Jurnal Ekonomi dan Bisnis Jagaditha
Volume 9, Nomor 2, 2022, pp. 193-198

EISSN 2579-8162
ISSN 2355-4150
https://ejournal.warmadewa.ac.id/index.php/jagaditha

JAGADITHA

Effects of Transfer Pricing, Tax Haven, and Thin Capitalization on Tax Avoidance

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Published: 15/09/2022

How to cite (in APA style):
Rini, I. G. A. I. S., Dipa, M., & Yudha, C. K. (2022). Effects of Transfer Pricing, Tax Haven, and Thin Capitalization on Tax Avoidance. *Jurnal Ekonomi dan Bisnis Jagaditha*, 9(2), 193-198. doi: https://doi.org/10.22225/jj.9.2.2022.193-198

Abstract—Tax avoidance can be defined as an effort made by taxpayers to ease their tax burden without violating tax rules. Tax avoidance is a complicated and distinctive problem because it does not violate existing rules and regulations, however, on the other hand, the government does not want the existence of tax avoidance because it can cause a lack of state revenue. The purpose of this study is to examine and obtain empirical evidence of the effect of transfer pricing, tax havens, and thin capitalization on tax avoidance. This study was conducted on basic and chemical industrial sector companies listed on the Indonesia Stock Exchange for the 2017-2020 period. The sample was determined using a non-probability sampling method through a purposive sampling technique, and 13 samples of companies that meeting the criteria were obtained. In addition, this study uses secondary data in the form of company annual financial statements and reports. Data were analysed using a multiple linear regression analysis technique. The results showed that transfer pricing has a negative effect on ETR as a proxy for tax avoidance; tax haven has a positive effect on ETR; while thin capitalization has no effect on ETR.

Keywords: tax avoidance; tax haven; thin capitalization; transfer pricing

I. INTRODUCTION

The tax sector has become one of the main sources of state revenue and has a major influence on the state, in addition to revenues originating from oil and gas and non-oil and gas sources. On the other hand, the company views taxes as a burden because they can reduce the company's net profit, so the company will try to minimize its tax payments. Tax avoidance refers to a manipulation activity to reduce taxes from income in a legal manner and still comply with applicable tax rules and regulations. The past study conducted by Taylor & Richardson (2012) revealed that transfer pricing, tax havens, and thin capitalization could affect tax avoidance.

The OECD (2019) stated that in 2017 Indonesia's tax ratio was 11.5%, which was still the lowest compared to those of countries in the Asia Pacific territory. A low tax ratio indicates that the government has not been involved in optimally absorbing the income derived from taxes and indicates the existence of tax avoidance actions taken by the company. Companies that practice tax avoidance tend to have low ETR. Based on data from several companies in the basic and chemical industries for the 2019-2020 period, the ETR value tended to decrease. Agents in agency theory will try to manage the company's tax burden in order that the compensation from the agent's performance remains unreduced.

The previous related studies have conducted the similar study that examined transfer pricing, tax haven, and thin capitalization on tax avoidance. Utami & Irawan (2022) in their study conducted about the effect of thin capitalization, transfer pricing aggressiveness on tax avoidance with financial constraints as moderating variable. Their results showed that thin capitalization, transfer pricing aggressiveness, and financial constraints have a positive effect on tax avoidance. Further research shows that financial constraints strengthen the effect of thin capitalization on tax avoidance, but financial constraints do not moderate the effect of transfer pricing aggressiveness on tax avoidance. Another similar study also conducted by Fasita et al. (2022) that *investigated the association of transfer pricing aggressiveness, thin capitalization, and political connection with tax avoidance and the corporate governance's role in moderating these associations. The results showed that transfer pricing aggressiveness and political connection are negatively associated with tax avoidance. In contrast, thin capitalization is positively associated with tax avoidance. However, corporate governance can weaken each of these associations. This study indicates that the Indonesian Tax Authority should consider multinational companies with large interest debt structures on the list of priorities in tax inspection policy. Also, this study shows Indonesian firms are less likely to use political connection and transfer pricing to avoid tax.*

Based on the background and the research gap obtained from the facts as described above, then the present study was conducted on companies in the basic and chemical industrial sectors listed on the Indonesia Stock Exchange in 2017-2020. This study aims to examine and obtain empirical evidence regarding the effects of transfer pricing, tax havens, and thin capitalization on tax avoidance.

II. LITERATURE REVIEW

Agency Theory

Agency theory is a theory that provides an explanation of the relationship that occurs between the principal or owner and the agent or manager in that the principal (owner) hands over the authority to manage the company to the manager Jensen & Meckling (1976). In the principal and agent relationship, it is assumed that all individuals will act in their personal interests, which then creates a conflict of interest. The interests of the manager (agent) in the company are to obtain as much compensation or incentives for their performance in obtaining high profits and the owner (principal) seeks to reduce the tax burden. In this situation, the practice of tax avoidance can be applied to deal with the problem of differences in interests. The bond between the principal and the agent can also occur in the relationship between the tax authorities and the taxpayers which then creates differences in interests. Fiscus (principal) expects tax receipts from the public to be as much as possible, while the company (agent) expects taxes to be paid to a minimum (Reinganum & Wilde, 1985).

