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Juridical Analysis of The Fairness Aspects of the Implementation of the Ar's Length Principle to Domestic Related-party Transactions in Indonesia

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Abstract. *This article examines the fairness and legal certainty of applying the Arm's Length Principle (ALP) to domestic affiliated transactions in Indonesia. Although the ALP was originally designed to prevent tax avoidance through profit shifting across jurisdictions with different tax rates, Indonesian tax law also applies it to domestic related-party transactions in which the parties are generally subject to the same tax rate. Using normative legal research, this study employs statutory, conceptual, and case approaches to analyze relevant tax regulations and selected Tax Court decisions. The findings indicate that the domestic application of the ALP raises significant fairness concerns because primary adjustments are not always accompanied by effective corresponding adjustments, thereby creating a risk of economic double taxation. Legal certainty is further weakened by inconsistent judicial reasoning and procedural limitations in the current regulatory framework. This article argues that a more proportionate policy model is required, including stronger protection of taxpayers' rights to corresponding adjustments, clearer limits on primary adjustments in domestic cases, and broader use of Advance Pricing Agreements as a preventive mechanism. These reforms are necessary to align domestic transfer pricing regulations with the principles of fairness, proportionality, and legal certainty.*

Keywords: *Arm's Length Principle; Corresponding Adjustment; Domestic Related-Party Transactions; Transfer Pricing*

1. Introduction

Tax, as the primary instrument of state revenue, occupies a central position in financing the administration of government and national development. Accordingly, it must be supported by a tax system grounded in fairness and legal certainty, capable of maintaining a proper balance between the State's fiscal interests and the rights of citizens as taxpayers. This conception places tax law as a normative framework that must proportionately accord with justice, legal certainty, and benefit principle (Musgrave & Musgrave, 1989: 218).

In Indonesian tax practice, one issue that continues to generate debate is the application of the Arm's Length Principle (ALP) to transactions between related parties. Fundamentally, the ALP is an instrument for controlling transfer pricing and has been widely accepted within the international tax regime. Theoretically, the ALP serves as a benchmark to approximate market-based conditions by aligning intra-group transactions with those that would be agreed upon by independent entities under comparable circumstances (OECD, 2022: 30). However, when this principle is applied to domestic related-parties transactions, a new problem emerges because both parties are subject to the same tax rate, and therefore the tax base is not distorted. In such circumstances, the application of the ALP by the tax authority pursuant to Article 18 verse (3) of the Income Tax Law may lead to double taxation that is inconsistent with the principle of fairness.

In addition to the issue of fairness, the application of the ALP to domestic affiliated transactions also raises questions of legal certainty, particularly as to whether the ALP should be applied at all in such transactions. This uncertainty is reflected in the disparity among final and binding Tax Court decisions concerning disputes over the application of the ALP to domestic affiliated transactions, making those decisions an unreliable guide for both taxpayers and the tax authority in the treatment of domestic affiliated transactions.

The insufficient fulfillment of the principle of fairness in the application of the ALP to domestic affiliated transactions is caused by the inadequacy of the current regulatory framework to guarantee taxpayers' rights as a consequence of ALP adjustments by the tax authority. One taxpayer right that has not been fully secured is the right to obtain a corresponding adjustment, which is the mechanism designed to eliminate double taxation.

Based on this background, this study was conducted to analyze the normative and practical factors that give rise to unfairness in the application of the ALP to domestic related-parties transactions. Based on these findings, the study formulates prescriptive policy recommendations to improve the regulatory design and practical implementation of the domestic ALP

2. Research Methods

This study is normative legal research focusing on a critical examination of positive legal norms, legal principles, and doctrinal constructions relating to the application of the ALP to domestic affiliated transactions. The main emphasis of the normative inquiry in this article lies in evaluating the coherence between tax regulations and the principles of fairness and legal certainty.

The research adopts statutory, conceptual, and case approaches. The statutory approach is used to examine relevant provisions, including the Income Tax Law, the Law on General Provisions and Tax Procedures, and Minister of Finance Regulation Number 172 of 2023 concerning the Application of the Arm's Length Principle. The conceptual approach is used to assess the compatibility of these rules with Rawls's theory of justice, Radbruch's notion of the basic values of law, and Satjipto Rahardjo's progressive law. The case approach is used to analyze the implementation of those rules by examining selected Tax Court decisions concerning disputes over the application of the ALP to domestic affiliated transactions.

