International Journal of Economics, Business and Innovation Research
https://e-journal.citakonsultindo.or.id/index.php/IJEBIR
E-ISSN : 2964-0865
IJEBIR

From Transfer Pricing Risk To Substantive Tax Compliance: Mechanisms, Boundary Conditions, And Future Directions

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Abstract

This systematic literature review examines the theoretical mechanisms, contextual conditions, and empirical evidence linking Transfer Pricing Risk (TPR) and Substantive Tax Compliance (STC). It synthesizes fragmented literature to explain how Multinational Enterprises (MNEs) manage the tension between transfer pricing optimization and substantive compliance within evolving global tax frameworks. Following PRISMA guidelines, this study reviewed peer-reviewed journal articles published between 2010 and 2024 from Scopus, Web of Science, ScienceDirect, and Emerald Insight. The final sample of high-impact studies was systematically analyzed using the Integrated Compliance Risk Framework (ICRF). The review identifies three mediating mechanisms linking TPR to STC: economic substance alignment, governance and internal control rigor, and regulatory scrutiny and enforcement capability. The shift from procedural to substantive compliance is moderated by institutional quality, firm-level risk appetite, digital tax administration, and transparency requirements such as CbCR. Aggressive transfer pricing increasingly involves complex structural arbitrage that satisfies formal documentation while challenging substantive intent. This study develops the ICRF by integrating Agency Theory, Institutional Theory, and the Slippery Slope Framework. It provides insights for risk-based tax audits and MNE tax strategies aligned with ESG standards.

Keywords: Base Erosion and Profit Shifting (BEPS), Multinational Enterprises, Substantive Tax Compliance, Systematic Literature Review, Transfer Pricing Risk

INTRODUCTION

The expansion of global trade and the digital economy has increased the role of multinational enterprises (MNEs) in international taxation. Transfer pricing, which

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determines the prices of transactions between related entities, facilitates business coordination but may also create opportunities for profit shifting and tax base erosion. Consequently, transfer pricing risk (TPR) has become a major concern for tax authorities and international organizations, particularly the OECD and G20. Although international initiatives, including the Base Erosion and Profit Shifting (BEPS) project and the Two-Pillar Solution, seek to strengthen tax transparency and prevent tax avoidance, regulatory compliance does not necessarily ensure that tax payments reflect economic substance and value creation.

This distinction highlights the difference between procedural tax compliance, which concerns formal documentation and reporting requirements, and substantive tax compliance (STC), which concerns the alignment of tax positions with applicable regulations, economic activities, and value creation. Existing studies provide important insights into transfer pricing practices and their regulatory implications. Kalra & Afzal (2023) examine the implications of transfer pricing for tax revenue in developing countries, while Martiza & Fuadah (2025) review contemporary transfer pricing issues and their global tax implications. Petruzzi & Padwalkar (2023) discuss the interaction between the arm's-length principle, transfer pricing, and the Two-Pillar Solution. Meanwhile, Suwarno (2026) examines determinants of substantive taxpayer compliance and the role of the arm's-length principle in business fairness. Reviews of the broader tax literature likewise show that corporate tax planning is shaped by organizational incentives, governance arrangements, and enforcement conditions (Cooper & Nguyen, 2020; Hanlon & Heitzman, 2010). However, the mechanisms linking transfer pricing risk to substantive tax compliance remain insufficiently integrated across organizational, institutional, and regulatory perspectives.

Transfer pricing risk is shaped by regulatory uncertainty, transaction complexity, the availability of comparable data, corporate governance, and tax enforcement capacity. These factors are particularly relevant in developing economies, where administrative resources and access to reliable information may constrain effective transfer pricing supervision. In Indonesia, strengthening substantive tax compliance therefore requires more than formal adherence to international standards; it also requires evaluating whether related-party transactions reflect underlying economic activities. The interaction between institutional quality, organizational incentives, technological capabilities, and evolving international tax regulations warrants further systematic investigation.