Tax Avoidance

Tax avoidance refers to an effort made by taxpayers with the aim of avoiding tax in a legal way, not contradicting the applicable tax rules, which is carried out by taking advantage of weaknesses or grey areas in tax rules and regulations so as to minimize the amount of tax payable (Pohan, 2016).

Transfer Pricing

Transfer pricing refers to a company policy to decide transfer prices in transactions between divisions in a company or between companies that have special relationships, or a multinational company (Afriyanti, 2019). In agency theory, agents can take advantage of transfer pricing schemes to reduce the tax burden so profits increase. Transfer pricing can be used as a method to minimize the amount of tax that must be paid through pricing in an unreasonable way, either by increasing the price (mark up) or by lowering the price (mark down) with the aim of getting around the company's profit; thus, it will reduce the tax paid. The first hypothesis in this study is H1: Transfer pricing has a negative effect on ETR (as a proxy for tax avoidance).

Tax Haven

A tax haven is defined as a policy that is intentionally given by a country in the form of tax facilities, in the form of applying low tax rates or not collecting taxes at all (Agata, Lembut, & Oktariani, 2021). Agents will try to manage their tax burdens through the use of tax haven countries so as not to reduce compensation from the agent's performance. In general, companies transfer their profits through transactions with complex schemes in countries that are categorized as tax havens to realize the personal interests of the company, that is to say, by implementing tax avoidance (Roza, Guritno, & Aswar, 2020). The second hypothesis in this study is H2: Tax haven has a negative effect on ETR (as a proxy for tax avoidance).

Thin Capitalization

Thin capitalization constitutes a company strategy to fund the operations of its business by prioritizing debt funding compared to equity (Andawiyah, Subeki, & Hakiki, 2019). The relationship with agency theory is that the application of thin capitalization can lead to tax incentives which can be a tax problem caused by the treatment of capital investments with different debts. The high amount of debt in the capital structure will result in an increase in the company's interest expense, thereby increasing the income tax deduction burden and reducing the company's taxable income. The third hypothesis in this study is H3: Thin capitalization has a negative effect on ETR (as a proxy for tax avoidance).

III. METHOD

This study was compiled with a research design and data collection conducted on companies listed on the Indonesia Stock Exchange for the basic and chemical industry sector for the 2017-2020 period as the research locus. The population in the study is all companies in the basic and chemical industrial sectors listed on the Indonesia Stock Exchange in 2017-2020, which total 66 companies. There were 13 companies used as samples that were selected using purposive sampling technique. In this study, quantitative data types in the form of numbers are used, which were obtained from company annual financial statements and reports to explore data and information. In addition, this study also uses secondary data. Secondary data serve another source data and they collected obtained from the Indonesia Stock Exchange official website. The technique used in collecting secondary data was the documentation. The data collected for this study were obtained from 13 samples of companies with an observation period of 4 years, so there were 52 data collected. There were 10 data outliers, so they were excluded to meet the classical assumption test. There were 42 data used in testing the hypothesis in this study. Multiple regression analysis was used as a technique for analyzing the research data.

IV. RESULTS AND DISCUSSION

Before the results of the regression testing were interpreted, the classical assumption testing had been conducted. The test results presented in Table 1 show that the Asymp value. Sig. is 0.999, which is greater than 0.05. It means that the research data are normally distributed.

Table 1
Normality Test Results

		Unstandardized Residual
N		42
Normal Parameters (a,b)	Mean	0,0000000
	Std. Deviation	0,05092267
Most Extreme Differences	Absolute	0,057
	Positive	0,057
	Negative	-0,047
Kolmogorov-Smirnov Z		0,371
Asymp. Sig. (2-tailed)		0,999

Source: Data Processed, 2022

The results of the multicollinearity test presented in Table 2 show that the variables X1, X2, and X3 produce a VIF value below the value 10 and a tolerance value above 0.1, so there is no problem with multicollinearity.

Table 2
Multicollinearity Test Results

		Collinearity Statistics	
Model		Tolerance	VIF
1	(Constant)		
	X1	0,967	1,034
	X2	0,930	1,076
	X3	0,905	1,105

Source: Data Processed, 2022

The results of the heteroscedasticity test presented in Table 3 show that the significance of all independent variables is above 0.05, so it implies that there are no symptoms of heteroscedasticity.

Table 3
Heteroscedasticity Test Results

Model		t	Sig.
1	(Constant)	3,136	0,003
	X1	1,744	0,089
	X2	1,271	0,211
	X3	-0,464	0,645

Source: Data Processed, 2022

The results of the autocorrelation test presented in Table 4 show that Durbin Watson (DW) has a value of 2.221, which is above the dU value of 1.6617, and below the 4-dU with the value of 2.3383, so in the regression model there is no autocorrelation problem because DW has a value between the dU value and the 4-dU value (dU < DW < 4-dU).

