THE EFFECT OF TRANSFER PRICING, THIN CAPITALIZATION AND FOREIGN OWNERSHIP ON TAX AVOIDANCE

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Abstract: This study aims to examine the effect of transfer pricing, thin capitalization and foreign ownership on tax avoidance. Scheme of tax avoidance in a form of transfer pricing is used through the transfer of profits from countries with higher corporate income tax rate to countries with lower corporate income tax rate. Another scheme is company's financing policy with a larger portion of debt than equity (Thin Capitalization). The last scheme in this study is foreign ownership with a relatively large portion. The objects of study are multinational manufacturing companies listed on the Indonesia Stock Exchange in 2017-2020. The procedure of sampling used is purposive sampling. The method of analysis applied is multiple regression analysis. The results of analysis prove that thin capitalization has an effect on tax avoidance.

Keywords: transfer pricing, thin capitalization, foreign ownership, tax avoidance.

1. Introduction

Every year in the State Budget (APBN), the largest state revenue comes from taxes. Taxes have a strategic role in performing development to realize public welfare. The tax revenue target set by the government is not fully achieved. Missed tax revenue target has implications for development. One of the causes is tax avoidance, it is a tax avoidance effort carried out legally by taxpayers that does not conflict with applicable tax provisions to reduce the tax payment. Pohan (2016) tax avoidance is an effort to avoid taxes that is carried out legally and safely for taxpayers because it does not conflict with tax regulations, because the methods and techniques used tend to take advantage of the weaknesses (gray areas) contained in the tax regulations themselves. to reduce the amount of tax paid. The tax avoidance carried out does not conflict with tax laws and regulations because it takes advantage of loopholes in tax laws which will affect state revenues from the tax sector (Yenni Mangoting, 2000).

Economic globalization results in many multinational enterprises (MNEs) having subsidiaries in various countries. From Corporate Tax Statistic, second edition by OECD (2020), Indonesia has an unbalanced contribution structure of MNE, domestic MNE affiliation is 15% and foreign MNE affiliation is 42%. The amount of foreign MNE investment indicates that Indonesia is very dependent on foreign investment, especially in case of tax revenue.

From several previous studies, the factors that affect tax avoidance in multinational companies are transfer pricing, thin capitalization and foreign ownership. The development of global business across countries makes each country has its own tax rules in accordance with the Tax Law of each country, especially income tax, so that the transfer pricing is also used as one of the tax avoidance media. In multinational companies, transfer pricing can affect the overall income tax (Hansen & Mowen, 2007: 441).

Transfer pricing is used by companies to maximize profits globally and minimize taxes (Amidu et al., 2019). This causes the total tax obligation borne by the company to be lower. This is done in order to reduce the total tax burden of the multinational company group (Darussalam, Danny Septriadi and Bawono Kristiaji, 2013). The studies conducted by Amidu et al. (2019), Turwanto (2022), Khomsatun & Martani, (2015), indicates that transfer pricing has effect on tax avoidance. However, the results of other studies indicate that transfer pricing does not have effect on tax avoidance, such as the studies conducted by Falbo & Firmansyah (2019), Napitupulu et al.

(2020).

Tax avoidance which is done through thin capitalization uses debt instruments to finance the company, so that debt is relatively large than equity which has an impact on the cost of capital or in a narrow sense the interest expense on loan increases so the profits become lower, the lower profits the lower corporate income tax. By many affiliates and subsidiaries spread across various countries, there is an opportunity to do tax avoidance (Waluyo & Doktoralina, 2018). The results of studies by Turwanto (2022), Falbo & Firmansyah (2019), Khomsatun & Martani (2015), state that thin capitalization affects tax avoidance. In contrast, the results of study by Olivia (2019) state that thin capitalization has no effect on tax avoidance.

Significant share ownership has effect on decision making related to business policy and tax policy. According to Salihu et al., (2015), the presence of foreign shareholders in a company will have an impact on tax avoidance behavior. Therefore, foreign owners can use their international scale to avoid taxes. The results of study by Maisaroh & Setiawan (2021) state that foreign ownership has effect on tax avoidance. Meanwhile, the results of study by Idzni & Purwanto (2017) state that foreign ownership has no effect on tax avoidance. This study aims to examine the effect of transfer pricing, thin capitalization and foreign ownership on tax avoidance.

