Factors Affecting Tax Avoidance through Thin Capitalisation: Multinational Enterprises in Indonesia

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Factors Affecting Tax Avoidance through Thin Capitalisation: Multinational Enterprises in Indonesia

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Abstract: The multiplication of direct investment in Indonesia is not equal to adequate tax regulations. In turn, it creates loopholes for the minimisation of tax burdens through thin capitalisation. The purpose of this research is to analyse the factors affecting tax avoidance using thin capitalisation. The independent variables in this research are multi-nationality, the utilisation of tax havens and institutional ownership, while the dependent variable in this research is tax avoidance. This study uses secondary data obtained from readily accessible sources and the annual reports of 122 multi-national enterprises listed on the Indonesian Stock Exchange. The determination method of sampling is by way of purposive sampling, that is sample selection according to specific criteria. The data analysis method used is path analysis. The results of the research show that multi-nationality and the utilisation of a tax haven positively affect thin capitalisation, while institutional ownership has a negative effect on thin capitalisation. Thin capitalisation has a positive impact on tax avoidance. Indirectly, multi-nationality and the utilisation of taxes have positive effects on tax avoidance through thin capitalisation, while institutional ownership negatively affects tax avoidance through thin capitalisation.

Keywords: Multinationality, Utilisation of Tax Haven, Institutional Ownership, Thin Capitalization, Tax Avoidance.

JEL Classification: F30,F38, G32,H25,H26.

1. INTRODUCTION

The tax avoidance phenomenon, as practised by the multi-national enterprise (MNE), attracts attention from countries all over the world (Uadiale, Fagbemi, & Ogunleye, 2010). The fact is that the proportion of tax to income before taxes increasingly rises; therefore, there is a decrease in distributable profit (Annuar, Salihu, & Obid, 2014).

Companies always attempt to evade taxes, even though every country has anti-tax avoidance regulations. Tax avoidance is the most challenging issue to prevent in every tax jurisdiction (Hundal, 2011). Recently, direct investments in Indonesia have increased. Data from the Investment Coordinating Board shows the realisation of finance on domestic investment and foreign investment in 2017 reached IDR 692,8 trillion (USD 47,779 billion), or growing of the target domestic investment and foreign investment. This realisation justifies optimism regarding the achievement of investment growth targets in the coming by providing clarity, certainty and speed in preparing various investment-related licenses (Nugroho & Doktoralina, 2010; Picciotto & Mayne, 2016).

Foreign investment growth in Indonesia is derived from several countries, such as Singapore, Japan, China, Hong Kong and South Korea. These companies can source capital from debt funding or other capital interest. In finding sources of capital, companies can choose their form of financing, be it debt or equity. Concerning debt funding, interest is charged on the debt. Meanwhile, for equity funding, dividends are paid as a return of the holder's investment. The difference in the tax treatment of interest and dividends is that, in general, interest expenses are deductible, while dividends are not. This benefit, in turn, leads to the preference of debt over equity financing.

The decision to utilize debt or equity in MNEs' capital structure is affected by company and country characteristics, such as investment risk, interest rate, country risk, tax law and tax regulations (Waluyo & Wirawan, 2012). This practice is a strategy to divert profits to other countries. Even companies benefit optimally from debt (Ronald, 2014). This means that it is also practiced in Indonesia to reduce companies' tax liability. The thin capitalization strategy can be executed through a direct, consecutive or parallel loan. Notable researchers who find different results have examined the topic of thin capitalization. For example, Taylor and Richardson (2013) suggest that the characteristic of multi-nationality significantly affects tax avoidance among Australian companies.

Based on research conducted earlier by Taylor and Richardson (2013), this study aims to analyse and find empirical evidence regarding the factors influencing MNEs' tax avoidance in Indonesia. The novelty of this research is the addition of institutional ownership as an independent variable (multi-nationality, tax haven utilization, institutional ownership) and thin capitalization as a mediating variable for tax avoidance.

2. THEORETICAL REVIEWS

2.1 Trade-Off Theory

The trade-off theory of capital structure means balancing the costs and benefits of the use of debt (Myers, 2001). Based on approach theory, to determine the optimal capital, several factors concerning the structure of taxation should be included, such as taxation, agency costs and financial distress, while maintaining or moved to the efficient markets assumption with asymmetric information as balance. When the debt can be optimally fulfilled, then the tax shield reaches the maximum of capital structure to reduce financial costs (Desai & Dharmapala,s 2008). Firms with high profitability will attempt to reduce their tax burden by increasing their debt-to-equity ratio; therefore, the extra debt will reduce tax liabilities. The trade-off theory predicts a positive relationship between capital structure and firm value, assuming that the tax burden is more than bankruptcy and agency costs.

2.2 Multi-Nationality

MNEs operate within several countries and nationalities simultaneously, but companies in their home country conduct decision making and supervision the companies themselves (Dunning & Lundan, 2008). An MNE consists of a transparent company in its state of origin and has (numerous) affiliates and potentials abroad. An MNE utilises debt as a part of tax planning (Dahlby, 2008; Feld, Heckemeyer, & Overesch, 2013). With its many affiliates and subsidiaries scattered throughout various countries, there are chances for the MNE to practise thin capitalisation. Based on the foregoing description, the proposed hypothesis is as follows:

H_1: Multi-nationality influences thin capitalisation.