To address this gap, this study conducts a systematic literature review of research published between 2010 and 2026, emphasizing developments since 2020. The review addresses three research questions:

1. RQ1: What theoretical mechanisms explain the relationship between transfer pricing risk and substantive tax compliance?

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2. RQ2: What institutional, organizational, and technological conditions moderate this relationship?
3. RQ3: How can an integrated conceptual framework explain MNE behavior in response to evolving international tax requirements?

Based on the literature synthesis, this study develops an Integrated Compliance Risk Framework (ICRF) that integrates perspectives from corporate governance, international business, and public economics. The framework conceptualizes substantive tax compliance as an outcome shaped by the interaction of transfer pricing risk, organizational governance, institutional enforcement, and technological capabilities within the evolving international tax environment.

This study contributes to the literature by integrating fragmented explanations of transfer pricing risk and substantive tax compliance, identifying the institutional, organizational, and technological conditions influencing their relationship, and proposing the ICRF as a foundation for future empirical research and risk-based tax supervision. The framework provides a conceptual basis for understanding how MNEs respond to regulatory pressures and how substantive tax compliance can be strengthened across jurisdictions.

METHOD

This study adopts a systematic literature review (SLR) methodology based on the approach proposed by Tranfield et al., (2003) and follows the PRISMA guidelines to promote transparency, methodological rigor, and reproducibility throughout the literature identification and selection process.

Search Protocol and Strategy

A systematic search was conducted across four academic databases: Scopus, Web of Science (WoS), ScienceDirect, and Emerald Insight. The search strategy combined keywords related to transfer pricing, tax compliance, and institutional and organizational factors using Boolean operators. The search string was structured as follows:

("Transfer Pricing" OR "Transfer Pricing Risk" OR "Arm's Length Principle")
AND
("Tax Compliance" OR "Substantive Compliance" OR "Tax Avoidance" OR "BEPS")
AND
("Governance" OR "Risk Management" OR "Institutional Quality")

The search protocol was designed to identify relevant studies addressing transfer pricing mechanisms, MNE tax strategies, substantive tax compliance, and the institutional

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factors influencing compliance outcomes. Table 1 summarizes the search parameters and initial results.

Table 1. Systematic Literature Review Search Protocol

Criterion	Details
Search timeframe	2010–2024
Databases	Scopus, Web of Science, ScienceDirect, and Emerald Insight
Language	English
Publication type	Peer-reviewed academic journal articles; conference abstracts, book reviews, and working papers excluded
Subject areas	Accounting, finance, economics, business and international management, and law
Initial search results	1,240 records identified across the four databases

Selection Criteria and PRISMA Flow Diagram

Predefined inclusion and exclusion criteria were applied to assess the relevance and quality of the retrieved publications. Studies were included if they directly examined transfer pricing mechanisms, MNE tax strategies, institutional tax compliance, or BEPS implementation and provided empirical evidence through quantitative or qualitative methods or rigorous theoretical analysis.

Studies were excluded if they focused exclusively on domestic indirect taxation, presented descriptive legal discussions without an analytical framework, or consisted of non-peer-reviewed commentaries. The selection process involved identifying records, screening titles and abstracts, assessing the eligibility of full-text articles, and determining the final set of studies for synthesis. Figure 1 presents the PRISMA flow diagram, illustrating the literature identification, screening, eligibility assessment, and inclusion process.

