



Can Thin Capitalization And Transfer Pricing Activities Reduce The Tax Burden?

Winarto¹, Apollo Daito²

¹)Department of Magister Accounting, Universitas Mercu Buana, Jakarta, Indonesia
55518110010@student.mercubuana.ac.id

²)Department of Magister Accounting, Universitas Mercu Buana, Jakarta, Indonesia

Corresponding Author: Winarto¹

Abstract. The purpose of this research is to examine the effect of thin capitalization and transfer pricing as a vehicle for companies to reduce their corporate tax burden. The research method used is a quantitative-explanation, with the proxy of tax avoidance is ETR. This research found that thin capitalization activities and transfer prices have a negative and significant effect on tax avoidance. This research also found that institutional ownership strengthens the effect of thin capitalization and transfer pricing on tax avoidance. This research contributes to the literature on using the PLI ratio, namely ROCE as a measurement tool for transfer pricing activity, which provides a new methodological contribution to tax avoidance research through transfer pricing activities in Indonesia's manufacturing companies. This study proves that Return On Capital Employed can be used as a transfer pricing activity measure.

Keywords: Manufacturing Companies, Quantitative-Explanation, Tax Avoidance, Thin Capitalization, Transfer Pricing, Institutional Ownership

INTRODUCTION

Tax avoidance has long been the object of research in accounting (Hanlon & Heitzman, 2010). Research on tax avoidance continues to evolve in line with current developments in digital transactions and globalization. Globalization has resulted in capital being very flexible and used in various tax territories by corporate taxpayers. The discrepancy between capital globalization and tax territories has been shown to irritate tax authorities when allocating revenue and expenses to multinational companies. One significant manifestation is multinational companies' circumstance (MNE) shifting profits to relatively low tax jurisdictions through transfer pricing (Rectenwald, 2012). This tax avoidance activity significantly affects low and middle-income countries that depend on tax revenue because it will reduce the tax received (Cobham & Janský, 2017). It is consistent with previous research, which found tax authorities around the world acknowledged that tax avoidance

activities have contributed to the erosion of tax revenues, as evidenced by a reduction in the effective corporate tax rate and an increase in the number of companies reporting zero tax liability (Richardson et al., 2013).

Based on data from Indonesia's External Debt Statistics as of April 2019, the value of External Debt for the manufacturing sector is \$ 35.8 billion, and \$ 14 billion in transactions with parent and affiliated companies. Using debt is a pervasive way that companies engage in tax avoidance. According to Modigliani and Miller's theory, debt in the company's capital structure provides benefits that can be used as tax incentives because loan interest is a deductible expense (Jaros & Bartosova, 2015). Debt is used as a tax incentive compared to equity because there are differences in tax treatment between dividends and loan interest. This difference is one of the ways companies carry out tax avoidance activities (Turner, 2017). Therefore, to regulate the total debt to equity ratio on tax reports, the Indonesian Ministry of Finance issued a PMK No. 169/PMK. 010/2015. In the regulation, the ratio of debt to equity is limited to 4:1.

According to prior research, transactions between affiliated companies with different locations had a greater chance of avoiding taxes (Desai et al., (2006). A company located in a high tax rate jurisdiction can shift its income and expenses to low tax jurisdiction. A company located in a high tax rate jurisdiction will generate small profits. On the other hand, companies located in low tax jurisdictions will generate high profits (Barker et al., 2017). Multinational firms can structure and price payments and intra-firm trade in such a method as to facilitate tax avoidance, particularly setting artificial intercompany transfer prices strategically (Grubert & Mutti, 1991; Richardson et al., 2013). The purpose of transfer pricing activities is that companies do not need to pay taxes, or the value is minimal compared to the company's overall income (OECD, 2013). Transfer pricing is a legitimate and necessary feature of multinational companies' commercial activities (The Platform for Collaboration on Tax, 2017). However, if the transfer price between the related companies does not comply with the international norms, it can distort profits among countries where the multinational company operates (OECD, 2013).

