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The Determinants of Transfer Pricing Intensity of Multinational Non-Financial Firms in Indonesia

Yulis Sarah Rizkya and Isnalita [a]
[a] *Universitas Airlangga. Indonesia*

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Abstract: This study examined the determinants of the intensity of transfer pricing practices engaged by a pool of selected firms. Data gathered from non-financial multinational enterprises (MNEs) listed on the Indonesia Stock Exchange (IDX) from 2014 to 2017, which involved 60 firm-year observations. Data analysed using ordinary least square regression analysis via SPSS 22 software. The study outcomes revealed that income tax, profitability, and firm size were not significantly related to the intensity of transfer pricing. In contrast, intangible assets displayed a significantly positive effect on transfer pricing. This study offers several implications for the government, investors or creditors, and financial analysts that clear and straightforward policies are integral in determining the prices of intangible assets, mainly because the transfer pricing activities carried out by non-financial MNEs in Indonesia were largely based on intangible assets. Study limitations and future research endeavours end this paper.

Corresponding aurther: *isnalita@feb.unair.ac.id*
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1. Introduction

The opportunities spread across international trade are undeniably vast within this present globalisation era. Ease of interaction and communication has driven the flow of goods, services, and investments across countries worldwide. Such vast opportunities have encouraged multinational enterprises (MNEs) to compete in establishing subsidiaries in other countries to expand their networks and to maximise profits (Herlambang & Nasih, 2019). Since MNEs are vital in international transactions that enable the recurrence of financial transactions, these MNEs are inclined to implement transfer pricing policies to affiliated firms abroad (Meidayati, 2017). Transfer pricing policies often involve parent and child intra-firms in other countries. Essentially, the transfer pricing method has been reckoned to enhance firm profitability (Kusuma, 2016; Rozakis et al., 2018; Loyrinic, 2018; Duran, 2019; Kim, 2019; Can & Kutluca Canbulat, 2019; Mokoena, 2019).

Transfer pricing refers to the process of offsetting the price of goods exchanged between related parties to allocate income across affiliated entities in different tax jurisdictions (Cristea & Nguyen, 2016). The MNEs may be involved in intra-firm trading to facilitate tax avoidance through the transfer of prices between fictitious firms (Richardson, Taylor, & Lanis, 2013). The Indonesian Ministry of Finance highlighted that around 2,000 foreign-owned firms had not paid taxes since a decade ago. These firms have avoided income tax worth 25 billion Rupiah (or 1.6 million USD) to state revenues every year (Kusuma, 2016; Kimanzi, 2019; Makalela & Asha, 2019; Mokoena & Dhurup, 2019; Garcia-Ceberino et al., 2019; Minh, 2019).

Indonesia has deployed several transfer pricing practices that pose as a prolonged problem (Klassen, Lisowsky & Mescall, 2017). Transfer pricing has been a concern to the government due to its adverse effect on the country's economy through tax evasion, especially when taxes are still the most significant contributor to state revenue (Holtzman & Negal, 2014). The Directorate General of Tax has yet to implement apparatuses, expertise, and standards to conduct transfer pricing checks (Kusuma, 2016). Since taxpayers in the Tax Court often win transfer pricing cases (Rahmiati & Sandi, 2016), MNEs seek to continue this transfer pricing practice.

The most common approach applied for transfer pricing is when a firm sells goods to its subsidiaries or holding firms in other countries (with lower tax rates) or below the market price, wherein the subsidiary or parent re-sells the goods to the market based on the market price (Rahmiati & Sandi, 2016; Harymawan, Lam, Nasih & Rumayya, 2019). The primary aim of this practice is to reduce the income tax expense in the country. Firms may minimise profits or even report losses to avoid paying taxes via transfer pricing (Kusuma, 2016). The criteria used to detect if a firm adopts transfer pricing practices to avoid taxes are as follows: First, the firm is an affiliated firm whose parent is in another country (Rahmiati & Sandi, 2016). Second, the firm hikes the cost of purchasing goods and lowers the selling price so that the firm appears to be at a loss (Klassen et al., 2017). Third, the firm often changes its name to gain tax incentives by displaying incurred losses (Kusuma, 2016; Kim, 2019; Duran, 2019; Can & Kutluca, 2019; Mokoena, 2019; Kimanzi, 2019; Makalela & Asha, 2019; Mokoena & Dhurup, 2019;).

