TRANSFER PRICING AGGRESSIVENESS, FIRM SIZE, PROFITABILITY, AND TAX HAVEN UTILIZATION AS DETERMINANTS OF TAX AVOIDANCE

Empirical Evidence from Companies Listed in Indonesia

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DECLARATION OF ORIGINALITY

I am, Valcataria Tamara Citra, hereby declare that this thesis is real and accurate to be my own work, especially written for partial requirement to complete Undergraduate Program of Accounting, and has not been presented in any other occasion before. I bear full responsibility for my undergraduate thesis.

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MOTTO AND DEDICATION

لَا يُكَلِّفُ اللَّهُ نَفْسًا إِلَّا وُسْعَهَا

"Allah does not burden someone beyond his/her capacity" (Al-Baqarah 2: 286)

"Do not go where the path may lead,
go instead where there is no path and leave a trail."
― Ralph Waldo Emerson

"Be the best version of you even if you are nobody"

I dedicate this thesis for:

My beloved parents

My all dearest family

They are the reason why I go this far

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ABSTRACT

The aim of the study was to examine the influences of transfer pricing aggressiveness, firm size, profitability, and tax haven utilization on tax avoidance, with including capital structure and industry sector as control variables. Firm size was measured by natural logarithm of total assets, profitability was measured by return on assets, and tax haven utilization was measured by dummy variable. Transfer pricing aggressiveness measured by TPA index consisted of three ratios were developed in this research. Populations were non-financial firms listed on IDX. Samples were taken for the year 2015-2017 and data were collected by purposive sampling method, by which several criteria were established. The total observations were 198 companies. Panel data analyzed by EViews 10 were used to test the research data. The result of this study demonstrated that transfer pricing aggressiveness, firm size, and profitability significantly influence tax avoidance. Meanwhile, tax haven utilization had no significant association with tax avoidance.

Keywords: transfer pricing aggressiveness, tax avoidance, tax haven utilization, political cost hypothesis.

ABSTRAK

Penelitian ini bertujuan untuk menganalisis pengaruh agresivitas harga transfer, ukuran perusahaan, profitabilitas, dan pemanfaatan tax haven *terhadap penghindaran pajak, dengan memasukkan struktur modal dan sektor industri sebagai variabel kontrol.Ukuran perusahaan diukur dengan logaritma natural dari total aset, profitabilitas diukur dengan* return on assets, *dan pemanfaatan* tax haven *diukur dengan variabel* dummy. *Agresivitas harga transfer diukur dengan* TPA index *yang terdiri dari tiga rasio yang dikembangkan dalam penelitian ini. Populasi adalah perusahaan non keuangan yang terdaftar di BEI. Sampel diambil untuk tahun 2015-2017 dan dikumpulkan dengan metode* purposive sampling *dimana peneliti menetapkan beberapa kriteria untuk dijadikan data penelitian. Total observasi sebanyak 198 perusahaan. Analisis data panel pada EViews 10 digunakan untuk menguji data penelitian. Hasil dari penelitian ini menunjukkan bahwa agresivitas harga transfer, ukuran perusahaan, dan profitabilitas berpengaruh signifikan terhadap penghindaran pajak. Sementara itu, pemanfaatan* tax haven *tidak memiliki hubungan yang signifikan dengan penghindaran pajak.*

Keywords: agresivitas harga transfer, penghindaran pajak, pemanfaatan tax haven, political cost hypothesis.

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CHAPTER I

INTRODUCTION

This chapter consists of five sub-sections. The chapter starts with the background as explanation about why this research is conducted, and then followed by problem statement, research objectives, research benefits, and outline of the research.

1.1 BACKGROUND

One of the company's objectives to run its business activities is to generate profit. High profit can be achieved when a company can manage its business efficiently and effectively. Accordingly, the profits generated from any business operation bring the consequence of mandatory tax payment to the state.

Tax is compulsory levies paid by people to the state, and it will be used as the main sources of government funding; thus, tax is one of the most important sectors of a country. According to *Badan Pusat Statistik (BPS)*, in 2010-2017 tax contributed major portion of the government revenue by 78% per year. Some regulations have put in place to maintain tax revenue by the government.

Companies are responding differently dealing with tax regulations; some comply with tax regulations; while, other tend to avoid, as tax reduces company's profit. For the second group, taxation has become their main concern, and they try to find ways to minimize their obligation by utilizing regulatory loopholes. As an effort to minimize payable tax, companies perform tax management strategies, one of which is known as tax avoidance.

Many researchers have tried to define the concept of tax avoidance. The concept can be defined as the art of avoiding tax without actually breaking the law (Flesch MC, 1968 as cited in Anouar and Houria, 2017). Tax avoidance is widely interpreted as the reduction in a company's explicit tax liabilities (Dyreng, Hanlon and Maydew, 2008). Unlike tax evasion that is illegal, tax avoidance is a legal practice to lower the amount of income tax owed through the regulatory loopholes.

Among methods to do tax avoidance, transfer pricing policy is one of the mechanisms to be choosen. According to Setiawan (2013), transfer pricing is a firm policy in determining transfer price of a transaction either goods, services, intangible assets, or financial transaction carried out by the company. There are two types of transfer pricing transaction; intra-company and inter-company transfer pricing.