2. Review of Related Literature

2.1 Review of Theories

Theory of agency according to Jensen & Meckling (1976) is a contract in which one or more people (principal) appoint one person (agent) to perform services for the interests of the principal in case of ownership separation and company control. The existence of asymmetric information to principal and self-assessment system can provide an opportunity for the agent to make the taxable income as small as possible.

Watts & Zimmerman (1986) by theory of positive accounting, explains the behavior of company management in preparing financial statements, namely using understanding, ability and accounting competences in accordance with accounting policies to deal with certain conditions in the future, in other words, how the theory of positive accounting gives company management the freedom to choose various alternatives from several accounting policies in order to minimize costs and reduce income tax payable by a company. To reduce the level of profit for the current period, the company management tries to allocate profit for the next period.

Theory of cost and benefit proposed by Dreze & Stern (1987) compares the costs and benefits obtained. Policies will be made by considering benefits and costs arising from an action taken. Therefore, if tax avoidance actions provide benefits which are higher than costs incurred, the company will tend to perform tax avoidance.

2.2 Frame of Thoughts and Hypotheses

Desai et al (2006) state that transactions in companies having special relationships raise the possibility of greater tax avoidance. Transfer pricing practices are often used by multinational companies to minimize the payable amount of tax. Transfer pricing practices can be done by increasing purchase price or reducing selling price between companies in a group and transferring profits earned to the group domiciled in a country that applies a low tax rate. This can result in the smaller total tax paid by the company.

Tax avoidance efforts can also be performed through intra-group debts and receivables, provision of management services, payment of royalty services, and cash dividends made by companies by not fulfilling the arm's length principle (Taylor & Richardson, 2013). These transactions identify the existence of transfer pricing.

Companies which conduct transfer pricing have a higher level of tax avoidance compared to companies that do not conduct transfer pricing. Companies performing transfer pricing aggressively have the ability to shift profits in order to avoid taxes in countries with higher tax rates to countries with lower tax rates (Turwanto, 2022). The studies conducted by Amidu et al. (2019), Turwanto (2022), Hadianto (2021), Khomsatun & Martani (2015), Ghasani et al. (2021), Yohana et al. (2022) state that transfer pricing has effect on tax avoidance.

H1. Transfer Pricing has effect on tax avoidance.

Company financing can be performed either by debt (debt financing) or by equity (equity financing). Generally, financing in multinational companies comes from group companies (intercompany financing). By thin capitalization with debt for company financing, debt is relatively higher than equity, this has an impact on the cost of capital or in a narrow sense the interest expense on loan increases so the profits become lower, the lower profits the lower corporate income tax.

Multinational companies tend to provide loans to their subsidiaries or branches because of the smaller tax payment. In addition, it is easier to make loans with subsidiaries or branch companies (Suryantari & Mimba, 2022). By the existence of this convenience in multinational companies, their funding uses more debt than equity. Companies performing tax avoidance in the long term have a high level of leverage (Dyreng et al., 2008). The studies conducted by Turwanto (2022), Falbo & Firmansyah (2019), Khomsatun & Martani (2015), Prastiwi & Ratnasari (2019) state that thin capitalization has effect on tax avoidance.

H2. Thin Capitalization has effect on Tax Avoidance.

Significant foreign ownership of corporations in Indonesia not only has an impact on business policies, but also on taxation aspects. The greater the portion of shares owned by foreign parties in a company, the greater the voting rights of investors to participate fairly in deciding company policies. With foreign ownership of 25% and above, it is considered to have a special relationship regulated in Article 18 clause (4) of the Income Tax Law. If the ownership is above 50%, the foreign shareholders can fully control the company's policies, including its tax management.

