THE EFFECT OF RELATED PARTY TRANSACTIONS ON TAX AVOIDANCE:

REAL EARNINGS MANAGEMENT AS A MEDIATING ROLE

(Empirical Study on Manufacturing Company listed in Indonesian Stock Exchange)

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Declaration Of Originality

I, Audia Cendekiawati, hereby state and declare that this thesis is true and accurate to be my own work specially written for partial requirement to complete Undergraduate Program of Accounting and has not initially been presented in any other occasion. I bear full responsibility for my undergraduate thesis.

Audia Cendekiawati

March 8th, 2016

MOTTO AND DEDICATION

فَإِنَّ مَعَ يُسْرًاالْعُسْرِ

For indeed, with hardship [will be] ease.- QS. Al Insyirah : 5

Nothing worth having comes easy

(Anonymous)

I dedicate this thesis for :

My beloved mom, Sri Utami

My beloved dad, M. Pujo Siswoyo

My beloved siblings, Anindita Sari and Arridho Arfan

My Family

All of my beloved friends

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ABSTRACT

This research aimed to examine the effect of related party transactions (RPT) on tax avoidance using real earnings management as a mediating role. This research used Book Tax Differences (BTD) to measure the tax avoidance conducted by the company while real earnings management is measured with real activities manipulation proxie.

Population of this research was all Indonesian Listed Companies in Indonesian Stock Exchange (IDX) in the year of 2012-2014. The samples of this research were listed manufacturing company which have at least three transactions between related party and reports their financial statements in Indonesian Currency (Rupiah). The sample selection based on of manufacturing company because real earnings management can only be identified through real activity conducted by the company. Partial Least Square (PLS) Analysis on SmartPLS 3.0 is used to examine the data.

This research proved that related party transactions have not a direct effect on tax avoidance, however real earnings management mediates the relationship between related party transactions and tax avoidance. It can be conclude that related party transactions significantly have a positive effect on tax avoidance through real earnings management as a mediating role.

Keywords : related party transactions, real earnings management, tax avoidance, real activities manipulation.

ABSTRAK

Penelitian ini bertujuan untuk menguji pengaruh antara transaksi pihak berelasi terhadap penghindaran pajak dengan menggunakan peran manajemen laba riil sebagai variable mediasi. Penghindaran pajak dalam penelitian ini diukur menggunakan Book Tax Difference (BTD) dari setiap laporan keuangan perusahaan sedangkan manajemen laba riil diukur menggunakan proksi manipulasi kegiatan riil perusahaan.

Populasi dalam penelitian ini adalah semua perusahaan yang terdaftar dalam Bursa Efek Indonesia (BEI) pada tahun 2012-2014. Sampel penelitian yang digunakan adalah perusahaan manufaktur yang terdaftar pada bursa efek yang memiliki paling sedikit tiga transaksi antar pihak berelasi dan melaporkan laporan keuangannya dalam mata uang Rupiah. Pemilihan sampel berdasarkan perusahaan manufaktur karena manajemen laba riil hanya dapat di identifikasi oleh perusahaan yang melakukan kegiatan operasi riil. Analisis yang digunakan dalam penelitian ini adalah Partial Least Square (PLS) menggunakan software SmartPLS 3.0

Penelitian ini membuktikan bahwa transaksi pihak berelasi tidak berpengaruh secara langsung terhadap penghindaran pajak, sedangkan manajemen laba riil terbukti memediasi hubungan antara transaksi pihak berelasi dengan penghindaran pajak. Hal ini dapat disimpulkan bahwa transaksi pihak berelasi tidak berpengaruh terhadap penghindaran pajak secara langsung namun membutuhkan peran mediasi manajemen laba riil.

Kata kunci : Transaksi pihak berelasi, manajemen laba riil, penghindaran pajak, manipulasi aktivitas riil.

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CHAPTER 1

INTRODUCTION

1.1. Background

Tax is the biggest source of income for the government's expenditure in Indonesia. The Ministry of Finance of Indonesia reported that tax revenue contributed 67% of total Indonesian's income in 2015. In 2015, the total of Indonesian's State Budget was IDR 1,201.7 trillion from which income tax revenue contributed the biggest percentage (46%). Therefore, the function of tax in a country is very essential following the definition of Soemitro (1988) that a tax is a levy of the people to the state treasury under the law with no gain reciprocal services (cons achievement) directly demonstrated and used to finance public expenditure. Similarly, Act 28 of 2007 Article 1 stated that tax is a mandatory contribution to the state owed by private persons or entities that are enforceable under the law, by not getting the rewards directly, and used for the purposes of state for prosperity of the people.