The crucial role of transfer pricing within the global business setting has intensified research work to further explore the internal and external factors that lead to transfer pricing. The prime external factor is income tax avoidance. Other factors that affect a firm's tendency to adopt transfer pricing are profitability, firm size, and intangible assets (Klassen et al., 2017). Majid, Mediaty, Habbe, Herryanto, and Possumah (2019) found that tax avoidance, intangible assets, firm size, and profitability significantly increased the involvement of transfer pricing. Richardson et al. (2013) postulated that intangible assets increased a firm's tendency to deploy transfer pricing. Meanwhile, Rego (2003) asserted that large firms were more actively engaged in tax avoidance practices, such as transfer pricing. Wilkie and Limberg (1993) discovered a positive link between pre-tax income and effective tax rates. These studies imply that firms with higher profits were more likely to minimise tax payment.

Prior studies have identified several transfer pricing determinants ranging from profitability, income tax, firm size, and firm intangible assets (Cristea & Nguyen, 2016; Davies, Martin, Parenti & Toubal, 2018; De Simone, 2016). Dudar, Spengel, and Voget (2015) found that tax had a significantly negative relationship with transfer pricing, while Pramana and Laksito (2014) discovered that tax was positively linked with transfer pricing. Kusuma (2016) documented that management and customer satisfaction emerged as determining factors for a firm to deploy transfer pricing. As such, this present study analysed the determinants of the intensity of transfer pricing practices adopted by a pool of non-financial MNEs listed on the Indonesia Stock Exchange (IDX) from 2014 to 2017 with 60 firm-year observations.

The remainder of this paper is structured as follows. Section 2 presents the literature review and the research hypotheses. Section 3 describes the research design, the sample, the variables, and the analysis methods adopted in this study. Section 4 specifies the empirical outcomes. Section 5 summarises the paper and presents the concluding remarks.

2. Literature Review and Hypotheses Development

Globalisation and increased mobility of capital across the world have created vast opportunities for global businesses to engage in tax avoidance practices. Empirical evidence largely highlight the involvement of MNEs in shifting their business profits from one country to another to avoid tax liabilities, which could result in low government tax collection in a country (Schimanski, 2017). The practice of shifting business profits by MNEs has turned into a critical problem for the global economy. Hence, it is imminent to identify factors that promote MNEs to adopt tax-avoiding strategies, such as transfer pricing.

2.1. *Income Tax and Transfer Pricing*

Higher-income tax rates prompt MNEs to devise ways to escape from the tax liabilities. These MNEs are robust and have multi-country linkages to benefit from overseeing sales and purchases with business affiliates (Holtzman & Nagel, 2014). Hopland, Lisowsky, Mardan, and Schindler (2014) depicted that transfer pricing practices adopted by MNEs tend to shift their tax obligations from high-tax countries to low-tax countries by reducing the selling price between firms within a group. This scenario reflects the concept of agency theory pertaining to actions taken to benefit shareholders (Hopland et al., 2014). Apart from overseeing, the principal demands the agent to achieve and maintain the prosperity of the principal (Pramana & Laksito, 2014). The firm would attempt to reduce its tax liabilities so that the income tax owed or paid to the state is relatively less. Holtsman and Nagel (2014) depicted that transfer pricing denotes price arrangement between firms related to business entities in terms of intellectual property transactions, tangible goods, services, loans, or other financial transactions. Transfer pricing refers to a strategy typically adopted by MNEs to reduce their tax payment (Klassen et al., 2013; Bozkurt, 2019; Garcia et al., 2019; Lovrinic, 2018;).

