
Reclassification of Excess Royalty Payments as Disguised Dividends in a Secondary Adjustment Framework Under Indonesian Tax Law and OECD Standards

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ABSTRACT

The increasing complexity of cross-border controlled transactions conducted by multinational enterprises has created significant challenges in international taxation, particularly concerning transfer pricing practices and profit shifting through excessive royalty payments. Such payments may reduce taxable income in source jurisdictions and contribute to potential tax base erosion, requiring effective legal mechanisms to ensure equitable taxation. This study aimed to examine the legal basis, normative challenges, and compatibility of Indonesia's secondary adjustment framework in reclassifying excessive royalty payments as deemed dividends under Indonesian tax law and OECD standards. This research employed a normative juridical method using statutory and conceptual approaches. Legal materials were collected from Indonesian tax regulations, including the Income Tax Law, Government Regulation Number 55 of 2022, Minister of Finance Regulation Number 172 of 2023, and international references, such as the OECD Transfer Pricing Guidelines. The findings indicated that Indonesia had established a legal foundation for secondary adjustments through the constructive dividend approach. However, several normative issues remained, particularly regarding the extension of the dividend concept to transactions involving non-shareholders, potential ultra vires interpretations, and the risk of international double taxation. The study concluded that Indonesia's framework required further regulatory clarification and technical guidance to ensure consistency with OECD principles, strengthen legal certainty, and establish a fairer approach to resolving transfer pricing disputes involving excessive royalty payments.

Keywords: Transfer Pricing, Secondary Adjustment, Disguised Dividends, Royalties

INTRODUCTION

The dynamics of economic globalization have driven a significant increase in cross-border controlled transactions conducted by multinational enterprises, thereby placing transfer pricing at the center of the international tax regime (Putri, 2024). Multinational enterprises not only operate as global economic actors but also as entities capable of strategically allocating profits across jurisdictions through transfer pricing policies. In this regard, transfer pricing is essentially a legitimate business mechanism; however, in practice, it is often exploited to facilitate tax avoidance through profit-shifting arrangements involving low- or no-tax jurisdictions (Huda, 2017). This phenomenon, known as Base Erosion and Profit Shifting (BEPS), has been estimated by the OECD to cause global tax revenue losses ranging from USD 100 billion to USD 240 billion annually (Imelda, 2025). For developing countries such as Indonesia, this issue not only affects state revenue but also reflects inequality in the allocation of taxing rights. Therefore, transfer pricing challenges can no longer be viewed merely as technical issues but also as matters of global fiscal justice.

Within profit-shifting practices, royalty payments arising from cross-border controlled transactions have become highly strategic instruments because they involve intangible assets that are difficult to evaluate objectively. Royalties are generally defined under Indonesian tax regulations as payments for the use of, or the right to use, intellectual property rights, as reflected in the implementation of Law Number 7 of 1983 concerning Income Tax, as

amended several times, most recently by Law Number 7 of 2021 concerning the Harmonization of Tax Regulations (Ramadhan, 2025). The intangible nature of these assets limits the availability of reliable comparable data, thereby creating opportunities for manipulation of transaction values through excessive royalty payments. Such practices directly erode Indonesia's tax base as the source jurisdiction because these payments are treated as deductible expenses that reduce taxable income, while the transferred profits may be subject to lower taxation in other jurisdictions (Butarbutar, 2022).

In response to these practices, international tax standards developed by the OECD introduced the Arm's Length Principle, which requires transactions between related parties to be conducted under conditions comparable to those between independent parties (Catarino et al., 2023; Qiu, 2019). This principle has been widely adopted, including within the Indonesian tax system, and implemented through various regulations, including the Directorate General of Taxes Regulation No. PER-22/PJ/2013 concerning Guidelines for Tax Audits of Taxpayers with Special Relationships. The OECD Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations (2017 and 2022 editions) serve as the primary international reference for applying this principle (Kurniawan, 2025). However, in practice, the Arm's Length Principle faces significant limitations, particularly in transactions involving intangible assets such as royalties, due to difficulties in identifying truly comparable transactions and the existence of information asymmetry. This demonstrates that an Arm's Length Principle-based approach does not always effectively prevent profit-shifting practices (Hukamawati, 2016).