The sources of income tax revenue in Indonesia are categorized into corporate taxes and personal taxes. Corporate taxes and personal taxes are the amount of money that must be paid to the government as an obligation of conducting taxed activities. According to Law No 36 of 2008 about subject of income taxes, the subject of personal taxes is an individual who resides in Indonesia, an individual who is in Indonesia for more than 183 days within a period of 12 months, or an individual who live in Indonesia and has an intention to reside in Indonesia within a tax year. Meanwhile, the subject of corporate taxes is established companies domiciled in Indonesia and operated their taxed activities in Indonesia. The compliance to fulfill their responsibility to pay taxes is very important due to its function.

The function of tax to a country is crucial as it is a fundamental source to finance the state budget for country's development such as improving infrastructure and prosperity of the people. In the Indonesian's state budget of 2015, IDR 647.3 trillion (32%) was spent for developing infrastructure; while, others were used for people prosperity such as education, health insurance, and pensions.

In regard to its focal significance, all people and institution are subjected to fulfill their obligation to pay taxes. However, not all are obedient. For example, some companies try to avoid paying taxes as it deducts their profit. The higher the profit a company generated the higher the tax should be paid. In dealing with this situation, some companies apply special tricks in preparing their financial statements; so that, those companies may continue gaining high profits. Tricks conducted by those companies in order to minimize the amount of tax to be paid are called tax avoidance (Desai and Dharmapala, 2006). Mangunsong (2002) stated that the reduction of the tax burden or tax avoidance is related to a tendency that no one likes to pay taxes. Moreover Mangoting (2004) explained that the nature of the tax which does not provide direct contra to the taxpayers makes them avoid paying it.

Tax avoidance may occurs because several reasons. First, the law maker in Indonesia are from different background such as Government and the Parliament, while parliament representing different interests and can be contrasted the one and the other. The two of the most dominant interests in the parliament is a parliament member representing the workers and the owners of capital. Therefore, they tried to compromised by making a win-win solution for each other. Each party is free to interpret the law in accordance with their interest which is resulted in different interpretations (Gordon et al., 2004)

Secondly, tax avoidance may occurs because companies are clever to take advantages of the loopholes and weaknesses of the tax legislation. For example, a company which is deliberately manipulates the report of financial statements causing the fiscal losses is allowed not to pay taxes until 5 consecutive years. This loopholes in Law No. 36 of 2008 about the fiscall losses compensation is utilized by the company to avoid the payable taxes.

The absence of strict sanctions on tax avoidance causing unconsciously losses to the state. According to Arnold and McIntyre (2002), tax avoidance or tax savings are still classified in order to comply with the statutory provisions. Furthermore, Mangoting (2004) stated that the government (in this case Directorate General of Taxes Indonesia) cannot impose the legal sanctions to companies although this behavior will avoid state’s income from tax sector.

The phenomenon of tax avoidance by some companies in Indonesia mostly conducted using two techniques. The first one is a transaction between related parties or in the research called the Related Party Transactions (RPT). Mentioned in PSAK 07(revised 2007) that the transactions with Related Parties is the relationship of the parties are considered related if one party has the ability to control the other party or exercise significant influence over the other party in making financial and operational decisions. Furthermore, the transaction between related parties is a transfer of resources or obligations between related parties, regardless of a price calculation.

In addition, tax law of article 18 paragraph (4) of Law No. 7 of 1983 on Income Tax and its amendment of law number 28 of 2007 states that a special transaction party (now it is called related parties) can form relationships because of ownership, relationship of mastery, and relationships of family. According to the Income Tax Law article 18 paragraph (4), relationship because of ownership occurs when the taxpayer has a direct participation of 25% or more on another taxpayer. Relationship because of mastery occurs if the taxpayer control over other taxpayer directly or indirectly, and it usually happens because of the management or technology relationship. Meanwhile, family relationship takes place when there is a family relationship either by blood or by marriage in direct lineage and or laterally of one degree.

Basically the transactions value is determined based on the process of bargaining and negotiation between the respective parties to achieve maximum profitability which forms a fair market price. Taxation Regulation No. PER-32 / PJ / 2011 article 3 paragraph (3) of the Principles of Fairness and Prevalence Enterprises (Arm's Length Principle) states that price or return on transactions made by parties do not have a special relationship determined by market forces; so that, the transaction reflects fair market value. However, it can also happen that the transaction value becomes unnatural if the parties involved in the transaction are a related party.

The facts show that RPT is a threat to the tax authority in Indonesia or even other countries around the world. The practice of RPT arises as the transfer price used in the transaction tends to be unnatural and unreasonable that leads to minimize the amount to be paid. In fact, it is common practice to fix the price above or below the fair price. If a company's profit declines, the tax burden paid will also be smaller. The transactions of RPT creates the intention of the companies to do tax avoidance (Trisnawati and Ompusunggu, 2014).

The second technique of tax avoidance is using the benefit of accounting policy. A company has an ability to establish policies that lead to financial statement called earning management practice. Earnings management is a manager's action to raise or lower the profits on financial statement to impress stakeholders of the company's performance (Hayn, 1995). Meanwhile, Sulistiyanto (2008) defined earnings management as an action conducted by a company by abusing components of the financial statement through accounting methods used in accordance with the person who record the transaction and prepare the financial statement.