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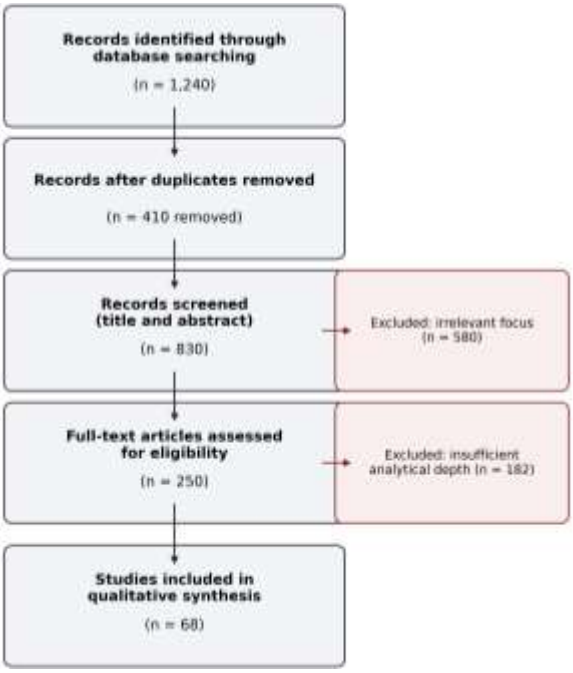


Figure 1. PRISMA Flow Diagram of the Literature Selection Process.

RESULTS

Conceptualizing Transfer Pricing Risk and Substantive Tax Compliance

The literature synthesis identifies transfer pricing risk (TPR) as a multidimensional construct involving potential financial penalties, double taxation, reputational damage, and operational disruption arising from tax authority challenges to related-party transactions. Three dimensions emerge: misalignment between profit allocation and economic value creation, procedural deficiencies in transfer pricing documentation, and regulatory uncertainty associated with ambiguous or inconsistently applied rules.

Substantive tax compliance (STC), in contrast, extends beyond formal documentation and reporting obligations. It requires tax positions and profit allocation to be consistent with applicable regulations and the economic substance of business activities, including the functions performed, assets employed, and risks assumed by MNE entities. This distinction indicates that procedural compliance alone may not adequately demonstrate substantive alignment between reported profits and underlying economic activities.

Mechanisms Linking Transfer Pricing Risk to Substantive Tax Compliance

The synthesis identifies three potential mechanisms connecting TPR with STC.

1. Economic substance alignment concerns the consistency between profit allocation and the functions, assets, and risks (FAR) associated with related-party

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transactions. This mechanism emphasizes the importance of aligning transfer pricing arrangements with actual business operations.

2. Internal control and corporate governance shape how MNEs identify, monitor, and respond to transfer pricing risks. Board oversight, enterprise risk management (ERM), and accountability mechanisms may strengthen tax governance and reduce incentives for overly aggressive tax planning. Evidence on managerial incentives further suggests that the link between incentive structures and tax sheltering depends on the strength of corporate governance (Desai & Dharmapala, 2006).
3. Regulatory scrutiny and enforcement capacity influence compliance incentives through the perceived likelihood of detection, the analytical capabilities of tax authorities, and the potential costs of non-compliance. Effective enforcement may encourage firms to improve both procedural compliance and the substantive justification of their tax positions. Empirical evidence indicates that firms adopt less aggressive tax positions when the probability of an audit is higher (Hoopes et al., 2012), and that income shifting is greater where local tax enforcement is weak (Beuselinck et al., 2015).

Institutional, Technological, and Regulatory Moderators

The literature also points to several contextual factors that may influence the relationship between TPR and STC.

1. Institutional quality affects regulatory predictability, enforcement consistency, and trust in tax authorities. These factors may shape whether MNEs respond to transfer pricing risks through substantive compliance or defensive tax planning. Behavioral evidence similarly indicates that compliance is motivated by more than deterrence alone, including nonpecuniary factors such as trust and perceived fairness (Alm, 2019).
2. Digital tax administration can strengthen monitoring through electronic invoicing, data analytics, and automated risk assessment. Such capabilities may help tax authorities identify discrepancies between reported transactions and underlying economic activities.
3. Tax transparency requirements, including Country-by-Country Reporting (CbCR), provide information that can support the assessment of profit allocation across jurisdictions. Public disclosure may also increase reputational pressure, although its effects depend on the disclosure regime, institutional context, and enforcement arrangements. Empirical studies show that private CbCR to tax authorities is associated with higher effective tax rates among affected firms (Joshi, 2020), while public CbCR in the European banking sector appears to deter income shifting

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without materially changing overall tax avoidance (Joshi et al., 2020). Public scrutiny can also raise tax expense among firms exposed to activist pressure (Dyreng et al., 2016).