2.3 Tax Haven Utilisation

In tax haven countries, the government gives 'tax breaks' in the form of a low or even zero tax rate (Edgar, Farrar, & Mawani, 2008; Jones, Temouri, & Cobham, 2018). The definition of a *tax haven country* varies. Therefore, the United States Government Accountability Office (2008) characterized a tax haven as the following: (a) Not imposing tax or imposing a lower charge. (b) A lack of productive exchange of information with foreign tax authorities. (c). A lack of transparency in tax law and regulation implementation. (d). The country's place as a centre of foreign finance. A company operating in a tax haven can shift its income from a jurisdiction that imposes a higher tax rate to countries with lower tax rates (Slemrod, 2004). Based on this description, a hypothesis can be formed:

H_2: The utilisation of a tax haven influences thin capitalization.

2.4 Institutional Ownership

Institutional ownership is the ownership of shares by the financial institution or other institutions that manage a company. Institutional ownership is useful in monitoring which also benefits investors. The bigger the share ownership of a financial institution, the greater the encouragement to optimize the company's value (Taylor, Richardson, & Lanis, 2015). Institutional ownership can make management's supervision more effective. Consequently, a manager will be pushed to focus more on company performance (Annuar et al., 2014; Suryanto & Wekke, 2017). Based on this description, the proposed hypothesis is as follows:

H_3: Institutional ownership increases thin capitalization.

2.5 Thin Capitalisation

According to Rohatgi (2005), *thin capitalization* can be defined as capital disguised by loans that exceed reasonable limits. Investments in the context of thin capitalization are loans in the form of money or wealth from shareholders or other parties with a special relationship with the borrower. Usually, MNEs accomplish thin capitalisation by increasing the amount of debt financing in high tax tariff countries (Mintz & Smart, 2004).

In practice, thin capitalisation is based on different treatments for interest and dividends when a parent company decides to shift its tax burden to low tax rate countries (Haufler & Runkel, 2012). The rules of thin capitalisation are expected to reduce the practice of international debt transfer and lower the debt-to-equity ratio in MNE affiliates. In turn, it will have a positive impact on state tax revenues. Otherwise, investors' supervision can force managers to focus more on companies' performance (Buettner, Overesch, Schreiber, & Wamser, 2012) and managers' acting on behalf of stakeholders (Annuar et al., 2014; Aziz, et.al. 2016; Awuah and Addaney, 2016)

). Based on the aforementioned description, the proposed hypothesis is as follows:

H_4: Thin capitalisation influences tax avoidance.

2.6 Tax Avoidance

In their daily activities, companies always communicate with other companies because management, shareholders and tax authorities have divergent interests (Waluyo, 2018). MNEs arrange their tax avoidance in various ways, for example restructuring funding policies to maximise profits (Hanlon & Heitzman, 2010). Their behaviours are likely caused by the tax rate that is considered too high if compared to other countries (Allingham & Sandmo, 1972; Gumpert, Hines Jr., & Schnitzer, 2016). The essential factor in solving the problem of thin capitalisation practices is the necessity for supervision and incentives to minimize the agency cost (Jensen & Meckling, 1976; Yazid & Suryanto, 2017). In fact, it can also be done with a combination of structured debt and equity to effect tax efficiency in the country that is the source of funds (Feld et al., 2013).

Tax avoidance can occur due to a country being a tax haven. In a tax haven country, the government provides incentives, such as low tax rates or even not collecting taxes (Slemrod & Yitzhaki, 2002). The Organization for Economic Co-operation and Development states that a *tax haven country* describes a nation becoming a shelter for non-compliant taxpayers (Desai, Foley, & Hines Jr., 2006). For that reason, an MNE may use a tax haven country to collect taxes with a high tax rate in lower tax rate countries (Hanlon & Slemrod, 2009). Otherwise, the debt policy for corporate funding could give incentives but does not cause financial distress that results in a decrease of firm value (Modigliani & Miller, 1963). Based on this description and the fact an MNE often minimizes its tax liability in tax planning, these hypotheses can be formed:

H_5: Multi-nationality influences tax avoidance through thin capitalisation.

H_6: The utilization of tax havens influences tax avoidance through thin capitalisation.

H_7: Institutional ownership influences tax avoidance through thin capitalisation.

The conceptual model of the research examines factors affecting tax avoidance through thin capitalisation in Indonesian MNEs, as in Figure 1.

3. RESEARCH METHODS

The design of this research explains the causal relationship between variables through hypothesis testing (Bryman & Bell, 2015). This study uses annual report data from 122 MNEs listed on the Indonesian Stock Exchange in the years 2015 to 2017. Therefore, there are 366 data units in total.

4. RESULTS AND DISCUSSION

Based on the above figure, the p-value, that is the impact of the multi-national variable to the thin capitalisation – where 0.005 < 0.05 and the CR value 2.821 > 1.96 – shows that the effect of a multi-national variable is positive and significant.