Additionally, Davies et al. (2018) found that tax motives can positively affect a firm's likelihood to practice transfer pricing. Therefore, the following hypothesis proposed:

Hypothesis (H1): *Income tax has a positive relationship with transfer pricing intensity of Multinational Non-Financial Firms in Indonesia.*

2.2. Profitability and Transfer Pricing

Business profitability has remained the prime motive for undertaking business activities. Probability portrays firm performance and highlights the efficiency of business operations. Profitability illustrates the ability of a business entity to generate profits using all its capital (Abdullah et al., 2019; Majid, Mediaty, Habbe, Herryanto & Possumah, 2019). Holtzman and Nagel (2014) claimed that profitability reflects the ability of a firm to generate profits from sales, assets, and equity. Rego (2003) discovered that firms with higher pre-tax income could avoid tax proportionally more than firms with less pre-tax income. Besides, more profitable firms can engage in transfer pricing practices to reduce (increase) profits in high-tax jurisdictions (low-tax country). Richardson et al., (2013) provided several concrete instances of very profitable firms, such as Apple, Google, and Microsoft, which have succeeded in finding advantages from low-tax jurisdictions, as well as increased spending to reduce taxes legally. Such actions are enabled via royalty payments in countries with high state jurisdiction to reduce taxable income. Kusuma (2016) reported that more profitable firms might deploy transfer pricing to reduce reported profits in high-tax jurisdictions by considering the pre-tax income of a firm within the context of transfer pricing implementation. As such, the following relationship hypothesised:

Hypothesis (H2): Profitability has a positive relationship with transfer pricing intensity of Multinational Non-Financial Firms in Indonesia

2.3. *Firm Size and Transfer Pricing*

Firm size refers to an indicator that describes the condition or characteristics of a firm (Kusuma, 2016; Lie, Ikhsan, Harmain & Nasution, 2020). Its numerous assets denote a large firm. Mills et al. (1998) and Schimanski (2017) asserted that larger firms have lower average tax planning costs than smaller firms. A large firm may achieve economies of scale through tax planning, besides possessing the resources and incentives to minimise corporate tax debt (Putri & Maksum, 2020). Niresh and Thirunavukkarasu (2014) opined that firm size could lead to firm stability, as well as the ability to generate higher profits via transfer pricing. Cecchini, Leitch, and Strobel (2013) found a positive link between firm size and transfer pricing practices, as MNEs tend to have substantial inter-firm transactions. Thus, the hypothesis below proposed:

Hypothesis (H3): Firm size has a positive relationship with transfer pricing intensity of Multinational Non-Financial Firms in Indonesia.

2.4. Intangible Assets and Transfer Pricing

Transfer pricing is the price inherent in MNE operations that involve many transactions with affiliated entities in countries with different jurisdictions, but under the same business group (Blouin, 2013). Gravelle (2010) opined that intangible assets are difficult to assess and offer a clear advantage to MNEs to practice transfer payments. Gravelle (2010) added that the problematic assessment of a firm's assets, such as royalties to the parent company, is challenging to value at fair prices. Intangible assets possess certain characteristics, such as lack of established market and subjective valuations, which are simultaneously exploited by firms in several jurisdictions (Richardson et al., 2013).

Intangible assets are one of the main components in transactions with related parties, such as MNEs (Rego, 2013). The MNEs distribute their intangible assets to related entities domiciled in countries with low-tax jurisdiction and receive royalty payments from affiliated firms in countries with high tax rates (Dudar et al., 2015). The flexibility in transfer pricing is greater for intangible assets than physical evidence as it is more difficult to determine fair prices for intangible assets (Hopland et al., 2014). Hence, MNEs have a greater opportunity to increase their involvement in transfer pricing through intangible assets between jurisdictions and imposition of various tax regimes. Therefore, the following hypothesis proposed:

Hypothesis (H4): Intangible assets have a positive relationship with transfer pricing intensity of Multinational Non-Financial Firms in Indonesia.

3. Research Methodology

3.1. Research Sample and Data Source

This study used all MNEs listed on the IDX from 2014 to 2017 as the sample. Data gathered from annual reports and financial statements of the selected firms displayed on the IDX official website. The purposive sampling technique was adopted, whereby samples selected by identifying specific criteria, such as MNEs working in Indonesia, published annual reports, sales information, transfer of funds between the partner companies, and missing data. Based on the results of sample selection, this study had a final sample of 60 firm-year observations. Table 1 tabulates the results of sample selection in this study.