Under Indonesian tax law, the authority to adjust transactions that do not comply with the Arm's Length Principle is explicitly regulated in Article 18 paragraph (3) of Law Number 7 of 1983 concerning Income Tax, as most recently amended by Law Number 7 of 2021 concerning the Harmonization of Tax Regulations. This provision grants the Directorate General of Taxes the authority to redetermine taxable income for taxpayers involved in related-party transactions (Susanto, 2022). This authority is implemented through the primary adjustment mechanism, which aims to restore the taxpayer's profit position in accordance with the Arm's Length Principle (Sari, 2022). However, conceptually, primary adjustments function only as fiscal corrections to reported income and do not fully address the economic substance of the cash flows generated by the transaction. Consequently, excess payments received by affiliated parties may remain outside Indonesia's taxing jurisdiction, resulting in unresolved economic distortions.

To address these limitations, the Indonesian tax system applies a secondary adjustment mechanism that recharacterizes transfer pricing differences as constructive transactions. The approach applied is the constructive dividend mechanism, which is legally supported by Article 4 paragraph (1) letter g of Law Number 7 of 1983 concerning Income Tax, as amended by Law Number 7 of 2021 concerning the Harmonization of Tax Regulations, which recognizes dividends, including disguised forms of dividends, as taxable income. This approach is further reinforced by Government Regulation Number 55 of 2022 concerning Adjustments to Regulations in the Income Tax Sector, particularly Article 36 paragraph (6), and Minister of Finance Regulation Number 172 of 2023 concerning the Application of the Arm's Length Principle and Business Customary Practice in Transactions Influenced by Special Relationships, particularly Article 37 paragraph (1). These provisions explicitly state

that the difference between the controlled transaction price and the arm's length price may be treated as a dividend (Judijanto, 2025). As a legal consequence, excessive royalty payments may not be recognized as deductible expenses and may be subject to Income Tax Article 26 as dividend payments to foreign parties.

However, the application of disguised dividend treatment within secondary adjustments raises significant normative issues, particularly concerning the definition of dividends under domestic tax law, which conceptually requires a share ownership relationship. In practice, secondary adjustments may also apply to transactions between affiliated entities without a direct shareholder relationship, such as transactions between sister companies, thereby creating potential inconsistencies with the explanation of Article 4 paragraph (1) letter g of the Income Tax Law (Kristianto, 2024). This situation may lead to interpretations exceeding the authority (*ultra vires*) of tax authorities and increase the possibility of disputes before the Tax Court. From an international perspective, the OECD Transfer Pricing Guidelines (Paragraphs 4.67–4.77) recognize secondary adjustments and provide flexibility through Article 10 paragraph (3) of the OECD Model Tax Convention on Income and on Capital, which allows countries to classify certain income as dividends under domestic law. However, because secondary adjustments are not explicitly addressed within the corresponding adjustment mechanism under Article 9 paragraph (2) of the OECD Model Tax Convention, the possibility of international double taxation remains a significant concern (Firmansyah, 2025). Mitigation efforts through Minister of Finance Regulation Number 172 of 2023, which introduced a fund repatriation mechanism, as well as through the Mutual Agreement Procedure based on Article 25 of the OECD Model Tax Convention, demonstrate progressive regulatory development. Nevertheless, their effectiveness requires further evaluation, emphasizing the urgency of an in-depth normative analysis regarding the legitimacy and consistency of this policy within the Indonesian tax law framework.

METHOD

This research employed a normative juridical research method to analyze positive legal norms governing the reclassification of excess royalty payments as disguised dividends within the secondary adjustment framework. The research applied statutory and conceptual approaches. The statutory approach involved examining relevant laws and regulations, including Law Number 7 of 1983 concerning Income Tax, as most recently amended by Law Number 7 of 2021 concerning the Harmonization of Tax Regulations, particularly Article 4 paragraph (1) letter g and Article 18 paragraph (3), Government Regulation Number 55 of 2022 concerning Adjustments to Regulations in the Income Tax Sector, and Minister of Finance Regulation Number 172 of 2023 concerning the Application of the Arm's Length Principle and Business Customary Practice in Transactions Influenced by Special Relationships. Previous regulations, including Director General of Taxes Regulation Number PER-22/PJ/2013, were also examined as supporting legal references. The conceptual approach was used to analyze legal concepts related to the Arm's Length Principle, secondary adjustments, constructive dividends, and disguised dividends based on the OECD Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations and the OECD Model Tax Convention on Income and on Capital and its Commentary.

