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WHAT THE THIN CAPITALIZATION AND FIRM SIZE MEAN FOR TAX AVOIDANCE?

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Abstract: One of the tax avoidance schemes is converting equity investments into loans either directly or through intermediaries, often referred to thin capitalization. Thin capitalization is where companies make funding through a high level of debt compared to owned capital. Funding through debt (debt financing) looks more attractive to shareholders than funding through capital (equity financing). However, prior research (i.e., Kurniasih and Sari, 2013) suggests that large-scale companies such as wholesellers are more likely to utilize the resources they have, than to use resources from debt. Therefore, the main objective of this study is to determine the effect of thin capitalization on the cash effective tax rate (CETR) among large wholesellers listed in Indonesian Stock Exchange (IDX) between 2014 and 2018. Specifically, this research analyses the effect of firm size in strengthening or weakening the relation of thin capitalization to Cash Effective Tax Rate (CETR).This quantitative research utilises purposive sampling technique; with a total samples of 9 wholesellers listed on IDX in the 2014-2018 periode. Thin capitalization is measured using the MAD ratio indicator, and firm size is measured using the natural log of total assets. The results of this study indicate that partially thin capitalization has a significant positive effect on tax avoidance and firm size has a significant negative effect on tax avoidance. Simultaneously thin capitalization, and firm size have a significant effect on tax avoidance. The findings of this research are important for companies, especially for large companies like wholesellers, in tax management to ensure that the taxes paid are truly efficient.

***Keywords**: Thin Capitalization, Firm Size, and Tax Avoidance.*

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INTRODUCTION

Tax is an important source of revenue that will be used to finance state expenditure, both routine expenditure and development expenditure. On the contrary, for the company, tax is an expense that reduces net income (Suandi, 2011). PSAK 46 (Revisi 2015) about Income Tax Accounting regulates how an entity presents and discloses an entity's income tax obligation. Taxation Regulations (UU PPh/Income Tax Law) and Finacial Accounting Standards (SAK) differ in the recognition and measurement of income and expenses that can be presented in the financial statements, due to differences in objectives between accounting standards and tax laws regarding corporate income tax (PPh) recognition, and this difference can lead to deferred taxes. Minimizing the tax liability can be done in various ways, ranging from still in tax regulation framework to violate tax regulations. Several attempts were made to reduce or minimize the tax burden, such as tax planning, tax evasion, and tax avoidance. According to Mayasari (2014), one way to minimize the tax liability that does not violate is called tax avoidance. Tax Avoidance is an effort to reduce tax liability by avoiding or minimizing the taxation of various types of non-taxable transactions. According to Hendry (2014) tax avoidance is an effort to minimize the tax liability that is often used by the companies, because it is still within the tax regulation framework. Tax avoidance actions can occur due to loopholes or weaknesses in tax regulation. Although tax avoidance is legal because it exploits the tax regulation weaknesses but in this case the government as the tax authorities still dislike tax avoidance because when the companies doing tax avoidance it will cause the burden of coorperate income tax reduced which will reduced state revenue from taxes.

The phenomenon of tax avoidance occurred at PT Toyota Motor Manufacturing Indonesia in 2014. TMMIN company carries out transfer pricing and restructuring with Toyota Japan or with the trademark Toyota Astra Motor (TAM). As a result of these activities Toyota's combined profits were reduced so the tax liability they pay to the government decreases dramatically.

In this study, tax avoidance is measured using cash effective tax rate (CETR) which is the ratio of tax payments in cash to company profits. Cash tax payments can be found on the income tax post in cash flow for operational activities, while the profit before income tax is found in the income statement. Based on Law Number 36 of 2008 clause 17 Section (1), the tax rate charged to the company is 25%. The higher percentage of CETR, which is close to the corporate income tax rate of 25%, indicates that the company tax avoidance level is getting lower. The lower percentage of CETR indicates that the higher the tax avoidance.

