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LEGAL BOUNDARIES OF TRANSFER PRICING IN ROYALTY PAYMENTS TO FOREIGN AFFILIATES: A STUDY BETWEEN TAX AVOIDANCE AND CRIMINAL TAX OFFENSES IN INDONESIA

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Abstract
International royalty payments between affiliated enterprises often fall within the regulatory gray areas of tax law. This study aims to analyze the legal boundaries separating legitimate tax avoidance schemes from tax evasion within the realm of cross-border royalty transfer pricing in Indonesia, as well as the standing of evidence utilized by tax authorities and taxpayers in such disputes. Employing a normative legal research method with statutory, conceptual, and case-law approaches, this paper dissects the taxpayer's legal liability from both administrative and criminal law perspectives. The research findings indicate that the primary line of demarcation between the two lies in the presence or absence of mens rea (criminal intent), manifested through material manipulation, fictitious royalties, and falsified documentation. A taxpayer's failure to meet administrative and commercial compliance in proving the arm's length principle constitutes a purely administrative law matter to be adjudicated before the Tax Court, rather than a criminal tax offense under Article 39 of the Law on General Provisions and Tax Procedures (UU KUP). Transitioning from an administrative regime to a criminal investigation requires a stringent standard of proof—beyond a reasonable doubt—to avoid undermining the principles of legal certainty, objectivity, and proportionality.
Keywords: Related Parties; Royalties; Tax Avoidance; Tax Evasion; Transfer Pricing

INTRODUCTION

Taxation constitutes a crucial state instrument of a coercive nature designed to finance state expenditures pursuant to Article 23A of the 1945 Constitution of the Republic of Indonesia (Undang-Undang Dasar, 1945). The tax authority, through the Directorate General of Taxes (DGT), is granted broad administrative powers to monitor compliance under a self-assessment system (Rinawati et al., 2026). With its extensive prerogatives, the Directorate General of Taxes can be analogized to an oversight instrument governing all economic transactions passing through Indonesia (Nurchalis, 2018). Nevertheless, the grand house of tax law essentially resides within the domain of state administrative law, although it remains inextricably linked to criminal and civil law intersections (Hadjon, 2011).

The Indonesian tax system adopts a self-assessment system, which accords full trust to taxpayers to calculate, remit, and self-report their tax liabilities in accordance with statutory provisions. This trust positions the DGT not as a direct collector, but rather as a supervisor monitoring the proper execution of tax obligation (Hadjon, 2011). Consequently, the supervisory function holds a strategic position in maintaining the integrity of the tax system, particularly when dealing with complex cross-border transactions (Sutedi, 2020).

In line with the growing complexity of global business transactions conducted by multinational enterprises, international transfer pricing practices frequently serve as a gateway for shifting domestic profits to low-tax jurisdictions (intellectual property holding companies). This is typically executed through royalty expense deductions for the exploitation of intangible assets such as trademarks, know-how, and secret formulas paid to foreign affiliates. In international transfer pricing transactions, entities located in different countries can manipulate transfer prices such that entities in low-tax jurisdictions maximize their profits, while subsidiaries in Indonesia bear excessive costs that erode the domestic tax base (OECD, 2022).

To prevent tax avoidance through transfer pricing, the Organisation for Economic Co-operation and Development (OECD) recommends that countries adopt transfer pricing rules.

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These rules empower tax authorities to distribute, apportion, or allocate gross income and deductions among related parties (OECD, 2022). Normatively (*das sollen*), Article 18 of the Income Tax Law (UU PPh) in conjunction with Law Number 7 of 2021 on the Harmonization of Tax Regulations (UU HPP), and Minister of Finance Regulation Number 172 of 2023 mandate the application of the Arm's Length Principle (ALP).

Empirically (*das sein*), however, a fundamental legal issue arises regarding the clear legal boundaries dividing legitimate tax avoidance or gray areas (*tax avoidance / tax minimization*) from criminal tax offenses (*tax evasion / tax fraud*) in affiliate royalty payments (Mansor, Mohd Fairuz, 2021). Determining the arm's length value of royalties relies on functional economic analysis, which is inherently subjective and open to multiple interpretations (Sastro, 2022). Ambiguity in these legal boundaries occurs when a taxpayer's administrative inability to substantiate Transfer Pricing Documentation (TP Doc) is directly equated by tax authorities to the criminal act of "submitting a Tax Return containing incorrect information," as governed by Article 39 of the Law on General Provisions and Tax Procedures (UU KUP) (Atmasasmita, 2021).

