last amended by PER-32/PJ/2011. This regulation serves as a guideline for taxpayers conducting affiliate transactions due to a special relationship.

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

The regulation regarding the application of the Arm's Length Principle for taxpayers with a special relationship is outlined in PER-32/PJ/2011, Article 1, Paragraph (5). The Arm's Length Principle governs the conditions of transactions between parties with a special

relationship to be equivalent or comparable to those in transactions between independent parties used as a benchmark. The application of the arm's length principle is mandatory, as it ensures that transactions between parties with a special relationship are conducted under conditions equivalent to those between independent parties, resulting in Fair Market Value. The application of the Arm's Length Principle requires steps as stipulated in PER-32/PJ/2011, Article 3, Paragraph (2), which are:

- a. Conducting a comparability analysis and determining comparable data,
- b. Determining the transfer pricing method,
- c. Applying the Arm's Length Principle based on the results of the comparability analysis and the selected transfer pricing method,
- d. Documenting each step in determining fair pricing or fair profit in accordance with applicable tax regulations.

The comparability analysis is conducted by comparing prices or profits. A special relationship transaction is considered comparable to an independent transaction if there are no material differences in the conditions of the compared transactions, or if such differences exist, adjustments can be made to eliminate the material impact of those differences on prices or profits.

The determination of fair pricing or transfer pricing must fall within the arm's length range. There are two types of ranges: the full range and the interquartile range. The interquartile range is suitable for the results of a comparability analysis when using external comparable data.

### **Transfer Pricing**

Transfer pricing refers to the pricing policy for transactions conducted between parties with a special relationship (www.ortax.com, May 17, 2025). According to Pohan (2019), transfer pricing is the price calculated for the transfer of goods/services or other intangible assets from one company to another with a special relationship, based on the arm's length price principle.

According to Darussalam et al. (2019), the purpose of transfer pricing from a taxation perspective is to set a pricing policy for transactions involving parties with a special relationship, determining the income for each entity. Since related companies have the advantage of setting costs differently from those typically used in transactions with unrelated parties, they can minimize costs by agreeing on predetermined transaction costs.

Transfer pricing methods, as regulated in PER-32/PJ/2011 and the OECD Transfer Pricing Guidelines (2017), include several methods that multinational companies can use to determine prices, as follows:

- a. Comparable Uncontrolled Price (CUP) Method
- b. Resale Price Method (RPM)
- c. Cost Plus Method (CPM)
- d. Profit Split Method (PSM)
- e. Transactional Net Margin Method (TNMM)

However, PER-32/PJ/2011, Article 20 states that if there is an error in the application of the method or if it is deemed incorrect by the examiner, the Directorate General of Taxes has the authority to recalculate the taxable income for transactions conducted between parties with a special relationship.

### **Profit Level Indicator (PLI)**

The application of the Arm's Length Principle using the Transactional Net Margin Method (TNMM) requires testing through the calculation of the profit level indicator (PLI). This involves comparing the profit level of affiliated transactions with independent transactions to determine the net profit from affiliated transactions. The selection of the PLI, as outlined in Circular Letter No. SE-50/PJ/2013, must be based on the company's conditions, such as the comparison of net profit to sales, total costs, assets, and other indicators, including:

- a. Net profit compared to sales, or Return on Sales
- b. Net profit compared to costs, or Net Cost Plus Mark-Up
- c. Net profit compared to assets, or Return on Assets
- d. Berry Ratio, or the ratio of gross profit to operating expenses

This study aims to identify the appropriate fair pricing method based on the characteristics of S firm Indonesia. The research is conducted by calculating the application of the profit level indicator for S firm Indonesia, compared with external comparable data, to establish the arm's length range.

### **3. Research Method**

This study employs a qualitative descriptive approach with a case study method. The data sources used in this research consist of primary and secondary data. Primary data were obtained from interviews with informants who assisted in the preparation of the transfer pricing document. Meanwhile, secondary data were sourced from the transfer pricing document, online financial platforms such as Yahoo Finance, journals, books, and Indonesian tax regulations. The study aims to thoroughly examine the application of the arm's length principle at S firm Indonesia.

The focus of this research is to evaluate the transfer pricing practices conducted by S firm Indonesia with its affiliated parties, specifically:

- a. To understand the application of the Arm's Length Principle at S firm Indonesia
- b. To identify the methods that S firm Indonesia can use to determine transfer pricing with affiliated parties
- c. To determine whether S firm Indonesia has complied with Indonesia's transfer pricing regulations.