The legal materials are analyzed qualitatively through systematic interpretation, conceptual interpretation, and argumentative reasoning. Systematic interpretation is employed to identify the interrelationship among norms within the ALP regulatory regime; conceptual interpretation is used to examine the meanings of fairness, legal certainty, and the balance of rights and obligations; and argumentative reasoning is used to assess whether the regulatory framework and judicial decisions satisfy the requirements of sound law. The findings are then formulated prescriptively as recommendations for legal reform in the application of the ALP to domestic affiliated transactions.

3. Results and Discussion

3.1. The Role of the Arm's Length Principle in Indonesian Tax Law

From a commercial perspective, the arrangement or determination of transaction prices among related entities is ordinary business practice aimed at maintaining the performance of each entity for business purposes. From a tax perspective, however, such pricing may conflict with tax rules that require prices in related-party transactions to reflect arm's-length conditions comparable to those in transactions between independent parties. The issue of price setting—known in tax law as transfer pricing—is generally associated with multinational enterprises operating in different countries, so that the transactions involved are cross-border in nature and thus span different tax jurisdictions.

In business practice, transfer pricing in affiliated transactions may occur both in cross-border transactions and in domestic transactions, such as purchases and management services between affiliated entities. For this reason, specific anti-avoidance rules (SAAR) play an important role in limiting transfer pricing practices, including in the domestic context (Sari & Husnasari, 2022). As the economy becomes increasingly transnational, the number of actors involved in transfer pricing has also increased, including in transactions among entities within the same country (Ignat & Ionescu-Feleagă, 2022). From a tax perspective, transfer pricing practices that do not follow market prices may significantly affect both the tax base and state revenue (Kalra & Afzal, 2023).

In general, one of the objectives of multinational corporations in arranging transfer prices among entities under common control is to minimize the tax burden by shifting to profits entities located in low-tax jurisdictions. To prevent tax avoidance through transfer pricing in related-party transactions, the Arm's Length Principle is applied. Under this principle, taxpayers must conduct an arm's-length analysis of their transactions, while the tax authority is vested with the power to examine the reasonableness of the transfer prices used.

In Indonesian tax law, the ALP function is used as a corrective instrument that allows the tax authority to adjust income or expenses where transactions between related parties are considered not to reflect ordinary business conditions (Article 18 paragraph (3) of the Income Tax Law). Normatively, this function rests on the assumption that a special relationship may influence the price or terms of a transaction, so that the outcome does not accord with market conditions. This instrument is not only recognized in domestic law but also forms part of the global transfer pricing regime developed by the OECD (OECD, 2022: 31). Therefore, formally speaking, there is no doubt that the ALP is a legitimate element of tax administration.

Even so, the application of the ALP in the structure of Indonesian tax law cannot be understood in a singular and mechanistic way. It simultaneously functions as an administrative norm, a corrective norm, and a norm for protecting the tax base. In cross-border transactions, these three characteristics generally work in the same direction because transfer pricing adjustments can be understood as an effort to prevent profit shifting to jurisdictions with lower tax rates. In domestic transactions, however, these characteristics do not always converge. The function of protecting the tax base becomes less significant when both parties are located in the same jurisdiction and are subject to the same tax rate. In such circumstances, the application of the ALP to domestic affiliated transactions instead gives rise to a new problem, namely the potential for double taxation if it is not accompanied by a corresponding adjustment.

3.2. The Fairness Aspect of Implementing the ALP to Domestic Related-party Transactions

In order to ensure that tax collection can be sustained without resistance from citizens, tax collection must uphold the principle of fairness in addition to legal certainty. The application of fairness in taxation is consistent with Rawls's framework of justice as fairness. Rather than merely restating Rawls's two principles, this study interprets them as normative benchmarks: (i) equal basic liberties, namely that each person has the same right to the most extensive basic liberties compatible with a similar liberty for others; and (ii) the difference principle and fair equality of opportunity, according to which inequality is permissible only if it benefits the least advantaged and economic inequalities are subject to fair equality of opportunity. These principles should be implemented within the basic structure of institutions, including the tax system as a form of pure procedural justice—that is, a fair procedure capable of leading to outcomes that also reflects fairness (Laden, 2014). In the tax system, Rawlsian fairness is manifested in horizontal justice and vertical justice, which in the Indonesian tax system is reflected in a single corporate income tax rate and progressive income tax rates for individual taxpayers.