Large trading sub-sector companies are also called distributors. This sector contributed Rp 114.37 trillion in the first semester of 2019. Growth was only 2.5 percent, smaller than the first semester of 2018 which grew 27.6 percent (Yoga Sukaman, 2019). If you look at the value of CETR owned by large trading sub-sector companies listed on the Indonesia Stock Exchange, these company is indicated avoid tax because there is a CETR value less than 25% from 2014-2018. The following is a chart of the CETR values of three companies in the large trading sub-sectors on the IDX.

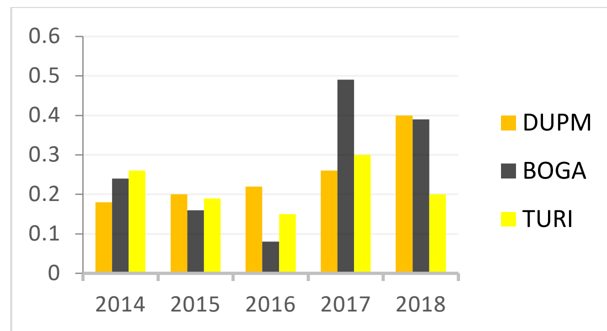

Figure 1: Cash Effective Tax Rate (CETR) Values of Companies in the Large Trading Sub-sectors on the Indonesia Stock Exchange (IDX)
(Sourced by Indonesian stock exchange 2019)

Aside from profits, tax revenues are also generated from expenses, one of them is interest expense. Companies will see loopholes in tax avoidance practices, one is through thin capitalization. According to Taylor and Richardson (2012) thin capitalization is the formation of a company's capital structure in which a combination of debt as much as possible and as minimum capital as possible. The practice of thin capitalization based on the differences in the tax treatment of interest on debt and dividends derived from the issuance of shares (Nurani, 2014)

Thin capitalization itself is often intended in situations where companies make funding through a high level of debt compared to owned capital or often called "highly leveraged". Tax regulations in several countries including Indonesia specifically allow the reduction of loan costs for debt in calculating the amount of taxable income. Therefore, at a fairly large level funding through debt (debt financing) looks more attractive to shareholders than funding through capital (equity financing).

In Indonesia some rules limit the ways to implement thin capitalization, that is the is regulation of capital structure which regulated in Ministry of Finance Regulation No.169/PMK.010/2015 concerning Determination of Comparison Between Debt and Own Capital for the Purpose of Income Tax Calculation. The rule states that the ratio between debt and capital is set at a maximum of four to one (4:1) or in other words the contribution of debt to the maximum capital structure is 80%. Thin capitalization is measured by the interest debt limit using the maximum allowable debt (MAD) is a ratio of debt (interest) to a safe harbor debt amount which is a calculation of the average total assets, debt (without interest) and debt limit by following under the regulation from the Minister of Finance. The more the MAD ratio approaches or exceeds 1, indicates the higher the thin capitalization is. Then there is a tendency in doing tax avoidance by emphasizing a company's tax liability and raises tax intensive.

The greater total assets indicate the size of the company’s ability to generate large profits so that the company's tax liability will be high. Companies can see loopholes in the practice of minimizing their tax liability by looking at the size of the company. Hormati (2009) defines firm size as a scale or value that can classify a company into large or small categories based on total assets, log size, and so on.

It allows companies to take advantage of existing loopholes to carry out tax avoidance actions from each transaction. In addition, companies operating across countries tend to take

tax avoidance actions higher than those operating across the country because they can transfer profits to companies in other countries, where these countries charge lower tax rates than other countries.

Khomsatun & Martani (2015) examines whether the limitation of interest bearing-debt on Indonesian sharia stock index companies (ISSI) can reduce the positive effects of thin capitalization and asset mix on tax avoidance. Although the hypothesis is accepted that the thin capitalization restrictions could reduce the positive effect of the thin capitalization on tax avoidance, the results indicate the significance of thin capitalization even at the 10 percent level. While Ismi & Linda (2016) studies found in a more narrow scope of study with strict restrictions, thin capitalization did not affect tax avoidance.

