

**THE ROLE OF THIN CAPITALIZATION AND FISCAL LOSS  
COMPENSATION ON TAX AVOIDANCE : CASE EVIDENCE IN  
INDONESIA MANUFACTURING COMPANIES**

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**ABSTRACT**

This study investigates the effect of thin capitalization, transfer pricing aggressiveness, political connections and fiscal loss compensation on tax avoidance. This study uses secondary data in the form of financial reports and annual reports of manufacturing companies listed on the Indonesia Stock Exchange for 2018-2021. The analysis was carried out on 30 companies selected by purposive sampling method in order to obtain 120 companies. The analysis uses SPSS 26 and removes 10 outlier data from observational data so that it passes the classical assumption test. Regression results show that thin capitalization and fiscal loss compensation have an effect on tax avoidance. Meanwhile, transfer pricing aggressiveness and political connections have no effect on tax avoidance.

**Keywords:** Thin capitalization, Transfer Pricing Aggressiveness, Political Connections, Fiscal Loss Compensation

**INTRODUCTION**

Taxes are one of the main revenues for a country (Moeljono, 2020). The importance of taxpayers paying taxes for the state is very significant, without taxes the state will lose the main source of state revenue and of course it will result in the inability to run the wheels of government in a stable manner (Djohar&Rifkan, 2019) Taxpayers in Indonesia are divided into two, namely individual taxpayers and corporate taxpayers. As a corporate taxpayer, a company is obliged to pay taxes for the company's activities carried out. However, according to the company, tax is a

cost that can reduce the company's net profit, therefore, companies minimize their tax expenditures with businesses that do not violate tax regulations and applicable laws and regulations (Moeljono, 2020). Expenditure for paying taxes is still considered burdensome, so companies carry out a tax avoidance scheme (Jumailah, 2020).

Tax avoidance or what is referred to as tax avoidance is a legal and legal way to earn profits by reducing the costs required in the company (Putri & Suryarini, 2017). Efforts in tax avoidance are one way to take action to pay a lower or less tax burden when compared to the provisions of the applicable regulations. This tax avoidance effort is carried out by looking for weaknesses in tax regulations, so that the law and regulations state that the practice does not violate regulations and is legal (Moeljono, 2020).

In Indonesia there are several cases of tax evasion. One of the cases of tax avoidance was carried out by PT Adaro Energy Tbk in 2019. PT Adaro Energi is suspected of embezzling US\$125 million in taxes to its Singapore subsidiary in the 2009-2017 fiscal year. In another case, PT Kaltim Prima Coal, PT Bumi Resources and PT Arutmin were found to have avoided taxes amounting to Rp 1.5 trillion, Rp 376 billion and US\$ 27.5 million in the 2008-2008 fiscal year 2010 (Ibrahim et al., 2021)

Thin capitalization is financing carried out by companies financed using a higher level of debt than capital. The impact resulting from the high liability of the company in paying debts means that the more interest that can be charged by the company and the more tax obligations that can be deducted by the company (Mahardika & Irawan Ferry, 2022).

Transfer pricing aggressiveness is an attempt by company management to reduce the tax burden through transfer pricing by allocating company profits to companies in other countries that have low tax rates, either without violating tax avoidance regulations or by reducing tax debt by violating regulations. The mechanism can be carried out by conducting transactions with companies that have a special relationship with a group of companies that receive tax facilities, companies that suffer losses, or are located in different tax rate areas (Mukhtar, 2020).

Political connection is a relationship that is owned between the company and its shareholders or company leaders who are members of the government either parliament, ministers, or figures from political parties. Companies that have political relations with government officials have protection so that it has an impact on reducing the transparency of financial reports (Sari & Somoprawiro, 2020).

Compensation for fiscal loss is compensation made by taxpayers who, based on their books, experience losses. Compensation will be made in the following year for five consecutive years. The balance of tax losses that can still be compensated for must be recognized as a deferred tax

asset if it is probable that future tax profits will be sufficient to compensate(Ongkopranoto et al., 2020).

