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Unraveling transfer pricing in construction sectors: Tax optimization, compliance, and environmental risk

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Abstract

This study highlights the consequence of tax optimization, regulatory compliance, and environmental risk index on the likelihood of transfer pricing in Indonesia's property, real estate, and building construction sectors. This study adopts a quantitative research approach, analyzing data from 19 companies in the property, real estate, and building construction sectors listed on the Indonesia Stock Exchange (IDX) between 2018 and 2021 (76 observations). This study contributes novelty by employing binary logistic regression to investigate the interaction of tax optimization, regulatory compliance, and environmental risk index on transfer pricing in Indonesia's property, real estate, and building construction sectors, providing valuable insights into the determinants of transfer pricing practices in these industries. The research employs multiple linear and binary logistic regression to examine the influence of tax optimization, regulatory compliance, and environmental risk index on transfer pricing likelihood. - Tax optimization and regulatory compliance significantly impact the likelihood of Transfer Pricing in the property, real estate, and building construction sectors in Indonesia. However, the interaction between tax optimization and the environmental risk index does not significantly influence transfer pricing likelihood. In contrast, the interaction between regulatory compliance and the environmental risk index does have a significant positive effect. The implications are that tax optimization may subtly influence transfer pricing in the studied sectors. Maintaining regulatory compliance appears to act as a deterrent, and a favorable environmental risk index may encourage transfer pricing practices in Indonesia's property, real estate, and building construction industries.

Keywords: Construction sectors; Environmental risk index; Regulatory compliance; Tax optimization; Transfer pricing.

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Introduction

Transfer pricing is a critical issue of multinational corporations' operations, involving setting prices for intra-group transactions (Plesner-Rossing et al., 2017). It has garnered significant attention from tax authorities and researchers worldwide due to its potential impact on tax revenue and the fair allocation of profits among related entities (da Silva Stefano et al.,

2022). This study delves into the domain of transfer pricing, specifically within Indonesia's property, real estate, and building construction sectors, which play a crucial role in the country's economic growth and development (Rathke et al., 2020). These sectors often involve complex supply chains, multiple entities, and intangible assets, making them susceptible to intricate transfer pricing practices (Muhammadi et al., 2016). Understanding the dynamics of transfer pricing in these sectors is vital for policymakers, businesses, and investors to ensure transparency, prevent tax avoidance, and promote a conducive investment climate (Sari et al., 2020).

Indonesia's property, real estate, and building construction sectors have experienced significant expansion in recent years, attracting substantial domestic and foreign investments (Muslih et al., 2020). As these sectors contribute substantially to the national GDP, their tax implications and financial practices have become subjects of heightened interest (Sinaga et al., 2023). With the growing complexities in business operations, it becomes imperative to investigate the influence of tax optimization, regulatory compliance, and environmental risk on the likelihood of transfer pricing within the sectors. Moreover, Indonesia's tax authorities have been intensifying their focus on transfer pricing regulations (Huda et al., 2017), making it essential for businesses to anticipate these challenges and maintain compliance.

Prior research in transfer pricing has primarily focused on general multinational companies, neglecting sector-specific investigations (Sundari & Susanti, 2016; Susanti & Firmansyah, 2018; Waworuntu & Hadisaputra, 2016; Yunus et al., 2022). In Indonesia's property, real estate, and building construction sectors, limited scholarly attention has been devoted to understanding the intricate relationship between tax optimization, regulatory compliance, and environmental risk in transfer pricing practices. Existing studies have primarily focused on tax planning strategies and the impact of transfer pricing on tax revenue (Irawan et al., 2020; Klassen et al., 2017; Kohlhase & Wielhouwer, 2023) without exploring the specific nuances within these sectors. This study aims to bridge this gap in literature by exploring the unique dynamics of transfer pricing in the specified industries and examining the implications of tax optimization, regulatory compliance, and environmental risk index on transfer pricing likelihood.

This study examines how tax optimization, regulatory compliance, and environmental risk index impact transfer pricing likelihood in Indonesia's property, real estate, and building construction sectors. Through detailed quantitative analysis, the study will determine the potential effects of these factors on the likelihood of transfer pricing in these industries. This study aims to pinpoint the primary transfer pricing drivers and their relative importance in the context of these sectors by analyzing the statistical significance of the relationships, which has been the subject of previous research by several authors (Korol et al., 2022; Marques & Pinho, 2016; Mescall & Klassen, 2018).