Putri (2017) research result showed that firm size variables measured by SIZE is positively and significantly affected on tax avoidance. These descriptions indicate that there is a significant effect between firm size on tax avoidance which triggers to take loophole in reducing the tax liability that must be paid to the firm size. Tommy and Maria (2013) state that firm size represents the stability and ability of the company to carry out its economic activities. The larger the size of a company, the more it becomes the center of attention of the government and will lead to a tendency for company managers to be compliant aggressive in taxation.

Based on the explanation above, the researcher wants to know whether the high debt value can affect the company in terms of minimizing the tax liability and if it viewed from the size of total assets it can be seen easily and accurately the company avoids tax or not.

LITERATURE REVIEW

The Tax has a very important role in the development of a country, especially to fill the state treasury. Based on the Law it is intended that Tax is a transfer of wealth from the community to the government, to finance state expenditure by not getting direct contra. In essence, tax definition varies depending on which perspective we look at this tax issue, but the purpose of the tax remains the same.

The definition of tax according to Law Number 16 of 2009 concerning the fourth amendment to Law Number 6 of 1983 concerning General Provisions and Tax Procedures in Article 1 paragraph 1 reads taxes are mandatory contributions to the state owned by individuals or entities that are coercive under the law, with no direct compensation and used for the state purposes and the greatest prosperity of the people.

Tax planning is the first step in carrying out tax management. At this stage, the taxation regulations are collected and researched so that the type of austerity measures will be selected. According to Chairil (2014) tax planning is " an effort that includes tax planning so that the taxes paid by companies are truly efficient". In line with the definition, according to Arles (2011), tax planning, is "[a] capacity that is owned by the taxpayer to arrange financial activities in order to get a minimum tax expenditure"

Tax Avoidance

Tax avoidance is an effort to streamline the tax liability by avoiding taxation by directing it to non-taxable transactions (Chairil, 2016). According to Suandy (2008) minimizing the tax

liability can be done in various ways, ranging from those still within the framework of tax regulations to those that violate tax regulations. The effort to minimize it is often referred as tax planning.

Suandy (2008) explains that tax avoidance can occur in the sound of the provisions or written in the law and be within the soul of the law or it can also occur in the sound of the law but contrary to the soul of the law

Tax savings can be done legally with a tax management strategy, in tax management it can be done in various ways both within the framework of taxation regulations, as well as those that violate taxation regulations, the two methods are commonly known as tax avoidance and tax evasion.

Rohatgi (2005) states that in many countries tax avoidance is divided into acceptable tax avoidance and unacceptable tax avoidance. From this it follows that tax avoidance can be said to be illegal if it is done solely for the purpose of tax avoidance and is not carried out with a good business purpose (bona fide business purpose).

According to Handayani (2015), the tax avoidance variable is calculated through the company's CETR (Cash Effective Tax Rate) i.e. cash spent on tax costs divided by profit before tax. The formula for calculating CETR according to D Rinaldi (2015) is as follows:

$$\text{CETR} = \frac{Cash\ Tax\ Paid}{Pretax\ Income}$$

Information:

Cash tax paid is the amount of tax cash paid by companies based on the company's cash flow financial statements. The greater the CETR indicates the lower the level of corporate tax avoidance (Budiman dan Setiyono, 2012).

Thin Capitalization

One of the tax avoidance schemes by using existing loopholes of tax provisions is by converting equity investments to related parties into loans either directly or through intermediaries or often referred to as thin capitalization.

Thin capitalization itself refers to a situation where a company has a much larger amount of debt when compared to the amount of capital or often called 'highly (Organisation for Economic Co-operation Development/OECD, 2012). For this reason, thin capitalization is made to prevent this from happening. Thin capitalization is used to detect hidden capital through excessive loans (Roy Rohatgi, 2002).