### **4. Results and Discussion**

#### **Implementation of the Arm's Length Principle and the Impact of Pricing by S Firm Indonesia**

Based on the analysis of S firm Indonesia's share ownership structure, it is known that SF Co., Ltd holds a 90.06% stake in S firm Indonesia. This confirms a special relationship between S firm Indonesia and SF Co., Ltd due to capital participation.

- a. *Conducting Comparability Analysis and Determining Comparable;*

S firm Indonesia conducted a comparability analysis using external data as comparable, sourced from the non-commercial financial database Yahoo Finance. The selected comparable data align with the company's characteristics, specifically in the consumer goods—home furnishing & fixtures sector. The comparability analysis using data matching S firm Indonesia's characteristics aims to prevent errors in applying the fair pricing method. The obtained comparable data were used to calculate the Profit Level Indicator (PLI) over three years (2021–2023).

S firm Indonesia performed a comparability analysis and a Functional, Asset, and Risk (FAR) analysis. The functional analysis addresses the company's economic characteristics, with S firm Indonesia acting as a producer and service provider. Its functions include ensuring quality control of product sales, training and managing production workforce, handling receivables and collections, and financial administration. In terms of asset analysis, S firm Indonesia bears the cost of intangible assets related to production ownership. However, product branding is determined by the ordering company. S firm Indonesia fully bears tangible assets, including factory machinery, production facilities, land and buildings, production-related technology, and inventory. The risk analysis reflects the transfer of pricing or the rate of return obtained by the company based on prevailing conditions. S firm Indonesia bears financial risks, including foreign exchange rate fluctuations and interest rates, credit risks related to customers' obligations to make timely payments (and potential defaults), and warranty risks related to product damage claims, requiring S firm Indonesia to incur costs for repairs or replacements.

b. *Determining the Appropriate Transfer Pricing Method;*

The determination of the transfer pricing method involves selecting the most suitable method based on profit indicators, starting from the Comparable Uncontrolled Price (CUP) method to the Profit Split Method (PSM). The testing of transfer pricing methods follows a pricing or profit hierarchy, applying methods in sequence from the CUP method to the Transactional Net Margin Method (TNMM).

The TNMM was deemed suitable for S firm Indonesia's conditions, as one party in the special relationship transaction provides a unique contribution, specifically the capital ownership by the affiliated party. Additionally, S firm Indonesia is appropriate for using TNMM due to its complex transactions, as evidenced by its production activities, which involve manufacturing goods based on specific customer orders, resulting in varying treatments for each transaction and party.

c. *Applying the Arm's Length Principle*

Based on the comparability analysis and the selected transfer pricing method, S firm Indonesia conducts transactions with its affiliated party using the Transactional Net Margin Method (TNMM). The comparison of profit level indicators shows that S firm Indonesia's transactions fall within the arm's length range, in accordance with the Arm's Length Principle.

d. *Documenting Each Step in Determining Fair Pricing in Accordance with Applicable Tax Regulations.*

S firm Indonesia documents its special relationship transactions in the "Transfer Pricing Documentation," which includes an overview of the company and the basis for selecting the appropriate method to comply with the Arm's Length Principle.

### **Application of Transfer Pricing Method by S Firm Indonesia**

The Profit Level Indicator (PLI) serves as a tool to test whether the method applied by S firm Indonesia aligns with actual conditions and complies with the arm's length principle. The application of the PLI must consider the company's conditions, such as the nature of its business, economic conditions, and financial conditions. Based on S firm Indonesia's characteristics, which involve production activities by accepting job orders from both affiliated and non-affiliated companies, the Berry Ratio is considered the most appropriate method, aligning with the company's characteristics as a service provider performing comprehensive functions such as market research, distribution, marketing, and advertising.



The following table presents the calculation of the Profit Level Indicator using the Berry Ratio, which is the ratio of gross profit to operating expenses, based on S firm Indonesia's financial statements from 2021 to 2023.