This lack of clear enforcement parameters risks creating an inequality of arms and lead to the criminalization of legitimate tax planning practices (Prastowo, 2021). In principle, criminal sanctions in taxation should serve as an *ultimum remedium* (last resort). In tax audit practice, royalty adjustments often stem from differing assessments regarding the existence of intangible assets, the economic benefits derived, or comparability methods (Darussalam, 2021). Such issues fundamentally belong to the realm of administrative burden of proof, typically resolved in the Tax Court, as reflected in Tax Court Decision Number Put-006760.15/2020/PP.M.XVIB of 2025. The primary issue arises when such administrative corrections are unilaterally drawn into criminal investigation regimes without established legal criteria regarding *mens rea* and material manipulation (Avi-Yonah, Reuven S., 2020).

Based on the background above, the research problems in this study are formulated as follows: (1) What are the legal boundaries for testing transfer pricing in royalty payments (trademarks, know-how, and secret formulas) to overseas affiliates to delineate between tax avoidance and tax evasion under Indonesian positive law? (2) What is the status and evidentiary weight of evidence utilized by tax authorities and taxpayers in determining the presence or absence of criminal tax intent in affiliate royalty transactions?

This study encompasses both objective and subjective purposes: (1) Objective Purpose: To analyze the legal boundaries separating tax avoidance schemes from tax evasion in royalty transfer pricing, and to clarify the characteristics and standard of proof regarding evidence in affiliate transaction disputes. (2) Subjective Purpose: To apply theoretical frameworks of state administrative law and criminal tax law acquired in academic settings, thereby contributing to academic literature on tax law.

The significance of this research includes: (1) Theoretical Significance: Contributing to the development of tax law, state administrative law, and criminal tax law, particularly regarding the *substance over form* doctrine and the *ultimum remedium* principle. (2) Practical & Policy Significance: Offering constructive input for the DGT in formulating criminal investigation guidelines to prevent the criminalization of commercial disputes, as well as providing guidance for taxpayers in mitigating TP Doc compliance risks.

LITERATURE REVIEW

Concept of Tax Administrative Law and Related Party Relationships

Tax law constitutes a branch of state administrative law regulating governmental authority to levy taxes while offering legal protection to citizens. Philipus M. Hadjon emphasizes that administrative power must always be restrained by the principle of legality and

general principles of good governance (Hadjon, 2011). In determining transfer pricing, Article 18 paragraph (3) of the UU PPh empowers tax auditors to recalculate taxable income if transactions with related parties fail to adhere to the Arm's Length Principle (ALP). Such fiscal corrections are embodied in administrative decisions (*beschikking*) via Tax Assessment Notices (SKP), which are subject to administrative review.

Legal Boundaries of Tax Avoidance and Tax Evasion

In international tax law doctrine, tax avoidance refers to schemes minimizing tax liabilities legally by exploiting legal loopholes without violating formal laws (Baker, 2018). Conversely, tax evasion involves illegal acts containing elements of factual manipulation, forgery, or tax fraud (Avi-Yonah, Reuven S., 2020). The fundamental demarcation between the two hinges on the presence of *mens rea* (criminal intent) and an unlawful material act (*actus reus*).

Characteristics of Royalty Transfer Pricing Testing

Pursuant to PMK No. 172/PMK.03/2023 and OECD Guidelines, testing intra-group royalty payments requires a two-stage test: (1) Existence and Benefit Test: Proving that the intangible asset actually exists, is legally/economically owned by the affiliate, and provides real commercial benefit to the domestic taxpayer. (2) Arm's Length Rate Test: Determining whether the agreed royalty rate corresponds to pricing agreed upon by independent parties under comparable circumstances through comparability analysis (FAR: Functions, Assets, Risks).

METHODS

This study employs normative (doctrinal) legal research focusing on the inventory, evaluation, and systematic analysis of positive law and legal doctrines. The research approaches utilized include:

1. Statutory Approach: Comprehensively examining UU KUP, UU PPh, UU HPP, PMK No. 172/PMK.03/2023, and Double Taxation Avoidance Agreements (DTAA/P3B).
2. Conceptual Approach: Analyzing state administrative law concepts (authority vs. legal protection), the *arm's length principle*, the *substance over form* doctrine, and elements of criminal tax offenses.
3. Case Approach: Examining Tax Court jurisprudence (including Decision No. Put-006760.15/2020/PP.M.XVIB of 2025) to identify judicial reasoning in adjudicating affiliate royalty disputes.

Primary legal materials comprise tax statutes and DTAAs. Secondary legal materials consist of legal textbooks, accredited scientific journals, and OECD Transfer Pricing Guidelines. Tertiary legal materials include legal dictionaries. All legal materials are analyzed through qualitative-deductive analysis to construct prescriptive legal arguments.