In accordance with the theory of cost and benefit, owners of companies will consider the benefits and costs arising from an action. If the tax avoidance carried out can result in greater benefits than the costs incurred, the company will tend to perform tax avoidance. Foreign owners strongly consider the costs arising from tax avoidance practices such as legal risks, company reputation and tax consulting fees. The study conducted by Maisaroh & Setiawan (2021) states that foreign ownership affects tax avoidance.

H3. Foreign ownership has effect on tax avoidance.

3. Method

3.1 Population and Sample

The population in this study is manufacturing companies listed on the Indonesia Stock Exchange for the period of 2017-2020. Method of sampling is purposive sampling with criteria: 1) Manufacturing companies listed on the Indonesia Stock Exchange for the period of 2017-2020 (excluding those that did not have complete financial statements during the study, moved sectors and delisted), 2) Samples have complete data to be analyzed (namely multinational companies, companies that do not experience losses and those that are related). By those criteria, 64 samples have been obtained for analysis.

3.2 Variables

In this study, the independent variables are transfer pricing, thin capitalization and foreign ownership, while the dependent variable is Tax Avoidance. Tax avoidance (TA) in this study is proxied using BTD (Book Tax Difference) Hanlon & Heitzman (2010) measured from profit before tax - current tax and divided by total asset. The measurement used is the same as the studies conducted by Turwanto (2022), Khomsatun & Martani (2015).

Transfer pricing (TP) in this study is measured by trade receivables that have a special relationship and divided by total receivables. The measurement used is the same as Utami & Irawan (2022). Thin capitalization (TC) uses a measure of the ratio of debt to assets by adopting the measurements used by Khomsatun & Martani (2015), Turwanto (2022). Foreign ownership (KA) in this study is measured by the number of shares owned by foreign parties divided by the total outstanding shares. This measurement is used by Maisaroh & Setiawan (2021).

4. Results and Discussion

4.1 Classical Assumption Test

By using SPSS software, the classic assumption test is summarized in the table below

Table 1 Classical assumption test

Variable	Normality Test	Multicollinearity Test Tolerance	VIF	Autocorrelation Test Durbin Watson	Heterocedasticity Test
TP		0.886	1.129		0.060
TC	0.200	0.868	1.152	2.097	0.093
KA		0.977	1.024		0.436

From the results of normality test, it indicates that the significant value of 0.200 is greater than 0.05 so it can be said that the residual data is normally distributed. The VIF value is less than 10 and the tolerance value is greater than 0.1 so there is no multicolonierity between the independent variables in regression model. A sig value greater than 0.05 for all independent variables indicates no heteroscedasticity. While the durbin Watson value of 2.097 does not result in autocorrelation.

4.2 Hypotheses Test

The results of hypotheses testing are summarized in table 2

Table 2 Hypotheses Test

Variable	R-Square	F Test Sig	T Test
TP			0.172
TC	0.165	0.012	0.015
KA			0.556

Based on the table above, it is known that the coefficient of determination (Adjusted R Square) is 0.165 or 16.5%, which means that 16.5% of tax avoidance is explained by the variables such as Transfer Pricing, Thin Capitalization and Foreign Ownership, while the remaining 83.5% is explained by other factors not contained in the model. The research model with sig. 0.012 below 0.05 means that the model in this study is fit (appropriate) and can be used to predict tax avoidance variables. The results of test indicate that Transfer Pricing (TP) variable have a sig. value of 0.172 greater than 0.05, so hypothesis 1 is rejected, thin capitalization (TC) variable has a sig. value of 0.015 lower than 0.05, so hypothesis 2 is accepted, and the Foreign Ownership (KA) variable has a sig. value of 0.556 higher than 0.05, so hypothesis 3 is rejected.

Regression equation TA = 0,166 - 0,071 TP - 0,165 TC + 0,016 KA+ e

The regression equation explains the constant value of 0.166, it means that if transfer pricing, thin capitalization and foreign ownership are equal to zero, tax avoidance is 16.6%. Transfer Pricing is worth -0.071 which means that every increase in the transfer pricing variable by one unit, tax avoidance will decrease by 0.071 or 7.1%. Thin Capitalization is worth -0.165, it means that every increase in the thin capitalization variable by one unit, tax avoidance will decrease by 0.165 or 16.5%. Foreign Ownership is worth 0.016 which means that each increase in the foreign ownership variable by one unit, tax avoidance will increase by 0.016 or 1.6%.