The legal materials analyzed consisted of primary legal materials, including national tax regulations and international tax instruments; secondary legal materials, including academic literature, scientific journals, and expert opinions; and tertiary legal materials as supporting references. The collected materials were analyzed qualitatively using grammatical, systematic, and comparative interpretation methods to assess regulatory consistency, identify legal gaps, and formulate prescriptive legal arguments regarding the legitimacy and application of secondary adjustments within the Indonesian tax legal system.

RESULTS AND DISCUSSION

Normative Basis for Reclassifying Excess Royalties in Indonesia's Secondary Adjustment Framework

The normative basis for reclassifying excess royalty payments as disguised dividends in Indonesia's secondary adjustment framework is rooted in the income tax legal system, which grants tax authorities broad authority to ensure that transactions between related parties are conducted in accordance with the principles of arm's-length business practice. In this context, the primary norm is Article 18, paragraph (3), of Law Number 7 of 1983 concerning Income Tax, as amended several times, most recently by Law Number 7 of 2021 concerning Harmonisation of Tax Regulations. This norm explicitly authorises the Director General of Taxes to redetermine the amount of income and deductions and to determine debt as Capital for related taxpayers. This norm serves as the legitimate basis for conducting transfer pricing corrections, or primary adjustments, as an instrument to return transaction conditions to the Arm's Length Principle, as recognised in international tax practice. (Nur Zam, 2025)

However, the authority in Article 18, paragraph (3), of the Income Tax Law essentially regulates only corrections to the amount of taxable income, without directly addressing the consequences for cash flows arising from these irregular transactions. In this case, additional normative construction is required to clarify the legal status of excess payments received by affiliated parties. This construction is found in Article 4 paragraph (1) letter g of Law Number 7 of 1983 concerning Income Tax, as most recently amended by Law Number 7 of 2021, which states that dividends are taxable, including direct and indirect distributions of profits, including disguised dividends. This article explicitly provides an example: payments to related parties that exceed reasonableness can be treated as dividends, thereby opening the possibility that excess royalty payments that fail the reasonableness test can be reclassified as disguised dividends. (Arianty, 2022)

Further development of this normative construction is evident in derivative regulations that increasingly explicitly accommodate the concept of secondary adjustments in the Indonesian tax law system. Government Regulation Number 55 of 2022 concerning Adjustments to Regulations in the Income Tax Sector, specifically Article 36 paragraph (6), emphasizes that the difference between the value of transactions affected by special relationships and the value that should be in accordance with the principles of arm's length and business custom can be treated as dividends. This provision represents an important normative reinforcement because, for the first time, it explicitly links the results of transfer pricing corrections to the legal consequences of constructive profit distribution. Thus, Government Regulation 55 of 2022 serves not only as an implementing regulation but also as

an instrument clarifying the direction of Indonesian tax law policy in adopting the secondary adjustment mechanism. (Kardinto, 2025)

Further strengthening is provided through Minister of Finance Regulation Number 172 of 2023 concerning the Application of the Arm's Length Principle in Transactions Influenced by Special Relationships, specifically Article 37 paragraph (1), which expressly states that the difference between the transaction price influenced by special relationships and the price that meets the arm's length principle is treated as a dividend. Furthermore, this provision stipulates that this treatment applies as long as the taxpayer does not adjust a refund or cash addition before the issuance of the tax assessment letter. (Rachmawati, 2023) Thus, PMK 172 of 2023 regulates not only the substantive but also the procedural aspects of secondary adjustments, including mitigation mechanisms such as fund repatriation, indicating significant progress in providing legal certainty for taxpayers.