The Income Tax Law in Indonesia already regulates thin capitalization, which is in clause 18 paragraph (1). The clause stipulates that the Minister of Finance has the authority to issue a decision regarding the range of the ratio between the company's debt and capital for to calculate taxes based on the Income Tax Law. For its implementation, a Minister of Finance Regulation No. 169 / PMK.010 / 2015 was issued.

When a multinational company will make cross-border investments, either by establishing a new subsidiary or acquiring an existing company, the multinational company must decide whether they will finance the investment using debt funding or by using capital funding or a mixture of both. From the taxation point of view, payment of debt with a certain

interest (interest bearing debt) is different from capital because of its nature that forms dividends.

However, it is quite clear that funding options, both using debt and capital, have implications both for corporate tax and for total group tax. Therefore, it is very important to clearly distinguish the two funding methods before discussing how the arms-length principle is applied to intragroup loans in thin capitalization situations (Eriksson & Richter, 2006).

One of the formula for calculating thin capitalization can use the Maximum Allowable Debt (MAD) formula because MAD calculation of this ratio uses non-IBL (Interest Bearing Liabilities) by checking the notes to the financial statements.

$$\text{MAD} = \frac{Interest\ Bearing\ Liabilities\ (IBL)}{(Average\ Total\ Asset - Non\ IBL)80\%}$$

The greater the level of large debt reaches 80% or close to number 1, implies a large interest expense. However, interest expense is an element of profit reduction. So companies can minimize the tax liability by thin capitalization.

Firm Size

In general, size can be interpreted as a comparison big or small size of an object. If this definition is associated with a company or organization, then the size of the company can be interpreted as a comparison of the size of the business of a company or organization (Sholichah, 2015). According to Sari (2014) firm sizes are generally divided into 3 categories, large firm, medium firm, and small firm.

According to Kurniasih and Sari (2013) in general, large-scale companies are more likely to utilize the resources they have than to use resources from debt. Logically, large companies are under the government spotlight because they are well-known companies. Large companies tend to be obedient in carrying out their tax obligations. On the other hand, small companies that are rarely have the government's attention tend to be disobedient in carrying out their tax obligations. Therefore, the larger the size of the company, they will consider the risks that arise when they do tax avoidance.

The calculation of firm size according to Abiodun (2013) and Niresh (2014) is measured using two formulas:

$$Firm\ Size\ Ln = Total\ Asset$$

The greater the assets owned by a company, the company can make investments both for current assets and fixed assets and also meet product demand. This will further expand the market share that will be achieved then it will affect the company's profitability.

DATA AND RESEARCH TECHNIQUE ANALISYS

In this study, the type of research used is verification research with an explanatory survey method (a method that aims to test hypotheses, which generally are studies that explain

the phenomenon in the form of relationships between variables). This study aims to examine and provide empirical evidence about the effect between independent variables that is the thin capitalization and firm size on the dependent variable i.e. tax avoidance in large wholesale sub-sector companies listed in Indonesian Stock Exchange (IDX) in 2014-2018.

Objects, Analysis Units, and Research Locations

The object in this study is thin capitalization and firm size as an independent variable namely tax avoidance as the dependent variable. Unit analysis in this study is an organization, which is a source of data whose unit of analysis is the response of the organizational division / large wholesale sub-sector companies listed in Indonesian Stock Exchange (IDX). The unit of analysis is the financial statements. The location in this study is a wholesale sub-sector company listed in Indonesian Stock Exchange (IDX) accessed from www.idx.co.id and the official website of each company.

Types and Sources of Research Data

The type of data that studied is quantitative data, that is data regarding number, level, comparison, volume in the form of figures seen from the company's annual financial statements. The Sources of data in this study are secondary data. Secondary data is research data obtained indirectly by researchers. The author collects data and information through the Indonesia Stock Exchange (IDX), www.idx.co.id, accounting journals, and the company's official website.