Companies see tax as a significant burden (Chen et al., 2010). Hence, managers as shareholders' agents will increase company value by minimizing taxes paid for shareholders' benefit (Chen et al., 2010). Previous research has also found companies with institutional ownership are generally more tax aggressive (Khurana & Moser, 2009). Base on that, this study uses institutional ownership as a moderating variable that will test whether institutional ownership can moderate the effect of thin capitalization and transfer prices on tax avoidance. This research contributes to several things. First, this study's results expand and strengthen the previous research literature on tax avoidance practices in Indonesia's manufacturing companies through thin capitalization activities and transfer prices with institutional ownership as a moderating variable. Second, this study's results are expected to provide positive input for tax authorities as rule makers and law enforcement in the field of tax disputes. Third, the author offers researchers, practitioners, and tax authorities to use of ROCE to measure transfer pricing activity when comparative transaction data is difficult to access. This study proves that ROCE can analyze tax avoidance through transfer pricing activity in Indonesia's manufacturing companies.

LITERATURE REVIEW

Agency Theory

Agency theory is an agreement between one or more economical resource holders (principals) by inviting other parties (agents) to manage resource holders' resources (Jensen & Meckling, 1976). Principals/shareholders delegate business decisions to agents/managers

as shareholder representatives. However, managers do not always make decisions that serve the interests of shareholders.

Modigliani and Miller's Theory

The capital structure theory from Modigliani and Miller states that companies that use debt will get two benefits. First, debt is a cheaper source than equity. Second, the loan interest is a deductible expense that can reduce tax profit so that the tax burden is small (Jaros & Bartosova, 2015).

Stakeholder Theory

According to Freeman, stakeholders are any group or party that can be influenced or influenced based on company goals. If the company can control some parties (or controlled), the manager needs to worry about those parties. It means that an explicit strategy is required to deal with these stakeholders (Parmar et al., 2010).

Tax Avoidance

Tax avoidance is a company activity producing explicit tax deductions, both legal and illegal (Dyrenge et al., 2008). Income tax represents a significant expense and cash outflow. To increase earnings per share after tax and available cash, companies spend time, energy, and money to minimize the tax burden by avoiding them (Chen et al., 2010). Tax avoidance is also a method that companies deliberately choose to reduce tax burdens either legally or illegally (Lee et al., 2015).

Thin Capitalization

A thin capitalization is an investment option for companies financing their business operations using debt, not equity, as a source of funding in their capital structure (Richardson et al., 2013). The funding investment return in the form of dividends will be taxed. Meanwhile, for those originating from loans, interest expense is deductible expenses, which will make taxable income smaller (Turner, 2017).

Transfer Pricing

Transfer pricing is when a company transfers physical or intangible goods or services to a related company (OECD et al., 2017). Multinational companies use this transfer pricing to manipulate pricing policies by sharing profits from high to lower tax areas (Grubert & Mutti, 1991).

Institutional Ownership

Institutional ownership is part of company shares owned by institutional investors (Chung & Zhang, 2011). The higher the concentration of share ownership, the more significant the proportion of the company regulation. According to prior research, institutional ownership size affects company policies and actions in reducing the tax burden (Khurana & Moser, 2013).

RESEARCH METHODS

Research data comes from manufacturing companies listed on the Indonesia Stock Exchange in 2014-2018. The type of data is panel data. The sample is 30 companies based on the criteria that the authors set. The sampling method is purposive sampling. Namely, samples were selected based on particular conditions that were considered capable of indicating the population's character (Daito, 2011). The proxies used to measure the dependent, independent, and moderator variables are as follows:

Effective Tax Rate (ETR)

The tax avoidance proxy in this study is ETR. ETR is obtained by divides the tax expense by the pretax accounting income (Chen et al., 2010; Dyreng et al., 2008). The ETR is compared to the prevailing rate to measure tax avoidance by knowing how much the company pays tax on the resulting profit. ETR reflects a permanent difference between the book and taxable income with statutory adjustments because the tax expense includes current and deferred tax costs (Lee et al., 2015). The corporate tax strategy of delaying tax payments does not change the ETR because the tax burden does not always reflect tax liability (Lee et al., 2015). Based on this, the equation for calculating ETR is as follows:

$$\text{ETR} = \frac{\text{Tax Expense}}{\text{Pretax income}}$$

Debt to Equity Ratio (DER)