Previous research has been conducted by Fasita et al. (2022)but does not use the variable fiscal loss compensation so this study will examine the effect of thin capitalization, transfer pricing aggressiveness, political connections and fiscal loss compensation on tax avoidance. The sample used is a manufacturing company listed on the IDX for 2018-2021. The choice of this company sector as a sample is due to the large number of companies in this sector that are able to provide additional tax income for Indonesia so that the government can consider this research to improve tax avoidance rules.

### **OBJECTIVE OF THE STUDY**

This study tries to examine the factors that are suspected of influencing tax avoidance including thin capitalization, transfer pricing aggressiveness, political connections and fiscal loss compensation.

### **REVIEW OF LITERATURE**

#### **Positive Accounting Theory**

Positive accounting theory uses a framework that explains accounting practices through observation and empirical approaches to address accounting practices in different situations or companies. The purpose of positive accounting is to provide explanations and provide predictions about accounting practices that exist in the real world. The political cost hypothesis under positive accounting theory is one of the critical views used in accounting. Positive accounting theory creates a political dimension in the relationship between companies and other parties with an interest in their operations, such as certain governments, unions, or communities. In the political cost hypothesis, companies assume that the transfer of wealth to the government from rules, regulations, or tax policies that impact the company is a political cost (Fasita et al., 2022).

#### **Tax Avoidance**

Tax avoidance is an arrangement to minimize or eliminate the tax burden by considering the tax consequences it generates, and not as a tax violation for business taxpayers to reduce, avoid, minimize or take the tax burden in a manner permitted by tax laws (Siregar et al., 2021).

#### **The Effect Of Thin Capitalization On Tax Avoidance**

Thin capitalization refers to investment decisions by companies in funding business operations by prioritizing debt financing rather than using equity in its capital structure (Taylor & Richardson, 2012). Thin capitalization is considered a problem in taxation when there is a difference in treatment between capital investment and debt investment. In capital investment, the return on capital in the form of dividends will be taxable, whereas through debt financing it will generate interest expenses which can be used as a deduction from taxable income (Olivia & Dwimulyani, 2019). Previous research on thin capitalization which has a positive influence and relationship with tax avoidance was conducted by Fasita et al. (2022); Jumailah (2020); Nadhifah & Arif (2020)

H<sub>1</sub> : Thin capitalization has an affect tax avoidance

### **The Effect Of Transfer Pricing Aggressiveness On Tax Avoidance**

Transfer pricing aggressiveness is one way to carry out profit shifting for tax purposes. The transfer of profits between the parent company and the entity or subsidiary company is a form of utilization of transfer pricing. Transfer pricing aggressiveness is carried out by companies to reduce their burden in paying their obligations, namely taxes (Fasita et al., 2022). Transfer Pricing and foreign ownership have a positive effect on tax avoidance. Research on multinational companies in Ghana regarding transfer pricing has a positive influence indicating that companies carry out transfer pricing aggressiveness activities to manipulate transfer prices and reduce reported profits (Amidu et al., 2019)

H<sub>2</sub>: Transfer pricing aggressiveness has an affect tax avoidance

### **The Effect Of Political Connections On Tax Avoidance**

Companies that have political connections are companies that have close ties with government officials, both central government and military agencies. Companies that have political connections will get political privileges as an advantage because of their relationships with prominent political figures (Khoirunnisa Asadanie & Venusita, 2020). Political connections have a positive and significant effect on tax avoidance (Istoyib & Novi Yushita, 2018)

H<sub>3</sub> : Political connection has an affect tax avoidance

### **The Effect Of Tax Loss Compensation On Tax Avoidance**

Compensation for taxable profits is a process in which it carries losses from one tax year to the next. Tax relief is given to companies that experience losses in one accounting period. The company will avoid the tax burden, because the taxable profit will be used to reduce the company's loss compensation amount. This makes companies that experience fiscal losses

usually not motivated to carry out tax avoidance because of the compensation for fiscal losses obtained by the company so that the greater the compensation for fiscal losses, the smaller the tax avoidance actions taken by the company (Siregar et al., 2021). Fiscal loss policy has a positive and significant effect on tax avoidance (Lestari & Solikhah, 2019; Saputra & Purwatiningsih, 2022).