Table 1. Sample Selection

Description	**Sample amount**			
	2014	**2015**	**2016**	**2017**
Initial sample	**154**	**154**	**154**	**154**
Excluded:				
Multinational firms that did not publish their audited financial report for 2014-2017	12	12	12	12
Firms that did not disclose their related party transaction data	28	28	28	28
Firms that incurred losses	59	59	59	59
Firms that did not have affiliated firms and/or subsidiaries in Indonesia or other countries	14	14	14	14
Firms that had missing data	26	26	26	26
Total observations each year	15	15	15	15
Total final observations	60			

3.2. Variable Definition

Transfer pricing served as the dependent variable in this study. Typically, transfer pricing is determined by dividing the transaction value of related party receivables with total firm receivables (Kiswanto & Purwaningsih, 2014), as given in the following:

TP =(Related party receivables)/(Total receivables)

The independent variables used in this study are income tax, firm profitability, firm size, and intangible assets. Income tax was measured based on the effective tax rate proxy, which refers to the ratio of income tax expense to profit prior to tax. Next, profitability was estimated using several ways, including return on assets (ROA), return on equity (ROE), and net profit margin (NPM) (Niresh & Thirunavukkarasu, 2014). The ROA was determined by dividing net profit after tax by total assets. In contrast, ROE was retrieved by dividing net profit after tax by total equity, and NPM was obtained by dividing net profit after tax by total sales. Firm size and intangible assets calculated using the natural logarithms of total assets and total intangible assets, respectively.

3.3. *Data Analysis Method*

Data were analysed using the ordinary least square regression test using SPSS 22 software. Regression analysis was employed to test the correlations of income tax, firm profitability, firm size, and intangible assets with the intensity of transfer pricing. The following equation presents the ordinary least square regression analysis model:

$TP_{it} = \alpha + \beta_1 TAX_{it} + \beta_2 PROFIT_{it} + \beta_3 SIZE_{it} + B4INTANGit + \varepsilon_{it}$ (1)

Where, TP: Transfer Pricing, TAX: Income Tax, PROFIT: Firm Profitability, SIZE: Firm Size, INTANG: Intangible Assets, ROA: Return on Assets, ROE: Return on Equity, NPM: Net Profit Margin

3.4. *Data Analysis Method*

For data analysis, this study has considered both descriptive and inferential statistics. Both methods are applied in a procedure way. For example, while going for the hypothesis testing of the study, it is quite important to analyse the trends in the dataset which may help the researchers to review the numerical values. For this purpose, descriptive statistics technique is applied firstly covering total observations in the dataset, mean score of each variable, minimum, and maximum as well. These measures provide the detail about the measures of central tendency and dispersion in the data as well.

After applying the descriptive statistics, this study has checked two of the major assumption while going for the inferential analysis which covers the title of regression method. Although there are various regression assumptions, but this study is confined to normality and collinearity diagnostics. Through normality diagnostic, normal trends of the study variable are examined, while collinearity diagnostic test has helped the researcher to analyse the strength and direction of the relationship between the study variables.

In the last step for the data analysis and methods, regression approach is applied in order to test the effect of individual explanatory variable on the main dependent variable as observed through beta coefficients. Furthermore, regression analysis has helped the researcher to confirm whether the association between the dependent and independent variables is significant or not. Findings for each of the above stated methods are provided in the section 4.

4. Result and Discussion

4.1. Descriptive Statistics

Results derived from the descriptive statistical analysis tabulated in Table 2. Based on the findings, the average transfer pricing was 0.216, which signified low engagement in transfer pricing activities by the selected sample. Next, the corporate income tax displayed an average value of 0.260, which was low as perceived by the sample. Upon being measured using ROA, firm profitability exhibited an average value of 0.134, while the average values for ROE and NMP were 0.235 and 0.107, respectively. The profitability ratios revealed moderate to low levels of profitability for the sample firms. The statistics exemplified reasonable profits earned by the MNEs working in Indonesia. The average firm size and the average intangible assets were 28.559 and 23.322, respectively. The intangible assets for the sample firms resulted in a higher value of intangible assets.

4.2. Normality Test

Table 3 presents the results of the normality test conducted using the Kolmogorov-Smirnov non-parametric statistical test. As a result, the significance or probability value of the four variables was 0.541, which exceeded the threshold value of 0.050. It indicated that the study data normally distributed.