Mapping the Core Theoretical and Empirical Literature

Table 2 summarizes selected studies that provide theoretical and empirical foundations for understanding tax compliance, profit shifting, transfer pricing enforcement, and corporate governance.

Table 2. Mapping of Core Theoretical and Empirical Literature

Author(s) and year	Core focus	Theoretical perspective	Main contribution
(Kirchler et al., 2008)	Tax compliance	Slippery Slope Framework	Distinguishes enforced compliance based on authority power from voluntary compliance associated with trust.
(De Simone et al., 2019)	Transfer pricing adjustments	Economic and organizational perspectives	Examines how transfer pricing enforcement and administrative requirements may affect MNE decisions and activities.
(Beer et al., 2020)	Global profit shifting and BEPS	International public finance	Examines international profit shifting and its implications for corporate taxation.
(Overesch & Wolff, 2021)	Country-by-Country Reporting	Stakeholder and signaling perspectives	Investigates the relationship between CbCR requirements, transparency, and corporate tax outcomes.
Sartono et al. (2023)	Corporate governance and compliance	Agency and institutional perspectives	Examines the role of corporate governance in tax risk management and compliance behavior.

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DISCUSSION

An Integrated Perspective on Transfer Pricing Risk and Substantive Tax Compliance

The findings suggest that the relationship between TPR and STC should not be interpreted as an automatic or linear process. Greater exposure to transfer pricing risk may encourage MNEs to strengthen documentation, internal controls, and economic substance assessments. However, the extent to which these responses produce substantive compliance depends on organizational incentives, institutional enforcement, and the capacity to evaluate complex cross-border transactions. Survey evidence suggests that MNEs differ in whether transfer pricing is managed mainly for tax minimization or for compliance, and these priorities are related to the tax outcomes they report (Klassen et al., 2017).

This interpretation extends the conventional view of transfer pricing compliance by distinguishing formal adherence to regulatory requirements from the substantive alignment of profits with economic activities. It also highlights the complementary roles of corporate governance and tax administration in translating risk awareness into more accountable tax practices.

The Integrated Compliance Risk Framework (ICRF)

Building on the literature synthesis, this study proposes the Integrated Compliance Risk Framework (ICRF) to explain how transfer pricing risk may influence substantive tax compliance through organizational and institutional mechanisms.

The framework comprises three interconnected elements. First, transfer pricing risk exposure represents the regulatory, procedural, and economic uncertainties associated with related-party transactions. Second, compliance mechanisms, including economic substance alignment, internal governance, and enforcement responses, explain how MNEs may respond to these risks. Third, boundary conditions, particularly institutional quality, digital tax administration, and transparency requirements, may strengthen or weaken the relationship between risk exposure and compliance outcomes. The ICRF therefore provides a conceptual basis for examining why similar levels of transfer pricing risk may produce different compliance outcomes across firms and jurisdictions. Figure 2 illustrates the proposed framework.