Earnings management can be categorized into real earnings management and accrual earnings management. Jones (1991) defined earnings management as a value determined by policies or management discretion using accrual incomes, receivables, plant, property, and equipments (PPE). Meanwhile Roychowdhury (2006) stated that earnings management is a deviation activity from normal business practices conducted by management in order to gain the targeted profit by manipulating sales, discretionary expenditure, and overproduction.

As a consequence, the capability of RPT in minimizing taxes to be paid and manipulating earnings may trigger a conflict of interest between management, shareholders, and other stakeholders. RPT is not only one indicator of tax avoidance; it also becomes the reason of a company to do earnings management. Gordon et al., (2004) stated that the RPT is a natural part of a business, and many companies have high volume of transactions without committing financial fraud. On the other hand, Ryngaert and Thomas (2007) stated that affiliated RPT is one way to do earnings management in Japanese companies. This finding is supported by a research conducted by the Warfield et al. (1995) which stated that the motivation of earnings management is to minimize the burden of the tax to be paid to the government.

So far, previous researches have only tested the effect of transfer pricing on earnings management and the influence earnings management on tax avoidance. There has been no research integrates three related variables of party transactions, real earnings management, and tax avoidance in one research. Therefore, this research intended to fill the research gap and provide an empirical study related to RPT, earnings management, and tax avoidance. Moreover, this study aimed to build a better knowledge and to examine the mediating role of real earnings management on the relationship between RPT and tax avoidance. The mediation analysis was chosen as real earnings management is assumed to be theoretically connected to either the independent variable (related party transaction) or the dependent variable (tax avoidance).

The samples of this study were manufacturing companies listed on the Indonesian Stock Exchange (IDX) during 2012 – 2014. The chosen companies should also have at least 3 transactions among related party transaction in assets, liabilities, sales, and purchases. The manufacturing companies were sampled as Roychowdhury (2006) suggested that there is a tendency that real earnings management only occurs in manufacturing companies.

1.2. Problem Formulation

The tax avoidance resulted Indonesian lost a lot of money. Almost IDR 1,300 trillion could not be collected because the manipulation in transfer pricing supported by internal politics of inter-related companies of the RPT that affects the selling price, purchase price, total assets, and total liabilities reported in the balance sheet and income statement of the company (Gordon et al., 2004). Furthermore, earnings in company's financial statement show how taxes should be paid to the state. There is a tendency that the RPT transaction is related to opportunity causing the company is able to manipulate its earnings for the purposes of tax avoidance (Subagyo and Kurniawati, 2012).

Prior research on related party transaction and tax avoidance has proved its advantages to Indonesia; although, its results are still varies. Moreover, there has been no investigation on mediating role of earnings management. Therefore, further investigation about this relationship and its practices in Indonesia needs to be conducted by providing empirical investigation through questions:

a. Does related party transactions affect tax avoidance?

b. Does related party transactions affect real earnings management?

c. Does real earnings managements affect tax avoidance?

d. Does real earnings management mediates the relationship between related party transactions and tax avoidance?

1.3. Research Objective

The objectives of the research were:

1.3.1. To investigate the effect of related party transactions to tax avoidance.

1.3.2. To investigate the effect of related party transactions to real earnings management.

1.3.3. To investigate the effect of real earnings management to tax avoidance.

1.3.4. To determine the function of real earnings management as a mediating role between related party transactions and tax avoidance.

1.4. Contributions of Study

Contribution of this study is based on background, problem formulation and research objectives. There are several contributions, such as:

1. For researchers, the result of this study is expected to give contribution on related party transactions, real earnings management, and tax avoidance.
2. For government, the result of this study is expected to provide benefits for the government's policy regarding the RPT and the prevention of tax avoidance.
3. For academics, the result of this study is expected to contribute the development of science in accountings management and taxation.
4. For society and future research, the result of this study is expected to be a reference for future research related to RPT, real earnings management, and tax avoidance.

1.5 Structure of the Study

CHAPTER I: INTRODUCTION

This chapter consists of background, problem formulation, research objectives and purposes, and the structure of this research.

CHAPTER II: LITERATURE REVIEW

This chapter consists of theories and concepts that formed from the basic of this study that relevance with this research. In addition to explain the theory and the relevant concepts, this chapter also explains the previous researches and the hypothesis development.

CHAPTER III: RESEARCH METHODS

This chapter describes about research design, type and source of data, data collect method, research object and data analysis. This study is quantitative approach with partial least square analysis using Software SmartPLS 3.0.

CHAPTER IV: RESULT AND ANALYSIS

This chapter explains about the research object, data analysis that consists of descriptive statistic, PLS analysis, hypothesis test result and interpretation of results.

CHAPTER V: CONCLUSION

This chapter consists of conclusion that can be drawn from the analysis result, research implications, the limitations of the study and suggestions for future research.