DER is the proxy of thin capitalization. DER calculates how much the ratio between total debt and equity. Based on DER's value, if the debt is more than equity, it has assumed to reduce tax profit using loan interest. DER calculation can use the following equation (Ross et al., 2003):

$$\text{DER} = \frac{\text{Total Debt}}{\text{Equity}}$$

Return On Capital Employed (ROCE)

Based on OECD guidelines, if there is difficulty accessing analytical data or not finding comparable transaction information, transfer pricing analysis tools can use the PLI ratio. Furthermore, the PLI ratio to analyze transfer pricing activities in this study uses ROCE (OECD et al., 2017). ROCE calculations can use the following equation (Steyn, 2012):

$$\text{ROCE} = \frac{\text{EBIT}}{\text{Capital Employed}}$$

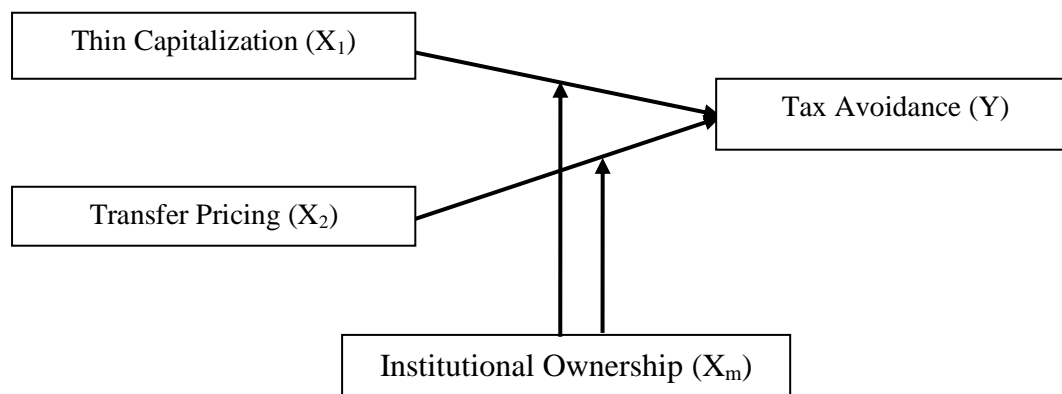
Share Ownership by Institutional Investor

Institutional ownership calculation uses the shares owned by institutional investors. To measure institutional ownership, using the following equation (Khurana & Moser, 2009):

$$\text{Institutional Ownership} = \frac{\sum \text{Shares owned by Institutional}}{\sum \text{Outstanding Shares}}$$

Research Framework

Developing a thought framework is to answer a problem rationally by formulating and identifying (why this phenomenon occurs) and channeling the way of thinking from the rationale (premise) based on standard pillars (propositions/assumptions/axioms) to thinking results/deductions/hypotheses) according to the logical framework (Daito, 2007a). Based on that definition, the framework on this research is:



Hypotheses:

Hypotheses are quick answers to existing problems researched (defined, formulated, and identified) (Daito, 2007b). Based on that definition, the hypotheses in this research are:

H₁: Thin capitalization affects tax avoidance

H₂: Transfer pricing affects tax avoidance

H₃: Institutional ownership moderates the effect of thin capitalization on tax avoidance.

H₄: Institutional ownership moderates the effect of transfer pricing on tax avoidance.

RESULT AND DISCUSSION

Statistic Descriptif

Based on descriptive statistical data, the mean Current ETR value is 24.48%. Its means the sample has an average ETR value smaller than the prevailing tariff. The assumption is that the companies in this sample avoid tax by minimizing current tax expenses.

Based on descriptive statistical data, the mean ETR value is 24.48%. Its means that the sample in this study had an average ETRR value smaller than Indonesia's statutory rate.