RESULTS AND DISCUSSION

Legal Demarcation Line Between Tax Avoidance and Tax Evasion in International Royalty Transactions

Establishing the legal demarcation line between tax avoidance and tax evasion in affiliate royalty transactions is a critical issue in domestic and international tax law (Mansor, Mohd Fairuz, 2021). Transactions involving Intangible Assets such as trademarks, know-how, and secret formulas inherently carry high levels of subjectivity due to their confidential nature and the absence of open market comparisons (OECD, 2022).

Administrative Law Perspective and the Arm's Length Principle

Within tax administrative law, a taxpayer's failure to satisfy the Arm's Length Principle (ALP) under Article 18 paragraph (3) of the UU PPh in conjunction with PMK No. 172/PMK.03/2023 is corrective-commercial in nature. The inability to present a comparability

analysis or disagreements over transfer pricing methods (such as the Resale Price Method, Transactional Net Margin Method, or Relief from Royalty Method) essentially represent an economic valuation disagreement (Mansor, Mohd Fairuz, 2021).

Corrections executed by tax auditors via the disallowance of royalty expenses and the re-allocation of income and deductions are strictly administrative acts (*beschikking*). Disputes arising from Underpaid Tax Assessment Notices (SKPKB) are resolved through administrative legal mechanisms, including Objections, Appeals to the Tax Court, Judicial Review (PK) in the Supreme Court, or inter-authority Mutual Agreement Procedures (MAP) (Hutagaol, 2014).

Demarcation of Mens Rea and Actus Reus Elements Leading to Criminal Offenses (Article 39 UU KUP)

Transitioning from an administrative regime to a criminal tax offense requires fulfilling both subjective elements (*mens rea* / criminal intent) and objective elements (*actus reus* / material unlawful act) (Avi-Yonah, Reuven S., 2020). Article 39 paragraph (1) letters c, d, or g of the UU KUP penalizes any person who willfully fails to submit an SPT, submits an SPT containing incorrect/incomplete information, or presents forged books or documents. Key distinctions between tax avoidance and tax evasion in royalty transactions include:

Tax Avoidance Line: The taxpayer factually utilizes know-how or trademarks in its Indonesian business operations. Intellectual property (IP) rights are legally registered, royalties are calculated as a percentage of sales, and payments are remitted to the IP owner. The taxpayer's failure lies merely in insufficient technical evidence demonstrating the exact contribution of know-how to profitability. This constitutes pure tax avoidance or commercial administrative non-compliance (Baker, 2018).

Tax Evasion Line: The taxpayer expenses royalties to a foreign affiliate functioning as a shell/paper company in a tax haven jurisdiction without real IP existence (*fictitious IP*), relying on falsified or backdated supporting documents (know-how manuals), with royalty cash flows routed back to the ultimate beneficial owner in Indonesia via round-tripping schemes (Surachmad, 2018). In this scenario, both *mens rea* (intentional transaction manipulation) and *actus reus* (use of forged documents to manipulate tax returns) are cumulatively fulfilled (Atmasasmita, 2021).

Substance Over Form Doctrine and BEPS Action 8–10 Framework

In line with OECD BEPS (Base Erosion and Profit Shifting) Action 8–10 Final Reports and PMK No. 172/PMK.03/2023, royalty testing adopts the substance over form doctrine via the DEMPE framework (Development, Enhancement, Maintenance, Protection, and Exploitation) (OECD, 2015). Tax authorities are required to identify which affiliate actually performs DEMPE functions and bears economic risks related to the IP. If a foreign royalty recipient holds only legal ownership without operational capability and economic substance to manage the IP, royalty allocations may be adjusted to zero. DEMPE-based adjustments represent administrative substance over form corrections, not immediate proof of criminal tax acts, unless physical document forgery is established (Avi-Yonah, Reuven S., 2020).

Under Indonesian criminal law reform pursuant to Law Number 1 of 2023 on the Criminal Code (New KUHP), the principle of *geen straf zonder schuld* (no punishment without fault) is explicitly affirmed in Article 36. Therefore, methodological transfer pricing disputes arising purely from differing perceptions of DEMPE cost allocation cannot be classified as criminal intent (*dolus*). Economic substance failures without physical forgery or fictitious schemes must remain strictly within tax administrative legal corridors.

Status and Evidentiary Weight of Evidence in Affiliate Royalty Disputes

The fundamental difference between administrative disputes in the Tax Court and criminal tax investigations lies in the standard of proof and the categories of evidence utilized.