While several studies have explored transfer pricing in multinational corporations, the specific focus on Indonesia's property, real estate, and building construction sectors remains largely unexplored in the literature. This research contributes to existing knowledge by unveiling the intricacies of transfer pricing practices within these industries. Moreover, using binary logistic regression to analyze the impact of tax optimization, regulatory compliance, and environmental risk index on transfer pricing is a novel approach, offering fresh insights into the unique determinants of transfer pricing likelihood in the specified sectors. We hope

that by addressing this research gap, this study provides valuable implications for the government, companies, and investors to foster a better understanding and governance of transfer pricing practices in Indonesia's property, real estate, and building construction sectors.

Research Design and Method

This study adopts a quantitative research design to investigate the impact of tax optimization, regulatory compliance, and environmental risk index on transfer pricing in Indonesia's property, real estate, and building construction sectors. Quantitative research allows for systematic analysis of numerical data, enabling the examination of relationships between variables and testing hypotheses. The research site comprises 19 property, real estate, and building construction companies listed on the Indonesia Stock Exchange (IDX) from 2018-2021. These sectors were chosen due to their significant contributions to Indonesia's economic growth and substantial involvement in complex financial transactions involving transfer pricing.

Various financial and non-financial variables related to tax optimization, regulatory compliance, environmental risk index, and transfer pricing were collected from public sources on the Indonesia Stock Exchange (IDX) and companies' official websites to obtain the necessary data. The selected companies' financial reports, disclosures, and annual reports provided data needed to calculate the Cash Effective Tax Rate (CETR), namely the current income tax expense ratio to the income before tax (Carolina & Oktavianti, 2022). A company's Regulatory compliance can be seen from its consistency in transfer pricing over time (measured by dummy variable: 0 = inconsistent; 1 = consistent). Companies can use the environmental risk index as a moderation variable to measure their Corporate Social Responsibility (CSR), particularly regarding environmental sustainability. This index can be determined by the percentage of sustainability reported in the annual reports or financial statements from the Global Reporting Initiative (GRI). A higher index indicates a lower environmental risk, while a lower index indicates a higher environmental risk. Finally, the transfer pricing is measured by a dummy variable (0 = without transfer pricing and 1 = with transfer pricing). In short, the data collection process involved thoroughly scrutinizing the annual financial reports, sustainability reports, and other relevant documents of the 19 companies from 2018 to 2021. Variables related to tax optimization, regulatory compliance, environmental risk index, and transfer pricing were meticulously extracted and compiled into a structured dataset for analysis. The data analysis comprised two essential statistical techniques: multiple linear and binary logistic regression.

Using multiple linear regression, the first analysis examined the impact of tax optimization, regulatory compliance, and environmental risk index on transfer pricing. The dependent variable, transfer pricing, was measured as a binary variable (dummy), indicating the presence or absence of transfer pricing practices. The independent variables included tax optimization, regulatory compliance, and environmental risk index. The regression model sought to assess these variables' relationships and statistical significance in influencing the transfer pricing. A binary logistic regression was employed to explore the transfer pricing likelihood further. This analysis allowed us to assess the probability of transfer pricing based on the independent variables of tax optimization and regulatory compliance and the environmental risk index moderator variable. The logistic regression model provided insights

into the magnitude and direction of the impact of each factor on the likelihood of engaging in transfer pricing within the property, real estate, and building construction sectors in Indonesia.

The hypotheses for the research model are:

H₁: *Tax optimization has a significant effect on the likelihood of transfer pricing.*

H₂: *Regulatory compliance has a significant effect on the likelihood of transfer pricing.*

H₃: *The interaction effect between tax optimization and the environmental risk index has a significant impact on the likelihood of transfer pricing.*

H₄: *The interaction effect between regulatory compliance and the environmental risk index has a significant impact on the likelihood of transfer pricing.*

Results and Discussion

Results and Discussion

The results show moderate multiple regression analysis and binary logistic regression outputs. Table 1 depicts the output of moderate multiple regression analysis.

Table 1. Output of Moderated Multiple Regression Analysis

	Unstandardized Coefficients		Standardized Coefficients			
	B	**Std. Error**	**Beta**	**t**	**Sig.**	**H0**
(Constant)	-0.136	0.119		-1.137	0.259	
Zscore: Tax Optimization	0.398	0.117	0.398	3.401	0.001	Rejected
Zscore: Regulatory Compliance	0.288	0.120	0.288	2.394	0.019	Rejected
Int1	-0.062	0.136	-0.047	-0.456	0.650	Not rejected
Int2	0.278	0.124	0.237	2.234	0.029	Rejected

Source: *SPSS Output (2023)*

Based on the information from Table 1, it can be said that a one-unit increase in Tax Optimization is associated with a 0.398 increase in the ZScore for Transfer Pricing. The coefficient is statistically significant (p = 0.001), indicating that Tax Optimization significantly impacts the likelihood of Transfer Pricing. A one-unit increase in Regulatory Compliance is associated with a 0.288 increase in the ZScore for Transfer Pricing. The coefficient is statistically significant (p = 0.019), indicating that Regulatory Compliance significantly impacts the likelihood of Transfer Pricing. The coefficient for Int1 is -0.062, which is not statistically significant (p = 0.650). This suggests that the interaction effect between Tax Optimization and the Environmental Risk Index does not significantly influence the likelihood of Transfer Pricing. The coefficient for Int2 is 0.278, and it is statistically significant (p = 0.029). This indicates that the interaction effect between Regulatory Compliance and the Environmental Risk Index significantly impacts the likelihood of Transfer Pricing.