Table 1. Statistic Descriptive

	ETR	DER	ROCE	INS
Mean	0.244800	1.152467	0.266867	0.711000
Median	0.250000	0.870000	0.170000	0.710000
Maximum	0.600000	6.590000	1.660000	0.960000
Minimum	0.000000	0.010000	0.000000	0.500000
Std. Dev.	0.085355	1.104840	0.323548	0.139672
Skewness	1.005176	2.459910	2.993411	0.176649
Kurtosis	7.538138	11.03358	11.44295	1.749857
Jarque-Bera	153.9763	554.6440	669.5344	10.54798
Probability	0.000000	0.000000	0.000000	0.005123
Sum	36.72000	172.8700	40.03000	106.6500
Sum Sq. Dev.	1.085544	181.8802	15.59783	2.906750
Observations	150	150	150	150

Source: Output Eviews

Determination Coefficient Test and F Test

Table 2. R-squared and F-statistic

R-squared	0.651425
Adjusted R-squared	0.548368
F-statistic	6.321009
Prob(F-statistic)	0.000000
Durbin-Watson stat	2.448695

Source: Output Eviews

Regression And Hypothesis

In this research, the regression method using the fixed-effects model with cross-section weight using GLS. Then, we reestimate this specification using White cross-section standard errors to allow for general contemporaneous correlation between the strong residuals. The cross-section designation indicates that non-zero covariances are allowed across cross-sections (Eviews, 2020). Panel data structures consisting of individual units and time units often produce various residuals that are not homogeneous or can lead to heterogeneous residuals between individuals (heteroscedastic cross-sectional). The heteroscedasticity problem will be solved by weighting the cross-section weight using GLS and cross-section standard error and covariance. The GLS estimation method accommodates heteroscedastic and autocorrelation problems (Gujarati & Porter, 2012). Based on that method, the result is an R-squared value of 0.651425, and an Adjusted R-squared value is 0.548368. It means the tax avoidance variable can be explained by 65% using thin capitalization, transfer prices, and institutional ownership. The remaining, namely 35%, explained variations from other variables outside of this study. The results of the F-test are Prob (F-statistic) 0.000000 $< \alpha$ (0.05) and the value of F-table (6.321009) $>$ F-table value (2.62). It means the independent variable has a simultaneous effect on the dependent variable.

Table 2. R-squared and F-statistic

Variable	Coefficient	Std. Error	t-Statistic	Prob.
C	0.209456	0.080277	2.609186	0.0103
DER	-0.014599	0.006507	-2.243750	0.0268
ROCE	-0.309325	0.087498	-3.535237	0.0006
INS	0.067719	0.109750	0.617028	0.5384
DER*INS	0.019823	0.009059	2.188125	0.0307
ROCE*INS	0.350056	0.098688	3.547108	0.0006

Source: Output Eviews

H₁: Thin capitalization affects tax avoidance.

The regression results show the p-value DER (0.0268) $< \alpha$ (0.05) with the regression coefficient value is -0.014599. Based on these results, thin capitalization has a negative and significant effect on tax avoidance, so it means that the hypothesis is accepted. Based on the research results, any increase in the DER value will be followed by a decrease in the ETR value. Its means that the use of debt will reduce the tax burden. These results are in line with

research by Taylor & Richardson (2012) and Waluyo & Doktoralina (2018), which found that thin capitalization negatively affects tax avoidance. This result is also in line with Modigliani and Miller's capital structure theory that companies that use debt will get two benefits. First, debt is a cheaper source of capital compared to equity. Second, the loan interest is a deductible expense that can reduce tax profit so that the tax burden is smaller (Jaros & Bartosova, 2015). This result is also in line with previous studies' results, which found tax avoidance was carried out by companies with a higher debt value than companies that did not avoid taxes (Dyrenge et al., 2008).

H₂: Transfer pricing affects Tax Avoidance.

The regression results show the p-value of ROCE (0.0006) $< \alpha$ (0.05) with the regression coefficient value is -0.309325. Based on these results, the transfer price variable has a negative and significant effect on tax avoidance. So it can be concluded that the hypothesis is accepted. Based on these results, an increase in the ROCE value will reduce the ETR value. This study's results are in line with research by Taylor & Richardson (2012), which found transfer pricing has a negative and significant effect on tax avoidance. The use of ROCE is to measure the profitability and effectiveness of the use of company capital (Bezuidenhout, 2016). ROCE can be used to measure transfer price activity in asset-intensive industries such as manufacturing companies, where no unique and valuable contribution is made by the tested party (The Platform for Collaboration on Tax, 2017). These results also confirm that ROCE can be used as a basis for analyzing the effect of transfer price activities on tax avoidance in manufacturing companies in Indonesia.

H₃: Institutional ownership moderates the effect of thin capitalization on Tax Avoidance.