Table 1
Variables Operationalization

Variables	Indicators	Size	Scale
Thin Capitalization Maximum Allowable Debt (MAD) (X1)	• Interest bearing liabilities (IBL) • Non Interest Bearing Liabilities (Non-IBL) • Total Asset	$\text{MAD} = \dfrac{Interest\ Bearing\ Liabilities\ (IBL)}{(Average\ Total\ Asset - Non\ IBL)80\%}$	Ratio
Ukuran Perusahaan *Firm Size* Ln = *Total Asset* (X2)	Total assets	$\text{Ln} = \text{Total Aset}$	Ratio

Variables	Indicators	Size	Scale
Tax Avoidance Cash Effective Tax Rate (CETR) (Y)	• Cash tax paid • Pretax Income	CETR = $\frac{Cash\ Tax\ Paid}{Pretax\ Income}$	Ratio

Source : Data Processed with Eviews 10 Application.

Sampling Method

The population in this study is large wholesale sub-sector companies listed in Indonesian Stock Exchange (IDX) in 2014-2018. The sample is part of the population whose characteristics are to be investigated and considered to be representative of the entire population (the number is less than the total population). The process of selecting samples in this research is using the purposive sampling method. The purposive sampling method is the determination of the sample based on criteria that have been formulated in advance by the researcher.

Normality Testing

This test measures differences in skewness and kurtosis of data and compared with when the data is normal. In the Jarque-bera number above is 0.05 (> 5%), then the data is normally distributed.

Hypothesis test

1. Coefficient of Determination (R^2)
   Analysis of the coefficient of determination (R2) is used to measure how far the model's ability to explain the variation of the dependent variable. A small R2 value means that the ability of the independent variables to explain the variation of the dependent variable is very limited.

2. Partial Test (T Test)
   The t statistic test basically shows how far the influence of one explanatory/independent variable individually in explaining the variation of the dependent variable. If the results of calculation value significant <α 5% states that an independent variable individually affects the dependent variable.

3. Simultaneous Test (Test F)
   The F test shows whether all independent are included in the model have a joint effect on the dependent variable or the dependent variable (Ghozali, 2013). The F test is used to test whether the multiple linear regression model used is good or not.

RESULT AND DISCUSSION

Normality Test

This chart represents the value of Prob. JB count is 0.433420 > 0.05 so it can be concluded that the residuals are normally distributed which means the classic assumptions about normality have been fulfilled.

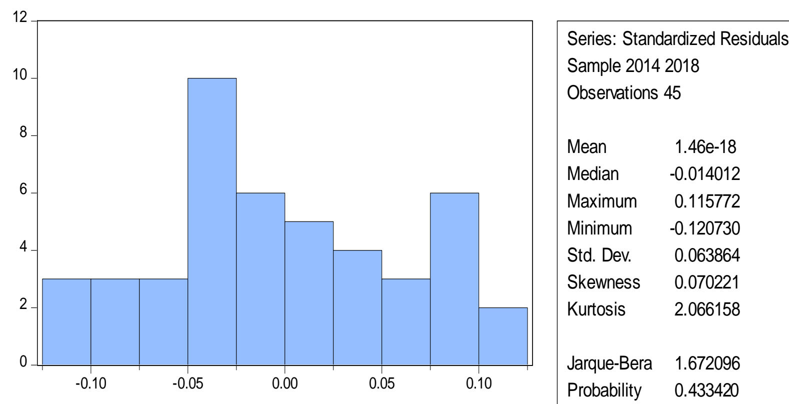

Figure 2: Results of the Normality Test

Source : Data Processed with Eviews 10 Application

Coefficient of Determination (R2)

Table 2
Coefficient of Determination (R2)

R-Square	Adjusted-R Square
0.476935	0.323093

Source : Data Processed with Eviews 10 Application

The table indicate the value from the coefficient of determination of r square is 0.476935, but this study uses more than 1 independent variable, so the adjusted r square value is used to measure the proportion of the effect between independent variables on dependent variable. The adjusted r square value is 0.323093, So this shows is that variable influence proportions are *thin capitalization,* and
regression model variables.