The results suggest that both Tax Optimization and Regulatory Compliance significantly positively impact the likelihood of Transfer Pricing in the property, real estate,

and building construction sectors in Indonesia. However, the interaction between tax optimization and the environmental risk index does not significantly influence the likelihood of transfer pricing. In contrast, the interaction between regulatory compliance and the environmental risk index has a significant positive effect.

Binomial logistic regression was then employed to explore the likelihood of transfer pricing. First, we must look at the model summary in Table 2. A logistic regression was performed to ascertain the effects of tax optimization, regulatory compliance, and environmental risk index on the likelihood that the companies have transfer pricing. The model explained 92.2% (Nagelkerke R2) of the variance in transfer pricing, implying a reasonably good fit.

Table 2. Model Summary of Logistic Regression

Step	-2 Log likelihood	Cox & Snell R Square	Nagelkerke Square
1	15.846[a]	.689	.922

a. Estimation terminated at iteration number 11 because parameter estimates changed by less than .001.

Source: *SPSS Output (2023)*

Table 3. Classification Table of Logistic Regression

			Predicted		
			Transfer Pricing		Percentage Correct
	Observed		Do Not	Do	
Step 1	Transfer Pricing	Do Not	40	2	95.2
		Do	2	32	94.1
	Overall Percentage				94.7

a. The cut value is .500

Source: *SPSS Output (2023)*

Table 4. Variables in the Equation of Logistic Regression

		B	S.E.	Wald	df	Sig.	Exp(B)
Step 1[a]	Tax Optimization	57.878	26.143	4.901	1	.027	1.369E+25
	Regulatory Compliance (1)	.489	1.296	.142	1	.706	1.631
	Enviromental Risk	.172	.079	4.763	1	.029	1.187
	Constant	-26.371	11.694	5.086	1	.024	.000

a. Variable(s) entered on step 1: TaxOptimization, Regulatory Compliance, Enviromental Risk.

The logistic regression model was statistically significant, $\chi 2(8) = 15.808$, $p < 0.05$. This test assesses whether the model (including all independent variables and interactions) significantly affects the likelihood of transfer pricing. The percentage of correctly classified cases is 94.7%. This indicates the model's overall accuracy in predicting whether companies have transfer pricing, as depicted in Table 3.

From Table 4, the tax optimization positively impacted transfer pricing and the effect was statistically significant. This implies that companies employing tax optimization strategies were likelier to use transfer pricing practices. Engaging in tax optimization and transfer pricing practices can allow companies to minimize their tax burden (Irawan et al., 2020), potentially leading to increased profits and improved financial performance. These findings confirm the positive impact of tax optimization on transfer pricing (Kohlhase & Wielhouwer, 2023). Conversely, overly aggressive tax optimization and transfer pricing

practices, especially with aggressive tax avoidance schemes, can expose companies to reputational risks and potential legal consequences (Khelil & Khlif, 2022). Tax authorities might challenge such practices, leading to audits, penalties, and reputational damage. Moreover, excessively complex transfer pricing arrangements may increase administrative burdens and resource allocation for compliance (Muhammadi et al., 2016).

Nevertheless, regulatory compliance positively impacted transfer pricing, but the effect was not statistically significant. This suggests that although companies adhering to regulatory requirements might exhibit higher transfer pricing tendencies, the relationship between regulatory compliance and transfer pricing likelihood did not reach statistical significance in this study. The lack of statistical significance in this study might suggest that other factors not considered in the model could influence the relationship between regulatory compliance and transfer pricing. Ideally, the higher the regulatory compliance, the higher the transfer pricing practice (Klassen et al., 2017). Regulatory compliance concerning transfer pricing may not significantly drive transfer pricing practices in the companies studied. It may not substantially impact on the company's decision-making regarding transfer pricing. Adhering to regulatory compliance requirements is generally considered favorable for companies, as it ensures they operate within the legal framework and avoids potential legal and reputational risks. Compliance can improve a company's reputation (Rathke et al., 2020).