H<sub>4</sub> :Fiscal loss compensation has an effect on tax avoidance

**METHODOLOGY AND SAMPLE SIZE**

The research was conducted using quantitative methods to express a causal relationship between variables or to see the relationship between the independent variable and the dependent variable. The population used in this study are manufacturing companies listed on the Indonesia Stock Exchange for the 2018-2021 period. Selection of samples in the population using techniques purposive sampling by using the following sample criteria:

**Table 1 Purposive Sampling**

Information	Amount
Manufacturing companies listed on the IDX 2018-2021	209
Companies that do not have foreign subsidiaries	(163)
Companies with negative pre-tax profits	(14)
Companies that do not meet the research variables	(2)
Research sample	30
Research Period	4
Total	120

Source: Data Process, 2023

**Variables and Measures**

**Table 2 Variable Measurement**

Variable	Indicator	Source
Tax Avoidance	$ETR = \frac{\text{Income tax expense}}{\text{Pretax income}}$	Darma, (2019)

Thin Capitalization	$DER = \frac{Total\ Utang}{Total\ Modal}$	Darma (2019)
Transfer Pricing Aggresiveness	$= \frac{TPA\ Index\ Criteria\ Score\ Met}{Maximum\ Score\ Of\ Index\ Criteria\ Met}$	Amidu et al. (2019)
Political Connections	Dummy	Lin et al. (2017)
Fiscal Loss Compensation	Dummy	Kurniasih& Ratna Sari (2013)

**DATA ANALYSIS**

Testing the research hypothesis using multiple regression analysis. Multiple analysis methods are used to determine the correlation of each independent variable to the dependent variable.

$$Tax\ Avoidance = a + b_1X_1 + b_2X_2 + b_3X_3 + b_4X_4 + e$$

**1. Descriptive Statistical Analysis**

**Table 2 Statistik Deskriptif**

Variable	N	Minimum	Maximum	Mean	Std. Deviation
TC	110	.131	2.415	.915	.530
TPA	110	.4	1.0	.775	.211
KP	110	0	1	.55	.499
KRF	110	0	1	.24	.427
TA	110	.020	.653	.263	.102

Source: Data Process, 2023

The Thin Capitalization variable has the lowest value of 0.131 and the highest value of 2.415 with an average value of 0.915 and a standard deviation of 0.530. The Transfer Pricing Aggressiveness variable has the lowest value of 0.4 and the highest value of 1.0 with an average value of 0.775 and a standard deviation of 0.211. The political connection variable has the lowest value of 0 and the highest value of 1 with an average value of 0.55 and a standard deviation of 0.499. The fiscal loss compensation variable has the lowest value of 0 and the highest value of 1 with an average value of 0.24 and a standard deviation of 0.427. The tax avoidance variable has

the lowest value of 0.020 and the highest value of 0.653 with an average value of 0.263 and a standard deviation of 0.102.

## 2. Normality test

This study used a normality test through the Kolmogorov-Smirnov (K-S) statistical test with the Monte Carlo exact test. Normality test with the Monte Carlo exact test if the significance is greater than 0.05, the data tested is distributed (Ghozali, 2018). Based on the test results, the value of Monte Carlo Sig. (2-tailed) of 0.085 (sign. > 0.05) it can be concluded that the data is normally distributed.

## 3. Multicollinearity test

To test the occurrence of multicollinearity, it can be seen from the tolerance value and the Variance Inflation Factor (VIF) value. To indicate the existence of multicollinearity, the cut off value commonly used is a tolerance value of 0.10 or the same as VIF above 10. If the tolerance value is more than 0.10 or the VIF value is less than 10, it can be said that there is no multicollinearity between variables in the regression model.

**Table 3 Multicollinearity test**

Variable	Tolerance	VIF	Information
TC	.973	1.028	No multicollinearity
TPA	.960	1.042	No multicollinearity
KP	.952	1.051	No multicollinearity
KRF	.959	1.043	No multicollinearity

Source: Data Process, 2023

Based on the table above, each variable obtains a tolerance value > 0.10 and a VIF value < 10. It can be concluded that it passes the multicollinearity test.