The regression results show the p-value DER*INS (0.0307) $< \alpha$ (0.05), with the regression coefficient value, is 0.019823. Based on these results, the hypothesis of institutional ownership strengthens the effect of thin capitalization on tax avoidance is accepted. This result is in line with (Khurana & Moser, 2009), who found that most companies with higher institutional ownership levels are more tax aggressive, and companies with higher levels of short-term institutional shareholders are more tax aggressive. These results also follow stakeholder theory and agency theory which states that institutional ownership is the principal and internal stakeholders of a company that will try to control and influence company goals for shareholders' benefit. When the results of thin capitalization activities reduce tax costs, institutional ownership will support these activities.

H₄: Institutional Ownership moderates the effect of transfer pricing on Tax Avoidance.

The regression results show the p-value of ROCE*INS (0.0006) $> \alpha$ (0.05) with the regression coefficient value of 0.350056. Based on these results, institutional ownership strengthens the effect of transfer prices on tax avoidance. It means the hypothesis is accepted. This result is in line with Khan et al. (2017), who found a positive relationship between institutional ownership and tax avoidance. This study found that institutional ownership strengthens the effect of transfer pricing on tax avoidance. It proves that institutional investors see the profitability and efficiency of using capital to benefit company performance as something important. The higher the ROCE value, the greater its efficiency level in using company capital and funds. It means that it will have an impact on the dividends that shareholders get. Based on agency theory, principals will motivate agents to act in their best interests (Kaiser, 2006).

CONCLUSIONS AND SUGGESTION

Conclusions

According to Modigliani and millers theory, this research found that thin capitalization activities have a negative and significant effect on tax avoidance. The use of debt in the capital structure is proven to reduce the tax burden. This study also found that ROCE had a negative effect and significant on the ETR value. Its means that ROCE is proven to analyze transfer pricing activities to reduce the tax burden. Tax avoidance is a deliberate attempt by a company to reduce its tax obligation using a legal or illegal strategy (Lee et al., 2015). Tax avoidance behavior also provides positive benefits for the company, namely savings and an increase in cash balances (Annuar et al., 2014). Besides, shareholder wealth will also increase due to more dividends and an increase in share value. Managers also receive benefits and compensation for effective tax management (Annuar et al., 2014). These results reinforce previous research that found that thin capitalization and transfers pricing activities negatively affect tax avoidance (Taylor & Richardson, 2012).

The moderation test results found that institutional ownership strengthens the effect of thin capitalization and transfer pricing on tax avoidance. This result is in line with previous research, which found institutional ownership more aggressive towards tax avoidance (Khurana & Moser, 2009). Institutional ownership will also support managers' behavior on transfer pricing policies because it impacts reducing corporate tax costs (Smart, 2012). These results also strengthen the argument that taxes are a high cost for the company. Therefore, tax avoidance by reducing tax costs benefits shareholders (Chen et al., 2010). According to agency theory, shareholders/principals will motivate management/agents to act in their best interest (Kaiser, 2006). Therefore, as internal stakeholders, shareholders will try to influence and control the achievement of company goals (Parmar et al., 2010).

Suggestion

1. The measurement of tax avoidance in this study uses ETR, which requires that the profit before tax is favorable to affect the number of samples used. Based on this, it is recommended for further researchers to use the Henry & Sansing (2018) measurement tool, which allows companies that have negative profits to be selected as research samples.
2. Institutional ownership in this study moderates the effect of thin capitalization and transfer prices on tax avoidance. Therefore, further researchers need to use other variables to expand the existing literature.
3. For tax authorities, tax avoidance activities through thin capitalization activities still have the potential to erode the potential for tax revenue in Indonesia. Based on this research results, the greater the ratio of debt to equity, the smaller the companies' tax burden, especially in the manufacturing industry. Therefore, the tax regulations governing thin capitalization activities in manufacturing companies need to be evaluated because there are still legal loopholes that companies can exploit, especially in Indonesia's manufacturing industry.
4. For tax authorities and researchers, this study's results have proven that the use of ROCE as a measuring tool for transfer pricing activity affects reducing ETR. Therefore, this study can be used as new empirical evidence in analyzing transfer pricing activities, especially for Indonesia's manufacturing industry.

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