In this model, the environmental risk index positively impacted transfer pricing, and the effect was statistically significant. Companies with favorable environmental risk indexes were more likely to use transfer pricing practices. This finding indicates that the environmental risk factor plays a noteworthy role in influencing the likelihood of transfer pricing among companies in Indonesia's property, real estate, and building construction sectors. Companies with a favorable environmental risk index are more likely to engage in transfer pricing practices, which can have several benefits. Those companies may have more significant international operations and global market exposure (Devos et al., 2019). Transfer pricing can provide them with a mechanism to optimize their tax planning strategies and effectively allocate profits between different entities across borders (Mescall & Klassen, 2018). This can enhance their competitiveness and facilitate expansion into international markets.

The companies that do the regulatory compliance were 1.631 more likely to exhibit transfer pricing. The companies with good environmental risk index were 1.187 more likely to exhibit transfer pricing. The findings suggest that regulatory compliance and an excellent environmental risk index are associated with an increased likelihood of exhibiting transfer pricing practices in Indonesia's property, real estate, and building construction sectors. The odds ratio of 1.631 indicates that companies adhering to regulatory compliance requirements are 1.631 times more likely to engage in transfer pricing practices compared to companies that may have lower compliance levels. This finding suggests that regulatory compliance significantly influences transfer pricing decisions among the studied companies. Companies that actively comply with transfer pricing regulations are more inclined to utilize transfer pricing strategies to optimize their tax planning and enhance their financial performance (Kohlhase & Wielhouwer, 2023).

The odds ratio of 1.187 indicates that companies with an excellent environmental risk index are 1.187 times more likely to exhibit transfer pricing practices than companies with a lower environmental risk index. This finding implies that the environmental risk factor is a

relevant determinant in shaping the likelihood of transfer pricing among the studied companies. Companies with a favorable environmental risk index may be more likely to engage in transfer pricing practices, possibly to strategically manage their tax liabilities in line with their environmental sustainability efforts (Bird & Davis-Nozemack, 2018).

Companies with higher environmental risk indices may actively pursue environmentally sustainable practices to align with global sustainability goals and regulations. Governments may incentivize such initiatives through tax benefits or credits, providing an additional reason for these companies to use transfer pricing practices to optimize their tax positions (Khan et al., 2017; Klassen et al., 2017). Moreover, companies with an excellent environmental risk index may invest significantly in eco-friendly technologies or green initiatives (Horng et al., 2017). Transfer pricing practices may be used to allocate profits and costs among entities involved in these green investments, reflecting the genuine allocation of resources and risks within the company (Hemling et al., 2022). Companies may use transfer pricing to manage their tax liabilities efficiently and strategically (Amidu et al., 2019). An excellent environmental risk index may indicate companies' commitment to comply with regulations and ethical business practices, and such companies may employ transfer pricing as a legitimate tax planning strategy (Heimert & Michaelson, 2018).

It's important to acknowledge the study's limitations. While the results show an association between regulatory compliance, environmental risk index, and transfer pricing practices, causality cannot be established from this study alone. Further research and longitudinal studies could explore causal relationships and understand the dynamic interactions between these factors.

Conclusions

This study sheds light on the complex dynamics of transfer pricing practices in Indonesia's property, real estate, and building construction sectors. The main findings reveal the significant positive impacts of both tax optimization and regulatory compliance on the likelihood of transfer pricing. The positive impact of tax optimization indicates that companies employing tax planning strategies are more likely to utilize transfer pricing to optimize their tax positions and enhance financial performance. Similarly, the significant positive effect of regulatory compliance emphasizes the importance of adhering to regulatory requirements to influence transfer pricing decisions positively.

Furthermore, the results demonstrate that the environmental risk index is noteworthy in influencing the likelihood of transfer pricing. Companies with a favorable environmental risk index are more likely to engage in transfer pricing practices, reflecting a potential alignment of tax strategies with environmental sustainability efforts. However, the study also reveals that the interaction between tax optimization and the environmental risk index does not significantly influence transfer pricing likelihood. This suggests that the environmental risk may not significantly influence the relationship between tax optimization and transfer pricing. On the other hand, the interaction between regulatory compliance and the environmental risk index has a significant positive effect on transfer pricing likelihood. This finding implies that companies with high regulatory compliance and a positive environmental risk index may use transfer pricing practices to support their sustainable business initiatives.

These results provide valuable insights for the governments (tax authorities), businesses, and investors in understanding the determinants of transfer pricing practices in the studied industries. Companies should consider the implications of tax optimization and the environmental risk index on their transfer pricing decisions and consider the regulatory compliance requirements to ensure fair and transparent business practices. The findings also highlight the importance of considering environmental risk factors in transfer pricing strategies and underscore the need for further research in this specific context to gain deeper insights into the dynamics of transfer pricing within these sectors.

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