## 4. Autocorrelation Test

The autocorrelation test in this study used Durbin Watson and obtained a value of 2.232. The DW test is said to have passed if the value obtained is  $D_u < DW < 4 - D_u$ .

## 5. Heteroscedasticity Test

This study used the heteroscedasticity test with the Spearman Rho test. The test results can be seen in the table below:

**Table 4 Heteroscedasticity Test**

Variable	Sig. (2-tailed)	Information
TC	.599	No Heteroscedasticity
TPA	.189	No Heteroscedasticity
KP	.622	No Heteroscedasticity
KRF	.467	No Heteroscedasticity

Source: Data Process, 2023

The heteroscedasticity test was carried out using Spearman's Rho and each variable obtained a significant value > 0.05 so that this study passed the heteroscedasticity test or did not have symptoms of heteroscedasticity.

**6. Analysis Multiple linear regression**

**Table 5 Multiple Regression Analysis**

Model		UnstandardizedCoefficients		StandardizedCoefficients	t	Sig.
		B	Std. Error	Beta		
1	(Constant)	.248	.039		6.336	.000
	TC	.038	.018	.195	2.081	.040
	TPA	-.050	.046	-.103	-1.089	.279
	KP	.009	.020	.045	.474	.636
	KRF	.059	.023	.244	2.581	.011

Source: Data Process, 2023

Based on the table above, the regression equation can be concluded as follows:

$$TA = 0.248 + 0.038TC - 0.050TPA + 0.009KP + 0.059KRF$$

Description

FACING = Tax Avoidance

TC = Thin Capitalization

TPA = Transfer Pricing Aggressiveness

KP = Political Connection

KRF = Fiscal Loss Compensation

Based on the results of the linear regression above, it can be interpreted as follows:

- 1) The results of the equation obtained a constant value of 0.248 with a positive value. This shows that if the values of Thin Capitalization, Transfer Pricing Aggressiveness, Political Connections and Fiscal Loss Compensation are assumed to be equal to zero, then the value of Tax Avoidance tends to increase by 0.248.
- 2) Thin Capitalization value of 0.038. This shows that for every 1 point increase in Thin Capitalization, Tax Avoidance increases by 0.038 points.
- 3) Transfer Pricing Aggressiveness value is -0.050. This shows that for every increase in Transfer Pricing by 1 point, Tax Avoidance decreases by -0.050 points.
- 4) Political Connection Value of 0.009. This shows that for every increase in Political Connection by 1 point, Tax Avoidance increases by 0.009 points
- 5) Fiscal Loss Compensation value of 0.059. This shows that for every increase in Fiscal Loss Compensation by 1 point, Tax Avoidance will increase by 0.059 points

**7. Test Coefficient of Determination (R-Square)**

The coefficient of determination (R<sup>2</sup>) is used to measure the model's ability to explain the dependent variable. The value of the coefficient of determination can be shown in the following table:

**Table 6 Test Coefficient of Determination**

Model	R	R-Squared	Adjusted R-Squared
1	.321	.103	.069

Source: Data Process, 2023

**8. Feasibility Test**

F-test indicates whether all the independent variables included in the regression model have a joint effect on the dependent variable. This study uses a significance level of 0.05. If the sig value <0.05 then the independent variables simultaneously affect the dependent variable. The test results can be seen in the table below :

**Table 7 Feasibility Test**

Model		Sum of Squares	df	Mean Square	F	Sig.
1	Regression	.118	4	.030	3.008	.021 <sup>b</sup>
	Residual	1.033	105	.010		
	Total	1.151	109			

Source: Data Process, 2023

The results of the Feasibility Test (Test F) showed a significant value of 0.021. Obtaining a significant value  $< 0.05$  indicates that the regression model is feasible to test and together the thin capitalization variables, transfer pricing aggressiveness, political connections and fiscal loss compensation have a significant effect on tax avoidance.