The normative construction formed from the combination of Article 18 paragraph (3) and Article 4 paragraph (1) letter g of the Income Tax Law, Government Regulation Number 55 of 2022, and Minister of Finance Regulation Number 172 of 2023 essentially forms a comprehensive legal regime for regulating secondary adjustments through the constructive dividend approach. In this regime, the primary adjustment serves as the basis for the fiscal correction, while the secondary adjustment recharacterizes excess payments as distributions of profits that should be taxed. The legal implication is that excess royalty payments cannot be deducted as expenses in calculating taxable income and must be treated as dividends subject to Income Tax in accordance with applicable regulations. In the context of payments to foreign taxpayers, this provision has implications for the imposition of Article 26 Income Tax under the Income Tax Law, which requires withholding tax on dividends paid to foreign taxpayers.

The normative basis for reclassifying excess royalties as disguised dividends within the secondary adjustment framework in Indonesia is strong and multi-layered, spanning from the statutory level to the implementing regulations. This construction demonstrates the consistency of Indonesian tax law policy, not only correcting profit amounts through primary adjustments but also ensuring that economic flows arising from irregular transactions are subject to appropriate tax treatment through secondary adjustments. However, the complexity of this construction also opens the door to further debate about the limits of its interpretation and application in practice, which is important to analyze within a more in-depth normative legal framework.

Normative Problems of Reclassification as Disguised Dividends from an Indonesian Tax Law Perspective

The normative problem of reclassifying excessive royalty payments as disguised dividends stems from the tension between the legal construction established by the tax authorities and the limited definition of dividends in Indonesian positive law. Article 4 paragraph (1) letter g of Law Number 7 of 1983 concerning Income Tax, as most recently amended by Law Number 7 of 2021 concerning the Harmonisation of Tax Regulations, does recognize that dividends are taxable, including in disguised forms. However, the explanation of this Article conceptually links dividends to the distribution of profits to shareholders. This raises a normative issue when the concept is expanded in secondary adjustment practice to include transactions between affiliated entities that lack a direct ownership relationship, such

as sister companies. Thus, there is a mismatch between the normative construction in the law and the evolving administrative practice.

This issue becomes even more complex when linked to the Directorate General of Taxes' authority under Article 18, paragraph (3), of the Income Tax Law, which allows it to redetermine taxable income for related-party transactions. While this norm provides a strong basis for primary adjustments, it is questionable whether it also confers the authority to legally recharacterize a transaction into another form, particularly as a dividend in the context of a secondary adjustment. If this authority is not explicitly regulated, then the tax authority's broad interpretation could be categorized as *ultra vires*, that is, exceeding the authority granted by the law. This situation creates legal uncertainty and may violate the principle of legality in taxation, which requires that every tax imposition have a clear and firm legal basis (Popović & Kostić, 2018).

The ambiguity of legal construction is also evident in the assumption of a constructive transaction underlying the secondary adjustment (McManus, 2023). In practice, when there is an overpayment of royalties, the tax authority automatically treats the difference as a dividend, without explaining the legal mechanism that links the payment to the distribution of profits. In the context of sister-company relationships, for example, there is no direct relationship between the payer and the recipient that could legally explain the distribution of dividends. This raises questions about the assumed transaction structure: whether it is an indirect scheme, such as a capital contribution to the parent company followed by distribution to another entity, or a purely legal fiction. This ambiguity creates a weak legal basis for applying secondary adjustments and leaves room for differing interpretations between tax authorities and taxpayers.

Empirically, this normative problem is reflected in the growing number of transfer pricing disputes involving secondary adjustments in the Tax Court. Before the strengthening of regulations through Government Regulation No. 55 of 2022 and Minister of Finance Regulation No. 172 of 2023, many court decisions favoured the tax authorities because they were deemed to lack a strong legal basis for recharacterizing the transactions as dividends. Even after the introduction of more explicit regulations, disputes continue to arise over the scope of application of disguised dividends, particularly in transactions that do not directly involve shareholders. This demonstrates that the issues faced are not only normative but also have significant empirical dimensions in the practice of tax law enforcement.