Table 2. Descriptive Statistics

	N	Minimum	Maximum	Mean
TP	60	0.000	0.983	0.216
TAX	60	0.066	0.628	0.260
ROA	60	0.010	0.618	0.134
ROE	60	0.021	1.358	0.235
NPM	60	0.007	0.331	0.107
SIZE	60	24.461	33.320	28.599
INTANG	60	18.691	29.473	23.322

Note: TP: Transfer Pricing, TAX: Income Tax, PROFIT: Firm Profitability, SIZE: Firm Size, INTANG: Intangible Assets, ROA: Return on Assets, ROE: Return on Equity, NPM: Net Profit Margin

Table 3. Kolmogorov-Smirnov Test

		Unstandardized Predicted Value
Normal Parameters[a]	Mean	0.217
	Std. Deviation	0.103
Most Extreme	Absolute	0.104
Differences	Positive	0.076
	Negative	-0.104
Kolmogorov-Smirnov Z		0.802
Asymp. Sig. (2-tailed)		0.541
N = 60		

4.3. Multicollinearity Test

The multicollinearity test carried out to determine the tolerance and the variance inflation factor (VIF) of the study variables. Table 4 tabulates the results derived from the multicollinearity test. The VIF values for income tax, profitability (ROA, ROE, and NPM), firm size, and intangible assets were below 7.7, while the tolerance value did not exceed 1.0. These outcomes reflected that the independent variables had no multicollinearity issue.

Table 4. Multicollinearity Test

	Collinearity Statistics	
Variable	Tolerance	VIF
TAX	0.877	1.140
ROA	0.324	3.088
ROE	0.432	2.314
NPM	0.522	1.917
SIZE	0.193	5.187
INTANG	0.194	5.164

Note: TP: Transfer Pricing, TAX: Income Tax, PROFIT: Firm Profitability, SIZE: Firm Size, INTANG: Intangible Assets, ROA: Return on Assets, ROE: Return on Equity, NPM: Net Profit Margin

4.4. Ordinary Least Square Analysis

4.4.1. *Coefficient of Determinant*

Table 5 presents the results of the coefficient of determination test for the regression model employed in this study. The R^2 value of 0.105 or 10.5% indicated that the regression model could explain 10.5% of the relationships between transfer pricing and income tax, profitability, firm size, as well as intangible assets.

Table 5. Coefficient of Determinant

Model	R	R^2	Adjusted R^2	Std. Error of Estimate
1	0.324[a]	0.105	0.004	0.318

4.4.2. Relationship between Tax Income and Transfer Pricing

Referring to Table 6, the ordinary least square regression analysis results highlighted that the link between income tax and transfer pricing (β = -0.126; t = -0.222) was not statistically significant. This signified that income tax was not related to transfer pricing, thus rejecting the first hypothesis of this study. Transfer pricing is one of the means used by MNEs to reduce their taxes (Klassen et al., 2013). This study finding is in agreement with that reported by Gravelle (2010), who discovered increased income tax was unrelated to transfer pricing. One factor that caused this irrelevance was because the tax authorities subjectively reckoned the sole purpose of transfer pricing was to avoid taxes. Hence, the tax authorities deployed measures to minimise the practice of transfer pricing (Klassen et al., 2013). Generally, the taxation apparatus identifies two fundamental aspects so that tax correction on transfer pricing practices has strong legitimacy for investors. The first is affiliation (associated enterprises) or special relationship, and the second is fairness (arm's length principle). Thus, the MNEs had minimised the practice of transfer pricing.

Table 5. Results of Ordinary Least Square Analysis

Variable	Coefficient	t-value	Sig.
(Constant)	0.914	1.126	0.265
TAX	-0.126	-0.222	0.825
ROA	-0.529	-0.911	0.367
ROE	-0.067	-0.320	0.750
NPM	1.205	1.502	0.139
SIZE	-0.076	-1.658	0.103
INTANG	0.063	2.069	0.043**

Note: TP: Transfer Pricing, TAX: Income Tax, PROFIT: Firm Profitability, SIZE: Firm Size, INTANG: Intangible Assets, ROA: Return on Assets, ROE: Return on Equity, NPM: Net Profit Margin

4.4.3. Relationship between Profitability and Transfer Pricing

Table 6 presents the relationship between company profitability (ROA, ROE, and NPM) and transfer pricing. The coefficient values of ROA, ROE, and NPM were -0.529 (t = -0.911), -0.067 (t = -0.320), and 1.205 (t = 1.502), respectively. The three proxies of profitability displayed statistically insignificant outcomes. The results indicated the irrelevance between firm profitability and involvement of MNEs in transfer pricing, which led to the rejection of the second hypothesis. Similarly, Kusuma (2017) reported that corporate profitability was unrelated to transfer pricing. This outcome portrays that the engagement of firms in transfer pricing was not to move the host country business profit to the parent company in the home country.