**9. Partial T test**

T test is a test used to determine the influence of each independent variable on the dependent variable. If the decision is made using the criteria if  $H_0$  is rejected and  $H_a$  is accepted if the probability  $< \alpha$ .  $\alpha = 0.05$  or 5%, which means that there is a significant influence between the independent variable and the dependent variable. The test results can be seen in the table below :

**Table 8 T test**

Variabel	t	Sig	Information
1 (Constant)	6.336	.000	
TC	2.081	.040	H <sub>1</sub> Accepted
TPA	-1.089	.279	H <sub>2</sub> Rejected
KP	.474	.636	H <sub>3</sub> Rejected
KRF	2.581	.011	H <sub>4</sub> Accepted

Source: Data Process, 2023

Based on the results of the T test in table 8, it shows that Thin Capitalization has a t-value of  $2.081 > 1.982$  and a sig-value of  $0.040 < 0.05$ , so there is a significant effect on Tax Avoidance. Transfer Pricing Aggressiveness has a t-value of  $1.089 < 1.982$  and a sig-value of  $0.279 > 0.05$ , so there is no significant effect on tax avoidance. Political connection has a t-value of  $0.474 < 1.982$  and a sig-value of  $0.636 > 0.05$ , so there is no significant effect on tax avoidance. Tax loss compensation has a calculated t-value of  $2.581 > 1.982$  and a sig-value of  $0.011 > 0.05$ , so there is a significant effect on tax avoidance.

## **RESULT AND DISCUSSION**

Based on the results of data processing in table 8, thin capitalization has a sig value of 0.040 < 0.05, so **H<sub>1</sub> accepted**. It can be concluded that thin capitalization has an effect on tax avoidance. This research supports previous research conducted by Falbo & Firmansyah (2018); (Fasita et al., 2022; Olivia & Dwimulyani, 2019). The high amount of funding from debt used by the company will cause higher interest costs arising from the debt. The high interest cost of the debt must be repaid by the company. This causes a reduction in company profits so as to be able to have the effect of reducing the company's tax burden.

Transfer pricing aggressiveness has a sig value of 0.279 > 0.05 then **H<sub>2</sub> rejected**. It can be concluded that transfer pricing aggressiveness has no effect on tax avoidance. This research is in line with previous research conducted by Nadhifah & Arif (2020); Fasita et al. (2022) and Falbo & Firmansyah (2018). Regulation No. 1 of 2016 No. 213/PMK.03/2016 causes taxpayers to comply with the rules because there are no loopholes that can be used for tax avoidance efforts. In addition, companies that carry out transfer pricing to related parties are used as a performance evaluation.

Political connection has a significant value of 0.636 > 0.05 then **H<sub>3</sub> rejected**. It can be concluded that political connections have no effect on tax avoidance. This research is in line with research conducted by Fasita et al. (2022; Khoirunnisa Asadanie & Venusita (2020). Boards of directors and commissioners who have political relations with the government are able to limit management's space so that it does not affect tax avoidance caused by political relations.

Tax loss compensation has a sig value of 0.011 > 0.05 then **H<sub>4</sub> accepted**. It can be concluded that fiscal loss compensation has an influence on tax avoidance. This research is in line with previous research conducted by Assalam & Pratomo (2020; Lestari & Solikhah (2019) Compensation for fiscal losses received by the company will reduce the tax burden that must be paid by the company or even the company does not pay taxes at all if the profits obtained by the company in the following year cannot cover the company's fiscal losses in the previous year.

## **CONCLUSION**

Based on the results of the analysis and discussion, it can be concluded that thin capitalization and fiscal loss compensation have an influence on tax avoidance. Meanwhile, transfer pricing aggressiveness and political connections do not have a significant effect on tax avoidance. This research has limitations. The limitations of this study only use a sample of manufacturing companies listed on the IDX in the 2018-2021 period. The political connection variable is only observed based on the profile reports of the directors and commissioners which are only found in the annual report so that they cannot know the curriculum vitae of the board of directors and

commissioners as a whole. Further research can use a sample of multinational companies either listed on the IDX or not and increase the research period. In addition, further research is able to add independent variables that are more influential on tax avoidance.

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