Furthermore, the application of the constructive dividend approach also raises questions regarding its compliance with the principles of fairness and proportionality in taxation. By reclassifying excess royalty payments as dividends, taxpayers not only lose the right to expense these costs but are also subject to Article 26 Income Tax on dividends deemed paid to foreign parties as stipulated in the Income Tax Law. In some cases, this approach can result in multiple tax burdens, as adjustments are made at both the corporate level and the profit distribution level. Without adequate mechanisms to prevent double taxation, this situation can create unfairness for taxpayers, particularly in cross-border transactions involving double taxation avoidance agreements.

Reclassifying excess royalties as disguised dividends within the secondary adjustment framework raises complex normative issues under Indonesian tax law. The conflict between the definition of dividends in Article 4 paragraph (1) letter g of the Income Tax Law and the

practice of applying it to non-shareholder transactions, the potential for ultra vires interpretations under Article 18 paragraph (3), and the unclear construction of constructive transactions indicate gaps in the existing legal framework. Coupled with the empirical facts in the form of increasing disputes in the Tax Court and the potential for injustice in the tax burden, this condition emphasizes the need for a critical evaluation of the current approach, both from the perspective of legal legitimacy and from the perspective of justice and legal certainty in the Indonesian tax system.

Consistency of Indonesia's Approach with OECD Standards and Its Implications for International Double Taxation

The consistency of Indonesia's approach in implementing secondary adjustments through disguised dividend construction needs to be analyzed within the framework of international standards, specifically the OECD Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations (Paragraphs 4.67–4.77), which explicitly recognize that primary adjustments are not always sufficient to reflect actual economic conditions, necessitating further adjustments in the form of secondary adjustments. In these guidelines, the OECD does not mandate a specific form; instead, it provides options for constructive dividends, constructive loans, and constructive equity contributions. Indonesia, through Article 36, paragraph (6), of Government Regulation Number 55 of 2022, and Article 37, paragraph (1), of Minister of Finance Regulation Number 172 of 2023, expressly chooses the constructive dividend approach by classifying transaction differences as dividends. Normatively, this choice is understandable because it has a direct legal basis in Article 4 paragraph (1) letter g of the Income Tax Law, thus providing ease of application and certainty of taxation through the Article 26 Income Tax withholding mechanism.

However, when compared with international practice, Indonesia's rather singular approach raises questions regarding flexibility and compliance with the OECD's discretionary principles. The OECD allows countries to tailor the form of secondary adjustments to the characteristics of the transaction, including the use of constructive loans to reflect debt-receivable relationships or constructive equity contributions to reflect additional Capital. In this context, Indonesia's approach can be considered less adaptive because it does not substantially differentiate transaction characteristics. Therefore, a concrete action that can be taken is the development of technical guidelines by the Directorate General of Taxes that allow the use of alternative constructions other than dividends under certain conditions, particularly for transactions between non-shareholder entities, thus better aligning with the principle of substance over form and international practice.

The consistency of Indonesia's approach also needs to be analyzed in relation to Article 10, paragraph (3), of the OECD Model Tax Convention on Income and on Capital, which provides countries with flexibility to define dividends in accordance with their domestic laws. This provision provides Indonesia with the authority to treat transfer pricing differences as dividends, so long as domestic law so requires. However, this flexibility is not absolute, as it must still consider the partner country's revenue within the framework of a double taxation avoidance agreement (P3B). In practice, not all countries recognize the concept of constructive dividends, leading to differences in tax treatment. Concrete action in this regard is strengthening Indonesia's position in P3B negotiations and reforms by including clauses

that explicitly recognize secondary adjustments, thereby minimizing conflicts of interpretation across jurisdictions.

The most significant implication of these differing approaches is the risk of double taxation across international borders. This occurs because secondary adjustments are not explicitly accommodated in the corresponding adjustment mechanism, as stipulated in Article 9, paragraph (2), of the OECD Model Tax Convention, which only regulates corrections to primary adjustments. Consequently, when Indonesia imposes Article 26 Income Tax on constructive dividends, the partner country may not necessarily recognize or provide tax credits for such income. This situation creates judicial double taxation that cannot be resolved through conventional mechanisms. To address this, concrete actions include encouraging the strengthening of bilateral mechanisms through competent authority agreements specifically governing the treatment of secondary adjustments, as well as increasing tax authorities' capacity to conduct cross-border negotiations.