Fair taxation also accords with the foundational idea of progressive law introduced by Satjipto Rahardjo. As illustrated by Satjipto Rahardjo through his well-known maxim "law for humans, not humans for law", progressive law places human beings at the center of law and promotes a sociological understanding of law by emphasizing substantive justice and encouraging law enforcers to move beyond the text of the law whenever strict textualism impedes the realization of substantive justice (Aulia et al., 2023). By adopting the humanistic orientation of progressive law, an optimal tax system requires the fulfillment of three main preconditions, which are: (i) tax law should prioritize substantive justice rather than mere formalities and procedures; (ii) tax administration should be service-oriented; and (iii) tax enforcement should be proportionate and fair. The satisfaction of these prerequisites will lead to humane yet effective tax enforcement that remains responsive to societal needs, in line with the spirit of progressive law. Such responsive implementation of tax law significantly affects public commitment to paying taxes through treatment grounded in mutual respect and trust (Braithwaite, 2007).

In the tax systems of nearly all countries, transfer pricing in affiliated transactions is a matter of concern for tax authorities because it is one of the means of tax avoidance. Heckemeyer and Overesch identified a strong correlation between levels of reported profit and international tax rate differentials, based on their study of twenty-seven cases (Heckemeyer & Overesch, 2017). This finding shows that differences in tax rates across countries provide multinational enterprises with incentives to minimize tax by shifting profits through transfer pricing to affiliated parties in low-tax jurisdictions, thereby distorting the tax base. To address this, the ALP—accepted by many countries—is applied to test whether the prices of affiliated transactions correspond to the prices that would have been used by independent parties. Through the application of the ALP to affiliated transactions, tax avoidance through profit shifting to low-tax jurisdictions can be prevented.

In the domestic context, related parties are located in the same country and are subject to the same tax rate, so they generally do not create profit-shifting issues aimed at avoiding tax. This raises the question of whether the ALP should be applied to domestic related-parties transactions at all. The concern is based on the fact that even if transfer prices do not satisfy the ALP and profits are shifted between domestic affiliates, when both parties are taxed at the same rate, the tax base and the amount of tax due to the State remain unchanged and are the same as they would be if the transaction had been carried out between independent parties at an arm's-length market price.

In the Indonesian tax system, Article 18 verse (3) of the Income Tax Law grants the tax authority the power to apply the ALP to affiliated transactions without distinguishing between cross-border and domestic transactions. The implementation of this provision was previously regulated by Director General of Taxes Regulation Number PER-43/PJ/2010 as amended by PER-32/PJ/2011, Article 2 of which provided that the ALP did not apply to domestic affiliated transactions unless tax avoidance could be proven—for example, where the counterparty was subject to final tax. Under this regulation, therefore, the ALP was not to be applied to domestic affiliated transactions taxed at the same rate. In practice, however, despite this limitation in PER-43/PJ/2010, the tax authority continued to make transfer pricing corrections by applying the ALP to domestic related-party transactions, giving rise to disputes between taxpayers and the tax authority that culminated in appeals before the Tax Court.

Subsequently, PER-43/PJ/2010 was effectively superseded by the higher-ranking Minister of Finance Regulation Number 172 of 2023, which no longer distinguishes between the application of the ALP to cross-border affiliated transactions and to domestic affiliated transactions. Since the entry into force of this ministerial regulation, the ALP has therefore been applied to domestic affiliated transactions in Indonesia.

The application of the ALP to domestic related-party transactions creates a new complexity, namely the potential for unfair double taxation because it imposes a tax burden greater than what should properly be due. This occurs because a primary adjustment made by the tax authority under the ALP increases the tax burden of the taxpayer being adjusted, without being followed by a corresponding adjustment for the counterparty that would reduce the latter's tax burden and restore aggregate tax neutrality. A corresponding adjustment is a symmetrical adjustment applied to the transaction counterparty. In cross-border transactions, the counterparty is generally located in the treaty-partner jurisdiction, and the mechanism is used to avoid double taxation when a primary adjustment is made by one State's tax authority. This is reflected in Article 9(2) of the OECD Model Tax Convention on Income and on Capital, which states that the other State “shall make an appropriate adjustment” to the primary adjustment (OECD, 2019). In line with the OECD Model Tax Convention, a primary adjustment in a domestic affiliated transaction should also be followed by a corresponding adjustment.