4.4.4. Firm Size and Transfer Pricing

Table 6 depicts that the relationship between firm size and transfer pricing was not statistically significant (β = -0.076; t = -1.658), thus failing to support the third hypothesis. In a similar vein, Putri and Maksum (2020) found that firm size was not significantly related to transfer pricing practice. The result signified that large firms had fewer incentives to perform transfer pricing than smaller firms. Kusuma (2014) postulated that small firms were more likely to deploy transfer pricing to display satisfactory performance.

4.4.5. Intangible Assets and Transfer Pricing

As shown in Table 6, the relationship between intangible assets and transfer pricing was significant at 5% significance level (β = 0.063; t = 2.069). It revealed that intangible assets exhibited a positive and statistically significant relationship with transfer pricing practices adopted by MNEs working in Indonesia. Hence, the fourth hypothesis of this study finds significant statistical support, which means that the more intangible assets a firm possesses, the higher the intensity of transfer pricing. The MNEs can increase the intensity of transfer pricing practices through intangible assets owned by the firm. Intangible property owned by a firm refers to the right to use industrial property, such as patents, trademarks, trade names, designs, and models, which indirectly increases the frequency of transfer pricing practices. Such liberty enables MNEs to distribute their intangible assets to related entities domiciled in countries with low-tax jurisdiction and receive royalty payments from affiliated firms located in countries with high tax rates (Dudar et al., 2015). Moreover, it is not easy to assess intangible assets at fair prices (Gravelle, 2010). Intangible assets have certain characteristics, such as lack of established market and subjective valuations, which can be exploited simultaneously by firms that deploy transfer pricing. Firms tend to take advantage of the difficulties in measuring intangible assets, especially when comparing their values with arm's length prices.

5. Conclusion

Despite the evident incentives for MNEs to engage in transfer pricing strategies and the vivid implications of transfer pricing for MNEs and for a country, the direct and empirical evidence remains unclear and untapped. The transfer pricing phenomenon deployed by MNEs lacks data availability and disclosure. Nevertheless, transfer pricing is a vital strategy for MNEs to shift their funds in multiple shapes with particular objectives. This present study analysed the determinants of the intensity of corporate transfer pricing practices adopted by non-financial MNEs listed on the IDX from 2014 to 2017. As a result, income tax, firm profitability, and firm size were not significantly related to transfer pricing practices among the MNEs working in Indonesia.

On the contrary, the intangible assets of MNEs displayed significantly positive link with the transfer pricing of MNEs working in Indonesia. The practice of transfer pricing with intangible assets owned by the parent firm empowered the MNEs to enjoy low-tax payment. Flexibility in transfer pricing is greater for intangible assets than for tangible assets, mainly because determining fair prices for intangible assets is more intricate.

This study offers several policy implications, wherein tax rates, profitability, and firm size do not directly encourage the affiliated global firms to engage in transfer pricing activities. Therefore, the government may offer incentives to enhance the tax rate to generate better revenue from the activities undertaken by MNEs working in a host country. Besides, concrete legislations and regulations should be implemented when evaluating intangible assets owned by global firms and transfer of funds in the name of royalties, patent fee, or license for the production or sales of goods under a global brand in a country. The MNEs need to disclose their annual payments made to the parent firm, so as to reduce the perception of transfer pricing activities.

This study has several limitations, as follows. Since the sample used in this study only reflected a small portion of firms listed on the IDX, the outcomes cannot be directly generalised to all firms listed on the IDX. Nonetheless, the study results may enrich the literature on transfer pricing intensity determinants, particularly within the context of non-financial affiliated firms of global business working in Indonesia. The study findings may serve as a reference to several parties, including the government, investors or creditors, and financial statement analysts when making decisions in light of transfer pricing. Future research is called for to develop this topic area by assessing other transfer pricing strategies and variables, including interest rate, foreign direct investment, barriers or loopholes lurking in the tax system, and foreign exchange movements.

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