Evaluation of Evidence in Tax Administrative Disputes

Tax administrative disputes before the Tax Court follow the preponderance of evidence standard under the principle of free evaluation of evidence (Article 76 of Law No. 14 of 2002 on the Tax Court). Taxpayers bear the burden of presenting comprehensive TP Doc to satisfy the Two-Stage Test:

- Existence and Benefit Test: Taxpayers must prove that intangible assets actually exist and yield genuine economic/commercial value, such as improved production efficiency, revenue growth, or reduced operational costs (OECD, 2022). Key evidence includes technical manuals, daily email correspondence concerning technical assistance, independent audit reports, and patent formulas.
- Arm's Length Rate Test: Evidence submitted includes benchmarking studies using international commercial databases (such as Cuatrecasas, Royaltystat, or KTMINE) to establish comparable arm's length royalty rates (Hutagaol, 2014).

Field dynamics demonstrate that tax auditor corrections are frequently overturned by Tax Court judges when taxpayers successfully present factual proof of know-how implementation in manufacturing processes. As reflected in Tax Court Decision Number Put-006760.15/2020/PP.M.XVIB of 2025, the Judicial Panel granted the taxpayer's appeal against royalty corrections because the taxpayer successfully substantiated patent certificates, routine technology transfer, and product quality improvements, despite tax authorities arguing a lack of economic substance.

Evaluation of Evidence in Criminal Tax Investigations

When a dispute is escalated to criminal investigation by Civil Servant Investigators of the DGT, a stringent standard of proof applies beyond a reasonable doubt as regulated under Article 235 paragraph (1) of the Criminal Procedure Code (KUHAP).

Article 235 paragraph (1) of the KUHAP expands admissible evidence to include:

1. Keterangan saksi,
2. Keterangan ahli,
2. Witness testimony,
3. Expert testimony,
4. Documents/letters (including digital documents),
5. Defendant statements,
6. Physical evidence,
7. Electronic evidence,
8. Judicial observation, and
9. “Anything" that may serve as evidence provided it is lawfully obtained.

Investigators must prove intentional material or formal offenses (Surachmad, 2018). Credible evidence to prove tax evasion in royalty payments includes:

- Forged Documents/Letters
  Forensic laboratory findings showing backdated license contracts or counterfeit foreign entity stamps.
- Witnesses and Digital Forensics
  Digital chat transcripts or internal executive emails detailing engineered fictitious royalty expenses solely designed for profit stripping prior to the fiscal year end (Avi-Yonah, Reuven S., 2020).
- Expert Testimony
  IT, criminal tax law, and transfer pricing experts confirming the total absence of knowledge transfer and verifying that claimed foreign server databases containing secret formulas were never accessed by the domestic taxpayer.

10. Ultimum Remedium Principle and Legal Certainty Protection
    Applying criminal tax sanctions to transfer pricing disputes must uphold the *ultimum remedium* principle (criminal law as a last resort) (Amirah Febtrina et al., 2022). Arbitrarily reclassifying transfer pricing valuation disputes from objection/appeal procedures into criminal investigations without establishing *mens rea* or fictitious documents constitutes an abuse of power that compromises legal certainty and the investment climate (Hadjon, 2011). Article 44B of UU KUP in conjunction with UU HPP reinforces that state revenue recovery (*ultimum remedium* and revenue reliability principles) takes precedence through investigation termination mechanisms upon payment of administrative penalties.

CONCLUSION

The legal boundary separating tax avoidance and tax evasion in cross-border affiliate royalty payments depends on the presence of *mens rea* (criminal intent) and material manipulation (*actus reus*). A taxpayer's inability to substantiate the arm's length principle, methodological differences in comparability analysis, or administrative deficiencies in TP Doc fall under administrative tax law, resulting in fiscal corrections to be adjudicated before the Tax Court. Conversely, tax evasion occurs when royalty transactions are fictitiously engineered through document forgery, paper entities lacking substance, and deliberate technical data manipulation aimed at eroding the domestic tax base.

Evidentiary assessment in tax administrative disputes focuses on economic substance testing (benefit test and rate test) governed by the *preponderance of evidence* standard via TP Doc, benchmarking studies, and daily operational proof. In criminal tax proceedings, investigators must satisfy the *beyond a reasonable doubt* standard under Article 235 paragraph (1) of the KUHAP by establishing material forgery, criminal intent, and transaction manipulation through digital forensics and key witness testimonies.

Recommendations

For the Directorate General of Taxes. The DGT should issue clear operational investigation guidelines defining objective indicators of *mens rea* in transfer pricing disputes. This will prevent commercial valuation disputes from being drawn into criminal regimes, thereby preserving legal certainty and the *ultimum remedium* principle.

For Taxpayers. Taxpayers must adopt an *ex-ante compliance* approach by maintaining not only formal TP Doc, but also contemporaneous daily operational documentation substantiating DEMPE functions and benefit tests in real-time to mitigate risks of fiscal adjustments and criminal tax allegations.

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