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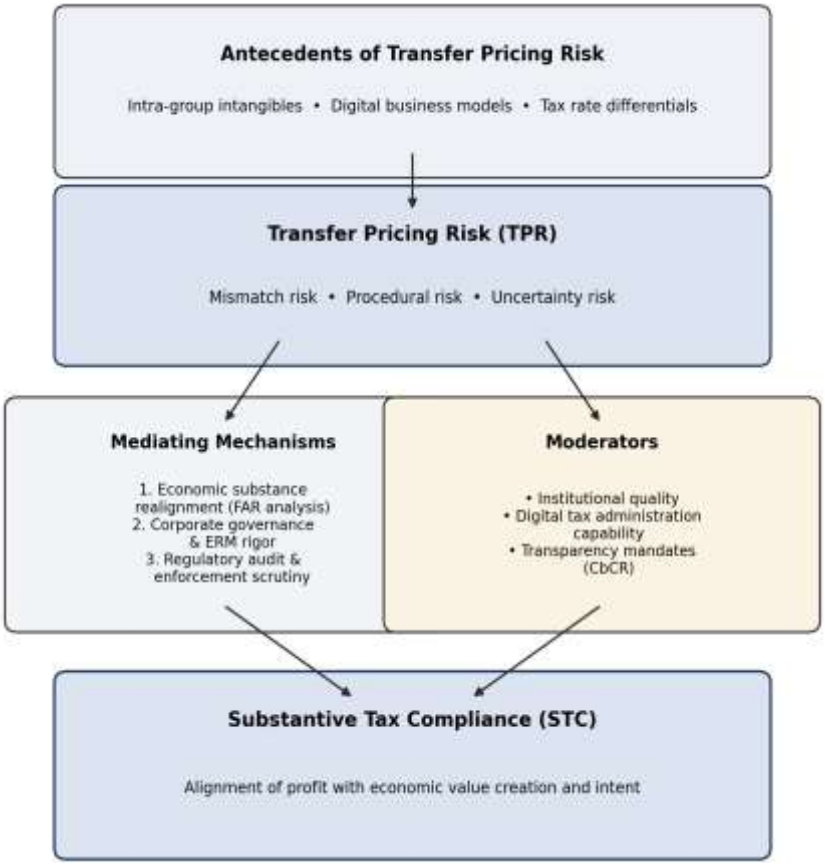


Figure 2. The Integrated Compliance Risk Framework (ICRF).

Implications for International Tax Governance

The ICRF highlights the importance of combining firm-level governance with effective institutional oversight. Documentation requirements remain necessary, but they may be insufficient when tax authorities lack reliable comparable data or the capacity to assess the economic substance of complex transactions.

Digital tax infrastructure and transparency mechanisms may improve risk identification and facilitate more targeted audits. Nevertheless, their effectiveness depends on data quality, analytical expertise, regulatory consistency, and appropriate safeguards. For developing economies, these considerations underscore the need to strengthen enforcement capacity while maintaining predictable tax rules and a supportive investment environment.

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Future Research Agenda

Four priorities emerge for future research :

1. The impact of Pillar Two. Future studies should examine how the 15% global minimum tax influences MNE transfer pricing strategies and whether it reduces profit shifting or changes the incentives underlying cross-border profit allocation.
2. Artificial intelligence in tax enforcement. Research should investigate how machine learning and advanced analytics support the detection of transfer pricing anomalies, as well as how MNEs use similar technologies to manage tax risks and prepare documentation.
3. ESG integration and tax transparency. Further research should assess whether ESG ratings, institutional investor expectations, and reputational pressures encourage substantive tax compliance rather than merely formal adherence to disclosure requirements.
4. Developing-economy contexts. Empirical studies should examine how resource-constrained tax administrations can strengthen transfer pricing oversight despite limitations in comparable data, specialist expertise, and enforcement resources, while avoiding unnecessary barriers to foreign direct investment.

Overall, these research priorities provide opportunities to test and refine the ICRF across institutional settings, regulatory regimes, and organizational contexts. Future empirical validation would help establish the relative importance of the proposed mechanisms and moderators and clarify their implications for international tax governance.

CONCLUSION

This systematic review synthesizes fifteen years of academic research on the transition from Transfer Pricing Risk to Substantive Tax Compliance. The analysis demonstrates that formal procedural compliance is insufficient to mitigate modern tax risks. Achieving substantive compliance requires a structural alignment of real economic activities, internal corporate governance frameworks, and dynamic regulatory enforcement capabilities. The Integrated Compliance Risk Framework (ICRF) established in this paper offers a comprehensive structure for future empirical work and provides strategic direction for tax policymakers and corporate decision-makers navigating an increasingly transparent global tax landscape.

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