Partial Test (t test)

Table 3
Statistical Test t

Variable	Coefficient	Std. Error	t-Statistic	Prob.
C	0.650807	0.442134	1.471969	0.1502
MAD	-0.225491	0.051102	-4.412559	0.0001
SIZE	-0.019340	0.029726	-0.650619	0.5197

Source : Data Processed with Eviews 10 Application

Prob value of thin capitalization variable <critical probability value (α = 5%) is 0.0001 <0.05, so that the variable thin capitalization affects tax avoidance. The conclusion of this study is accepting H1.

Prob firm size variable value > critical probability value (α = 5%) is 0.5197> 0.05, so the firm size variable does not affect tax avoidance. The conclusions of the study reject H_2

a. Simultaneous Test (F Test)

Table 4
Statistical F Test Results

R-squared	0.476935	Mean dependent var	0.349491
Adjusted R-squared	0.323093	S.D. dependent var	0.238770
S.E. of regression	0.072651	Sum squared resid	0.179459
F-statistic	3.100150	Durbin-Watson stat	2.286920
Prob(F-statistic)	0.006564		

Source : Data Processed with Eviews 10 Application

Based on the table, f-statistic probability value is smaller than alpha (0.05) which is 0.006564 <0.05, which means that thin capitalization and the firm size simultaneously affect the tax avoidance. The conclusion of this research is accepting H3, thin capitalization and firm size, affecting tax avoidance in wholesale sub-sector companies listed in Indonesian Stock Exchange (IDX).

Interpretation of Research Results

The author tests the hypotheses from statistics on 10 wholesale sub-sector companies listed in Indonesian Stock Exchange (IDX) on 2014-2018 by using E-Views software version 10 about the effect of thin capitalization and firm size on tax avoidance. The author interprets the results of his research which are strengthened by existing theories and the results of previous studies as follows:

i. **Effect of Thin Capitalization (X1) on Tax Avoidance (Y) on wholesale sub-sector companies listed in Indonesian Stock Exchange.**

In the results of the t test, partially thin capitalization affects tax avoidance, Hypothesis 1 is accepted. But the average value of MAD owned by the company is still below 80% in accordance with the Minister of Finance Regulation (PMK) Number 169 / PMK.010 / 2015 which regulates the value of debt that is allowed in the company. So with an increase or decrease in the value of MAD in large trading sub-sector companies followed by an average value of CETR above 25%, it means the company does not utilize thin capitalization in minimizing the tax liability.

Table 5
SIZE The calculation result of wholesale sub-sector companies in 2014-2018

	Average				
	2014	**2015**	**2016**	**2017**	**2018**
MAD	0,45	0,48	0,46	0,45	0,50
CETR	0,45	0,52	0,40	0,31	0,24

Source: Developed for this Research.

Based on table 4.16 it can be stated that any increase or decrease that occurs in thin capitalization, there are indications that companies use debt as an element of profit reduction because there are interest costs incurred due to high debt levels. The average value of thin capitalization as measured by the Maximum Allowable Debt (MAD) is close to 1 but the average value of the Cash Effective Tax Rate (CETR) is still above 25 percent in accordance with article 17 paragraph (1) section B UU No.26 of 2008, although in 2018 it has decreased below 25 percent and the results of the t test have an effect but the company does not use thin capitalization to minimize tax liability.

The results of this study are consistent with research conducted by Rizqi A.A Vidamaya (2016) which states that thin capitalization affects tax avoidance and research from Agung setiawan (2018) which states that thin capitalization affects tax avoidance. But the results of this study contradict with Susi Dwimulyani (2019) who states that thin capitalization does not affect tax avoidance.

ii. Effect of Firm Size (X2) on Tax Avoidance (Y) on wholesale sub-sector companies listed in Indonesian Stock Exchange.