Table 4
Autocorrelation Test Results

Model	R	R Square	Adjusted R	Std. Error of	Durbin-
1	0,659[a]	0,435	0,390	0,05289	2,221

Source: Data Processed, 2022

Based on Table 5, the value of Sig. on the F-test results is 0.000, which is below 0.05. This condition implies that the independent (free) variable can be used to predict the dependent (bound) variable and the model in this study is feasible to use.

Table 5
F-Test Results (Model Feasibility Test)

Model		Sum of Squares	df	Mean Square	F	Sig.
1	Regression	0,082	3	0,027	9,748	0,000[a]
	Residual	0,106	38	0,003		
	Total	0,188	41			

Source: Data Processed, 2022

Based on the results of the analysis presented in Table 6, the regression equation is:

Y= 0,273 – 0,075X1 + 0,593X2 + 0,006X3

Table 6
Multiple Linear Regression Test Results

Model		Unstandardized Coefficients	
		B	Std. Error
1	(Constant)	0,273	0,020
	X1	-0,075	0,029
	X2	0,593	0,126
	X3	0,006	0,028

Source: Data Processed, 2022

The results of the t-test presented in Table 7 show that the X1 variable has a regression coefficient with a negative value and a significance with a value below 0.05, which implies that transfer pricing has a negative effect on ETR. Variable X2 has a regression coefficient with a positive value and a significance with a value below 0.05, which means that tax havens have a positive effect on ETR. Variable X3 has a positive regression coefficient and a significance with a value above 0.05, which means that thin capitalization has no effect on ETR.

Table 7
t-test results

Model		Unstandardized Coefficients		t	Sig.
		B	Std. Error		
1	(Constant)	0,273	0,020	13,886	0,000
	X1	-0,075	0,029	-2,546	0,015
	X2	0,593	0,126	4,722	0,000
	X3	0,006	0,028	0,206	0,838

Source: Data Processed, 2022

Based on Table 8, the adjusted R^2 value is 0.390 or 39%. This shows that the independent variables (transfer pricing, tax haven, and thin capitalization) can explain the dependent variable (tax avoidance) by 39%, and the remaining 61% is influenced by other variables that are not examined.

Table 8
Coefficient of Determination Test Results

Model	R	R Square	Adjusted R Square	Std. Error of the Estimate	Durbin-Watson
1	0,659[a]	0,435	0,390	0,05289	2,221

Source: Data Processed, 2022

The results of the data analysis indicate that the transfer pricing variable has a negative effect on ETR as a proxy for tax avoidance, so the first hypothesis in this study is accepted. The results of the study indicate that transfer pricing can be used by companies to minimize the payment of the company's tax burden by exploiting weaknesses in tax rules. Transfer pricing practices are generally implemented through the sale of goods or services at a lower than market price between companies that have a special relationship and transfer profits to companies, which are domiciled in a country that has a lower tax rate, so the tax burden that must be paid by the company is lower.

The results of the study show that the tax haven variable has a positive effect on ETR as a proxy for tax avoidance, so the second hypothesis in this study is rejected. Damayanti & Prastiwi (2017) claimed that such a situation could be caused by several factors. First, based on the data, only 11 companies have subsidiaries in countries classified as tax havens and 8 companies with subsidiaries in Singapore. Most of the subsidiaries are located in Singapore so the numbers are unrepresentative (Michael and Lianto, 2020). Second, at the G-20 meeting, which was held on April 2, 2009, member countries agreed to issue a blacklist category, and other members were obliged to implement international tax treaty standards. Most of the tax haven countries, including Singapore, have become a white list category. Third, the OECD implemented strict sanctions which then caused many tax haven countries to amend their tax rules and regulations. In addition, this condition can also occur because multinational companies prefer not to do tax evasion to get benefits related to market share so companies choose to open branches in countries which they find to be large market shares.

The results of data analysis indicate that the thin capitalization variable has no effect on ETR as a proxy for tax avoidance, so the third hypothesis in this study is rejected. This can be caused by the issuance of the Indonesian Ministry of Finance Regulation No. 169/ PMK.010/2015 regarding the ratio of debt to capital in a company which is determined with a maximum size of four to one (4:1) (Michael and Lianto, 2020). The regulation prescribes restrictions on the use of interest expense to reduce taxable income so it can reduce the gap for companies (Roza et al., 2020). Komariah (2017) also argues that the condition can occur because the company does not take advantage of interest expense for tax avoidance, but the debt is used for other purposes, like company expansion and operations.

V. CONCLUSIONS

The results of this study indicate that the practice of transfer pricing has a negative effect on ETR as a tax avoidance proxy, tax haven has a positive effect on ETR as a tax avoidance proxy, and thin capitalization has no effect on ETR as a tax avoidance proxy. Next researchers are expected to be able to update and increase the range of research periods, research in sectors other than basic and chemical industries, add other variables that can affect tax avoidance and use other proxies in measuring corporate tax avoidance. For companies, it is expected to be able to observe every decision making in compliance with applicable tax rules and conduct more intensive supervision in order to minimize tax avoidance behavior within the company. For the government, it is expected to conduct a review of the applicable tax rules and regulations to anticipate tax avoidance practices. For investors, the results of this study are expected to add insight in analyzing financial statements for decision making.

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