The need for a corresponding adjustment is also in line with several Tax Court decisions on disputes concerning the application of the ALP to domestic related-party transactions. Within the Indonesian tax legal system, Law Number 14 of

2002 concerning Tax Court establishes the Tax Court as a special court within the administrative court system, whose judgments are final and immediately binding. Tax Court decisions should therefore serve as guidance for both taxpayers and the tax authority in interpreting regulatory texts. Although there is a disparity among Tax Court decisions concerning the ALP, the author considers those decisions to be valuable material supporting this research.

In Tax Court Decision Number PUT-004273.15/2024/PP/M.IVB of 2025, the Tax Court annulled the tax authority's transfer pricing correction in relation to a domestic related-party transaction. Among its legal considerations, the court found that tax avoidance had not been proven because the parties involved in the domestic affiliated transaction were subject to the same tax rate. The court further held that, if a primary adjustment was nevertheless to be maintained, the tax authority should have made a corresponding adjustment to the counterparty.

Similarly, in Tax Court Decision Number PUT-011033.15/2022/PP/M.IIIB of 2024, the Tax Court canceled a primary adjustment arising from the application of the ALP to a domestic affiliated transaction. The court reasoned, inter alia, that the ALP may only be applied where there is tax avoidance through the exploitation of tax rate differentials, whereas in the case of the domestic affiliated transaction at issue the parties were subject to the same tax rate, making the application of the ALP inappropriate. The court also reasoned that applying the ALP to only one of the parties in a domestic affiliated transaction would generate excessive tax revenue and create unfairness in the form of economic double taxation. Therefore, if a corresponding adjustment were made, there would in fact be no tax efficiency to gain.

Based on these two Tax Court decisions, it may be concluded that the ALP may be applied to domestic affiliated transactions only where tax avoidance is proven, and that if the tax authority nevertheless makes a primary adjustment under the ALP, it must be accompanied by a corresponding adjustment to the counterparty to avoid unfair double taxation. From this analysis, an essential factor for ensuring fairness in the application of the ALP to domestic affiliated transactions is the existence of a guarantee that affiliated parties can obtain the right to a corresponding adjustment. Without such a guarantee, the application of the ALP to domestic affiliated transactions cannot be considered fair.

Corresponding adjustments were regulated both under PER-43/PJ/2010 and under Minister of Finance Regulation Number 172 of 2023, although the two frameworks differ. Under PER-43/PJ/2010 as amended by PER-32/PJ/2011, corresponding adjustments were provided for in Article 21, which vested the authority to make such adjustments exclusively in the tax authority. Under this arrangement, taxpayers themselves could not initiate corresponding adjustments. This was highly disadvantageous to taxpayers because, in practice, the tax authority never made corresponding adjustments, and there was no mechanism governing how such adjustments should be implemented. PER-43/PJ/2010 thus failed to guarantee the implementation of corresponding adjustments to offset primary adjustments, and consequently the application of the ALP to domestic affiliated transactions under the PER-43/PJ/2010 regime did not reflect fairness.

The regulation of corresponding adjustments under Minister of Finance Regulation Number 172 of 2023 is set out in Article 40. Unlike PER-43/PJ/2010, this regulation provides a mechanism for corresponding adjustments that may be implemented through self-assessment by amending the Annual Tax Return according to Article 8 paragraph (1) of the Law on General Provisions and Tax Procedures, or through voluntary disclosure of incorrect reporting under Article 8 paragraph (4) of the same law where the counterparty is under tax audit. In addition, where the counterparty has already been audited, the corresponding adjustment may be sought through an application to amend the tax assessment pursuant to Article 16 of the Law on General Provisions and Tax Procedures.

Nevertheless, although Minister of Finance Regulation Number 172 of 2023 has introduced a mechanism for corresponding adjustments, a deeper analysis shows that the regulation still does not fully reflect fairness. This is evident from the requirement that, in order to obtain a corresponding adjustment, the taxpayer must agree to the primary adjustment and refrain from filing legal remedies in the form of an objection or appeal. The loss of the taxpayer's right to pursue legal remedies if it wishes to obtain a corresponding adjustment creates a potential for arbitrariness on the part of the tax authority in making transfer pricing corrections to domestic affiliated transactions under the ALP. The taxpayer therefore faces two difficult options: relinquish the right to challenge the primary adjustment even if the taxpayer disagrees with it, or maintain the right to seek legal remedies while bearing the risk of losing the right to a corresponding adjustment. Both options expose the taxpayer to the loss of the right to achieve justice in the form of paying the correct amount of tax and avoiding double taxation.