The results of t tests, partially the size of the company has no effect on tax avoidance so hypothesis 2 is rejected. In this study the size of the company has no effect on tax avoidance on wholesale sub-sector companies, it can be interpreted that an increase in the total value of the assets of a wholesale sub-sector companies does not become a benchmark for the company in carrying out tax avoidance activities as seen from the average value of CETR owned by the company which is still above 25% by following under the clause of regulation 17 paragraph (1) section (b) Law No.36 of 2008 concerning PPh rates charged to companies.

Table 6
Average Firm Size and Tax Avoidance

	average				
	2014	**2015**	**2016**	**2017**	**2018**
SIZE	15,27	15,38	15,45	15,59	15,78
CETR	0,45	0,52	0,40	0,31	0,24

Source: Developed for this Research.

Comparison in Table 4.17 can be concluded that any increase or decrease that occurs in firm size cannot affect the level of significance of the company in carrying out tax avoidance practices in wholesale sub-sector companies. These results indicate that the greater the total assets owned by the company, it will reduce the level of profit management in the company. In this study, the amount assets owned by the company is not utilized by management as a loophole to practice tax avoidance.

The results of this study are consistent with M Khoiru Rusydi (2013) which states that company size does not have a significant negative effect on tax avoidance. As well as Afifah S.S Vany (2017) which states that firm size has no significant effect on tax avoidance. But the results of this study contradict with Muhammad Ridho (2016) which states that company size has an effect on tax avoidance.

iii. **Effect of Thin Capitalization variable and Firm Size simultaneous on the Tax Avoidance variable**

On the F test results the thin capitalization (X1) and company size (X2) variables simultaneously affect the tax avoidance. The conclusion of this research is accepting H3 namely thin capitalization and company size affecting tax avoidance in wholesale sub-sector companies listed on the Indonesia Stock Exchange (IDX) in 2014-2018. These results is suitable with hypothesis 3 which simultaneously Thin Capitalization and Company Size affect Tax Avoidance.

Table 7
Summary of Research Results

No	Information	Hypothesis	Result	Conclusion
1	The effect thin capitalization to tax avoidance	H_1 = thin capitalization effect to tax avoidance	Thin Capitalization effect on Tax Avoidance	Accepted
2	The effect firm size to tax avoidance	H_2 = Firm size effect to tax avoidance	Firm size effect on Tax Avoidance	Rejected
	The effect t*hin capitalization*	H_3 = Thin Capitalization and	Thin Capitalization	

No	Information	Hypothesis	Result	Conclusion
3	dan firm size to t*ax avoidance*	Firm size effect together to tax avoidance	and firm size simultaneous effect on tax avoidance	Accepted

Source: Developed for this Research.

CONCLUSION

Based on the results of the study "The Effect of Thin Capitalization and Firm Size on Tax Avoidance on wholesalers which listed on the Indonesia Stock Exchange in 2014-2018", the writers conclude partially changes in Thin Capitalization (MAD) variable effect on Tax Avoidance or H1 accepted. With a high increase in debt value reaching 80% or close to 1 followed by CETR value under 25% means the company can minimize the tax liability seen from an increase in debt. However, based on the acquisition of the average value of MAD-CETR in wholesale sub-sector companies, the average value of MAD is still below 80% or less than 1 followed by the average CETR value is still above 25%. This means that companies in the wholesale sub-sector do not utilize debt or thin capitalization to minimize their tax liabilities.

Firm Size has no effect on Tax Avoidance in whole sale sub-sector companies listed on the Indonesia Stock Exchange in the 2014-2018 or H2 is rejected. The average value of the total assets owned by all companies in the wholesale sub-sector has increased but the average CETR value is still above 25%, which means the company does not take advantage of tax avoidance in terms of the size of the company.

Simultaneously changes in Thin Capitalization variable (MAD) and Company Size (SIZE) affect Tax Avoidance. In other words, tax avoidance can be caused by many biased factors, beside thin capitalization and the size of the company above there are other factors that can trigger companies to do tax avoidance or H3 is accepted.

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