4.3 Discussion

The results indicate that transfer pricing has no effect on tax avoidance. By the enactment of regulations related to transfer pricing such as the obligation to have transfer pricing document (TP Doc) as mentioned in Regulation of the Minister of Finance No. 213/2016, the tax avoidance by using transfer pricing is relatively ineffective. And in practice, the transactions related to transfer pricing have the potential to become positive fiscal corrections found by tax auditors. Therefore, transfer pricing is no longer effective for tax avoidance.

The results of this study are in line with the results of studies by Falbo & Firmansyah (2019), Napitupulu et al. (2020) which indicate that transfer pricing has no effect on tax avoidance, and different from the results of studies by Amidu et al., (2019), Turwanto (2022), Hadianto (2021), Khomsatun & Martani, (2015), Ghasani et al. (2021), Yohana et al., (2022).

Thin Capitalization in this study has an effect. The company's financing pattern can be through debt instruments (Debt Financing) or through equity instruments (Equity Financing). The size of the portion of debt or equity depends on the composition of company's assets and return to be obtained. If it is used for long-term investment or where the risk is relatively high, the equity portion tends to be larger, but from a tax perspective there are restrictions as stipulated in the Regulation of the Minister of Finance of the Republic of Indonesia No. 169/PMK.010/2015 concerning Determination of the Ratio between debt and capital which indirectly applied on assets. If the company averagely has a portion of debt exceeding the ratio as regulated by PMK 169, thin capitalization has no effect on tax avoidance and vice versa if the portion of debt or debt instruments is still below the ratio regulated by PMK, thin capitalization has effect on tax avoidance.

If PMK regulates the maximum debt to equity ratio (Debt Equity Ratio) of 4 to 1, in other words, the debt to asset ratio (Debt Asset Ratio) is equal to 4 to 5 or 0.80. In this study, the average debt to asset ratio (Debt Asset Ratio) or DAR average of 0.56% is still below the maximum limit, so thin capitalization has effect on tax avoidance. Financial expenses can be recognized fiscally (Deductible Expense), so that fiscal profit decreases. Therefore, the corporate income tax becomes smaller.

The results of this study are in line with the results of study by Turwanto (2022), Falbo & Firmansyah (2019), Khomsatun & Martani, (2015), Prastiwi & Ratnasari (2019) and not in line with the results of study by Olivia (2019).

Foreign ownership in this study has no effect on tax avoidance. Foreign ownership is reflected in business strategy policies. In general, it does not enter the domain of technical taxation. Foreign share ownership below 25% cannot control company policies and foreign shareholders strongly consider the company's risks both company's reputation and legal risks prevailing in the country.

The results of this study are in line with the results of study by Idzni & Purwanto (2017). Meanwhile, the results of study by Maisaroh & Setiawan (2021) are not in line with this study because foreign ownership has effect on tax avoidance.

5. Conclusions and Suggestions

1. Transfer Pricing has no effect on tax avoidance, because the obligation to have transfer pricing document (TP Doc) and transactions related to transfer pricing have the potential to be positive fiscal corrections found by tax auditors.

2. Debt Asset Ratio or DAR is still below the maximum limit, so thin capitalization has effect on tax avoidance. Companies can use thin capitalization in order to conduct tax avoidance as long as it is still below the debt and asset ratio that refers to the applicable PMK.

3. Foreign ownership is reflected in the business strategy policy. In general, it does not enter the domain of technical taxation. So that foreign ownership has no effect on tax avoidance. Foreign shareholders strongly consider the company's risk, both the company's reputation and the legal risks that apply in the country.

4. For further writers, it is recommended to add other variables such as multinationality and earning management, and use other proxies for measuring tax avoidance such as Cash Effective Tax Rate and Effective Tax Rate.

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