The first hypothesis (H_1) states that multi-nationality influences thin capitalisation. The result shows the coefficient is as much as 0.055, while the p-value is as much as 0.005 or smaller than 0.05. The direction prediction is positive.

The second hypothesis (H_2) states that the utilisation of a tax haven influences thin capitalisation. The result shows the coefficient is as much as 0.464, while the p-value is as much as 0.000 or smaller than 0.05. In addition, the direction prediction is positive.

The third hypothesis (H_3) states that institutional ownership influence thin capitalisation. The result shows the coefficient is as much as -2.848, while the p-value is as much as 0.000 or smaller than 0.05. Moreover, the direction prediction is negative.

The fourth hypothesis (H_4) states that thin capitalisation influences tax avoidance. The result shows the coefficient is as much as -0.046, while the p-value is as much as 0.000 or smaller than 0.05. Additionally, the direction prediction is negative.

The fifth hypothesis (H_5) states that multi-nationality influence tax avoidance through thin capitalisation. The result shows the coefficient is as much as -0.078, while the p-value is as much as 0.007 or smaller than 0.05. The direction prediction is negative. Therefore, H_5 cannot be rejected, meaning that multi-nationality has a positive impact.

The sixth hypothesis (H_6) states that the utilisation of a tax haven affects tax avoidance through thin capitalisation. The value of the coefficient is as much as -0.128, and the p-value is as much as 0.000 or less than the level of error (5%). Therefore, H_6 cannot be rejected, meaning the utilization of a tax haven has a positive influence.

The seventh hypothesis (H_7) states that institutional ownership affects tax avoidance through thin capitalisation. While the coefficient value is as much as 0.134, the p-value is at 0.000 or smaller than the level of error (5%). The prediction direction is positive.

5. CONCLUSIONS

Based on the results of this research and analysis of MNEs, it can be concluded that multi-nationality and the utilisation of tax havens have a positive and significant effect on thin capitalisation. This result proves that multi-national corporations are 'thinly capitalized'. However, institutional ownership negatively and indirectly affects thin capitalisation. Multi-nationality and tax haven utilisation have a positive effect on tax avoidance through thin capitalisation.

5.1. Suggestions

To appropriately address companies' tax evasion, governments must make every effort to study tax evasion practices. There is a need to improve tax evasion prevention rules according to the current circumstances. Moreover, it is necessary to increase tax employees' knowledge of international taxation to learn about the tax avoidance schemes that occur in other countries. The government is also required to improve the quality of examination results by establishing specialist examiners based on expertise. Furthermore, increased domestic and international information exchange activities should also be conducted simultaneously. Ultimately, the authors suggest that it is mandatory that firms' tax evasion should streamline the tax burden without violating any applicable provisions. There should be a confirmation that tax avoidance activities are permitted as long as these efforts are made not solely to avoid taxes and are still within the limits of good business practice.

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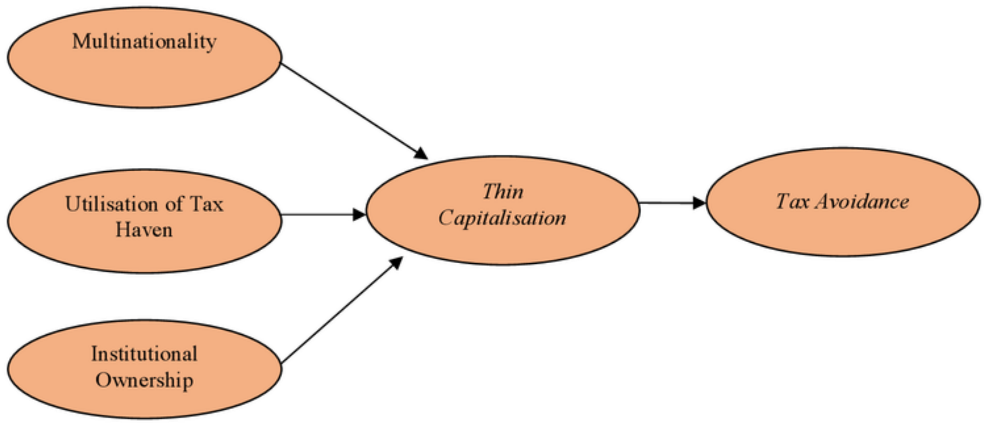

Figure 1. *Conceptual Model of the Research.*

Table 1. *Hypothesis Testing.*

No.	Exogenous Variables	Mediator Variables	Direction Prediction	Koef.	P-Value	Decision
1	Multi-nationality	.	+	0.055	0.005	Supported
2	Tax Haven	.	+	0.464	0.000	Supported
3	OwnershipInstitutional	.	-	-2.848	0.000	Supported
4	Thin Capitalisation	.	-	-0.046	0.000	Supported
5	Multinationality	Thin Capitalisation	-	-0.078	0.007	Supported
6	Tax Haven	Thin Capitalisation	-	-0.128	0.000	Supported
7	OwnershipInstitutional	Thin Capitalisation	+	0.134	0.000	Supported

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