In response to these risks, Indonesia has taken progressive steps through Minister of Finance Regulation Number 172 of 2023, specifically Article 37, which introduces a repatriation mechanism to cancel secondary adjustments. This mechanism allows taxpayers to obtain refunds of overpayments before issuance of a tax assessment letter, thereby eliminating the need for reclassification as dividends.

In addition to domestic mechanisms, dispute resolution resulting from secondary adjustments can also be achieved through the Mutual Agreement Procedure (MAP) as stipulated in Article 25 of the OECD Model Tax Convention. MAP provides a platform for tax authorities from two countries to reach an agreement to avoid double taxation, including that arising from secondary adjustments. However, in practice, the MAP process is often time-consuming and does not always provide certainty of outcome for taxpayers. Therefore, concrete actions include strengthening the institutions and capacity of MAP units in Indonesia, accelerating the dispute resolution process, and encouraging the use of advance pricing agreements (APAs) as a preventive measure to avoid disputes in the first place. Therefore, the consistency of Indonesia's approach with OECD standards is assessed not only from a normative perspective but also from the effectiveness of its implementation and its ability to mitigate the risk of double taxation effectively.

CONCLUSION

The conclusion of this study indicated that the reclassification of excess royalty payments as disguised dividends within Indonesia's secondary adjustment framework had a relatively strong and multilayered normative basis derived from Article 18 paragraph (3) and Article 4 paragraph (1) letter g of Law Number 7 of 1983 concerning Income Tax, as most recently amended by Law Number 7 of 2021 concerning the Harmonization of Tax Regulations, and reinforced by Government Regulation Number 55 of 2022, particularly Article 36 paragraph (6), and Minister of Finance Regulation Number 172 of 2023, particularly Article 37 paragraph (1). This legal framework reflected Indonesia's policy choice to adopt a constructive dividend approach as the primary mechanism for secondary adjustments to ensure that differences arising from controlled transactions inconsistent with the Arm's Length Principle were subject to appropriate taxation. Normatively, this approach was also compatible with international standards, particularly the OECD Transfer Pricing

Guidelines and Article 10 paragraph (3) of the OECD Model Tax Convention on Income and on Capital, which provide countries with flexibility to define dividends under their domestic laws. However, this study identified significant normative challenges, particularly the tension between the domestic legal concept of dividends, which generally requires a shareholder relationship, and its application to transactions involving non-shareholder entities; the potential for ultra vires interpretations by tax authorities; and the uncertain legal characterization of the deemed transaction. Furthermore, this approach created practical implications in the form of international double taxation risks that cannot be fully resolved through the corresponding adjustment mechanism, thereby presenting substantial challenges to its implementation.

Based on these findings, this study recommended that the government and tax authorities strengthen and refine the regulatory framework and implementation policies concerning secondary adjustments. First, clearer normative provisions are required in tax laws and regulations, particularly regarding the application of disguised dividend treatment to transactions between non-shareholder entities, to prevent interpretative conflicts with the Explanation to Article 4 paragraph (1) letter g of the Income Tax Law and to ensure legal certainty and compliance with the principle of legality. Second, the Directorate General of Taxes should develop more comprehensive and flexible technical guidelines that allow alternative secondary adjustment approaches, such as deemed loans or deemed equity contributions, where appropriate, to better align with OECD practices and the characteristics of specific transactions. Third, to mitigate the risk of international double taxation, the implementation of Minister of Finance Regulation Number 172 of 2023 should be optimized, particularly regarding the fund repatriation mechanism, while strengthening the effectiveness of Mutual Agreement Procedures and Advance Pricing Agreements through improved institutional capacity and bilateral cooperation. Through these measures, the implementation of secondary adjustments in Indonesia may achieve stronger normative legitimacy while providing greater legal certainty, fairness, and effectiveness within the international tax system.

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