The option of making a corresponding adjustment through an amendment of the Annual Tax Return cannot always be used in practice. Tax audits are often completed close to the statute of limitations for assessment—namely, five years from the tax due date, as provided in Article 13 of the Law on General Provisions and Tax Procedures. The slow completion of audits that result in primary adjustments may therefore deprive the counterparty of the opportunity to make a corresponding adjustment by amending its tax return. Under Article 8 paragraph (1a) of the same law, an amended annual return that reports a loss or an overpayment must be submitted no later than two years before the statute of limitations expires. A corresponding adjustment for the counterparty will often create an overpayment position or reduce the declared loss, so the amendment may only be submitted within that time limit. If the primary adjustment is made after the deadline for amendment, the corresponding adjustment cannot be made. The same problem arises where the counterparty is under audit: if the primary adjustment becomes known only after the issuance of the audit findings letter (SPHP), the counterparty can no longer seek a corresponding adjustment through voluntary disclosure under Article 8 paragraph (4) of the Law on General Provisions and Tax Procedures.

This analysis of the rules governing related adjustments shows that taxpayers still face various obstacles to obtaining such adjustments and that the existing framework does not adequately guarantee the fulfillment of taxpayers' rights. Without a reliable guarantee that corresponding adjustments can actually be implemented, the application of the ALP to domestic affiliated transactions does not reflect fairness.

Accordingly, if the ALP is to continue to be applied to domestic affiliated transactions, policy improvements must be made to the corresponding adjustment mechanism. Such improvements should include at least the following: first, amending the requirements so that a corresponding adjustment may still be granted to the counterparty even where the primary adjustment is being challenged through legal remedies, with the consequence that, if the legal challenge to the primary adjustment is upheld, the tax authority may cancel the corresponding adjustment already granted to the counterparty; and second, limiting the making of primary adjustments by considering whether the counterparty still has an opportunity to obtain a corresponding adjustment through an amendment to its Annual Tax Return. If the counterparty can no longer obtain a corresponding adjustment, then the primary adjustment should not be made.

3.3. Advance Pricing Agreements as an Instrument for Preventing Disputes

An Advance Pricing Agreement (APA) is an agreement between a taxpayer and the tax authority that determines the transfer pricing method for a specified future period, as regulated in Article 18 paragraph (3a) of the Income Tax Law and Articles 55 to 71 of Ministry of Finance Regulation Number 172 of 2023. The APA mechanism places the tax authority and the taxpayer on a more equal footing than exists in the audit process. APA is an important instrument for preventing disputes over transfer pricing because it emphasizes an ex ante agreement between the tax authority and the taxpayer. The agreement increases legal certainty by providing clarity regarding the arm's-length pricing method and the economic assumptions used before the transactions occur (Sulastri et al., 2025).

APA plays a significant role in reducing disputes concerning the ALP. Its role may be explained as follows. First, APA functions as a preventive measure against the emergence of disputes: once an APA is concluded between the tax authority and the taxpayer, significant pricing adjustments should no longer be necessary during a tax audit, while the taxpayer obtains certainty that its transfer pricing policy will not be corrected. Second, APA enhances legal certainty because the agreement is binding upon the parties and provides an assurance that the tax authority will not make a primary adjustment to transactions covered by the APA. Third, APA implementation prevents double taxation because the transfer prices between domestic affiliated parties become settled, so there is no longer any primary adjustment that could trigger double taxation.

Given the importance of APA in reducing ALP disputes, intensive promotion is needed to encourage taxpayers—especially those belonging to corporate groups—to submit APA applications. As the number of taxpayers entering into transfer pricing agreements with the Directorate General of Taxes increases, the potential for disputes over the application of the ALP to domestic affiliated transactions will decrease. This development would not only improve legal certainty and fairness but also reduce taxpayers' compliance costs

4. Conclusion

From this juridical analysis of the application of the ALP to domestic affiliated transactions, it may be concluded that the current application of the ALP to domestic transactions in Indonesia does not yet reflect fairness because it is not supported by an adequate corresponding adjustment framework. Corresponding adjustment is the balancing mechanism for a primary adjustment; it ensures that double taxation does not occur and ultimately realizes fairness in the application of the ALP to domestic affiliated transactions. In order for the domestic ALP to be applied while still respecting fairness, policy improvements are needed in the corresponding adjustment mechanism, including more accessible requirements and limitations on primary adjustments where corresponding adjustments can no longer be made. The prevention of domestic ALP disputes must also continue to be strengthened through the broad implementation of Advance Pricing Agreements (APAs)..

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