**Table 1. Calculation of Profit Level Indicator PT S**

	<b>2021</b>	<b>2022</b>	<b>2023</b>
<b>Sales</b>	22.278.074.643	28.423.149.794	22.680.091.104
<b>COGS</b>	408.608.541	574.552.771	479.688.509
<b>Gross Profit</b>	5.557.002.464	7.206.363.344	6.570.360.912
<b>Operating Cost</b>	5.055.030.896	6.541.347.236	6.140.451.446
<b>Berry Ratio</b>	<b>1,10</b>	<b>1,10</b>	<b>1,07</b>

Source: Secondary data (2025)

The Berry Ratio serves to test a company's efficiency in generating net profit from sales. The Berry Ratio results for the 2021 to 2023 period must be compared with the Berry Ratio values of comparable companies. The following table shows the Berry Ratio calculations for six comparable companies.

**Table 2. Comparison of Profit Level Indicator using Berry Ratio**

<b>Company</b>	<b>2021</b>	<b>2022</b>	<b>2023</b>
<b>ETH</b>	1,04	1,15	1,13
<b>SJK</b>	0,3	0,43	1,87
<b>HVT</b>	1,11	1,08	1,1
<b>HOF</b>	1,25	1,56	1,56
<b>LNT</b>	1,31	1,2	1,18
<b>BZET</b>	1,06	1,03	1,06
<b>S FIRM</b>	1,10	1,10	1,07
<b>Q1</b>	1,05	1,06	1,06
<b>Q2</b>	1,18	1,18	1,2

Source: Secondary data (2025)

In 2021, S firm Indonesia's Berry Ratio was 1.10, falling between the first quartile of 1.05 and the third quartile of 1.18. The same trend occurred in 2022 and 2023. In 2022, S firm Indonesia's Berry Ratio of 1.10 fell within the first quartile of 1.06 and the third quartile of 1.18. In 2023, S firm Indonesia's Berry Ratio of 1.07 also fell within the reasonable range of the first quartile of 1.06 and the third quartile of 1.20. Of these three values, S firm Indonesia's Berry Ratio has been between the first and third quartiles for three consecutive years, indicating that S firm Indonesia's transactions with affiliated companies indicate that the profit margin earned by S firm Indonesia is still considered reasonable and comparable to transactions with non-affiliated companies.

### **The Influence of Capital Ownership and Transfer Pricing on Tax Avoidance**

SF Co., Ltd.'s share ownership of S firm Indonesia represents institutional ownership. According to Larasati (2017), institutional ownership is the investment in shares held by other institutions, such as companies, pension funds, and mutual funds, in large amounts. SF Co., Ltd. owns 90.06% of S firm Indonesia's shares, representing a significant shareholding. This indicates that S firm Indonesia operates thanks to the presence of SF Co., Ltd.'s shares.

Based on research conducted by Putranti & Setiawanta (2012), high share ownership will lead to low tax avoidance. This is in line with S firm Indonesia's affiliation with SF Co., Ltd.

If SF Co., Ltd. were to blatantly engage in tax avoidance, it could impact S firm Indonesia's reputation, as share ownership also serves as a control mechanism for the actions taken by company management. Furthermore, there was no indication that the company engaged in tax avoidance.

S firm Indonesia has implemented the Arm's-length Principle in accordance with tax regulations both in Indonesia and internationally, guided by transfer pricing guidelines. S firm Indonesia has complied with the steps required to implement arm's-length pricing, as evidenced by the transfer pricing document.

## **5. Conclusion**

The special relationship between S firm Indonesia and SF Co., Ltd. is due to their share ownership. S firm Indonesia complies with the applicable tax regulations regarding transfer pricing in Indonesia, namely PER32/PJ/2011 article 3 concerns the steps for implementing the Arm's Length Principle. In accordance with the company's circumstances and after analyzing the steps of the Arm's Length Principle, S firm Indonesia has established the Transactional Net Margin Method (TNMM) as the method for determining the transfer price in affiliated transactions with SF Co., Ltd.

The Transactional Net Margin Method (TNMM) determination test refers to the Arm's Length Principal guidelines. This test uses one of the profit level indicators, the Berry Ratio. The Berry Ratio is a calculation method that tests the comparison between gross profit and operating costs of a company and a comparison company. S firm Indonesia obtained data from six comparison companies with similar businesses and characteristics. The calculation of the profit level indicator shows that the transactions conducted by S firm Indonesia with the six comparison companies fall within the arm's length range.

S firm Indonesia fulfills its tax obligations in accordance with applicable regulations, including the application of transfer pricing, without any indication of using this mechanism as a means to avoid tax obligations. This is achieved by preparing transparent transfer pricing documents in accordance with the Arm's Length Principle.

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