Intra-company transfer pricing is transfer pricing conducted between divisions or sub-units within a company. Within a manufacturing company, one department transfers its output to another department. This transfer is called intra-firm sale and the head office should set the selling price (Galway, 2009). The prices set for transactions between divisions or sub-units of the company are usually lower compared to market price, because of a special relationship or known as related parties. Meanwhile, inter-company transfer pricing is a transfer pricing between two different companies that have a special relationship. The transaction can be done in the same country (domestic transfer pricing), as well as in different countries (international transfer pricing).

Transfer pricing is a legal normal business transaction. The application of transfer pricing is legitimate if it is done in accordance with the arm's length principle. This principle means transaction in which buyers and seller of a product act independently and have no connection to each other (Holtzman and Nagel, 2014). Regulation in Indonesia also makes reference to the arm’s length principle, which is contained in Law Number 36 of 2008.

However, sometimes transfer pricing lead to unethical issues even breaking the law, commonly called abuse of transfer pricing. The application of transfer pricing is widely misused as an effort to avoid taxes, such as in the cases of Google, Starbucks, Amazon, etc. These misappropriations are commonly conducted by multinational companies, since there is difference in the imposition of tax rates among countries. So, the multinational companies can establish subsidiaries in low tax rates countries even countries with tax-haven country status. The multinational companies can further minimize the amount of tax paid by manipulating prices transferred between divisions or between their subsidiaries.

As for the government side, the abuse of transfer pricing is surely very detrimental to the country, especially for taxation aspects. Audit activity by tax authorities and economic analysis by treasury departments have collectively found that mispricing of transactions is a major factor contributing to a progressive erosion of corporate tax revenue (Richardson, Taylor and Lanis, 2013). Indonesia loses trillions of rupiah because of the practice of transfer pricing of foreign companies in this country *(KONTAN, June 20th 2012).* The main key to the success of transfer pricing from the tax side is the existence of transactions between related parties due to a special relationship.

Currently, there are many regulations concerning transfer pricing policy in Indonesia, as government concern in preventing tax avoidance. Some of regulations concerning to transfer pricing and special relationship are: Article 18 paragraph 3 of Income Tax Law, Directorate General of Taxation: PER-43/PJ/2010, and other regulations. The Minister of Finance has also issued PMK-213/PMK.03/2016 as new regulation regarding transfer pricing documentation and country-by-country reporting, in line with recommendations from the OECD. The purpose of the Indonesia's transfer pricing regulations is to ensure that related party concerning international transactions are conducted on an arm's length principle so that profits are not artificially deflated (inflated) in high-tax jurisdictions (low-tax jurisdictions).

Although there are many laws and regulation related to transfer pricing, it has become a complex global issue and cannot be partially resolved. In fact, there are still many cases related to transfer pricing misappropriation. Recently, the use of transfer pricing tax strategies has attracted a high level of international attention, due to the part of the rapid rise of multinational trade, the opening of several significant developing economies and transfer pricing's increased impact on corporate income taxation (Holtzman and Nagel, 2014). Survey by Ernst and Young (2011) found that risks associated with transfer pricing constitute one of the most critical and challenging issues being faced by companies internationally. Conflict of interests between management's companies and tax offices in various countries make this issue not easily to be resolved. Including Indonesia, it is impossible to avoid completely the impact of transfer pricing practices.

The free flow of goods and services in the globalization will enhance the practice of transfer pricing. Moreover, the existence of tax haven countries will facilitate firms to use transfer pricing practice in order to minimize their tax payment. This opportunity can be utilized by companies as the operational location of companies or subsidiaries. Thus, tax haven utilization is an opportunity to carry out tax avoidance.

Given that situation, this study attempts to find out the determinants of tax avoidance. Research about the practices of tax avoidance with the company’s characteristics as the proxy has been done by researches in both developed and developing countries. However, previous researches still found different conclusions regarding the determinants of tax avoidance. In addition, a very limited number of studies have examined the impact of transfer pricing aggressiveness and tax haven utilization on tax avoidance, especially in Indonesia. Therefore, this research extends the previous researches by analyzing the effects of transfer pricing aggressiveness and tax haven utilization on tax avoidance.

This research is different from previous studies related to variable measurement. The transfer pricing aggressiveness is measured by TPA Index developed in this study consists of three ratios based on the related party transactions. Another difference, this research used Cash ETR rather than GAAP ETR in order to overcome the limitation of GAAP ETR. The research is conducted in Indonesia, a developing country located in the southeast region of

Asia. The populations of this study are non-financial firms listed on the Indonesian Stock Exchange during 2015-2017. The sample selection is using purposive sampling in order to match the specified criteria.

1.2 PROBLEM STATEMENT

Previous researches regarding the determinants of tax avoidance have been conducted in both developed and developing countries. However, limited research in the determinants of tax avoidance focusing on both transfer pricing aggressiveness and tax haven utilization is available, especially in Indonesia. Furthermore, some researches on the determinants of tax avoidance are inconclusive and inconsistent in findings.

A study by Anouar and Houria (2017) in Morocco jurisdiction showed that only multinationality, intra-group transactions, and debts contribute significantly associated with tax avoidance; while, group size, profitability, intangible assets are not related to tax avoidance. In other jurisdiction, Australia, a study by Taylor and Richardson (2012) found that thin capitalization, transfer pricing, income shifting, multinationality, and tax haven utilization are significantly associated with tax avoidance. A study by Isma, Hamdi, and Yunilma (2017) identified that firm size influences tax avoidance while transfer pricing does not affect tax avoidance. Other research in Indonesia by Sima (2018) showed that tax haven utilization does not significantly affect tax avoidance, but firm size have significant effect on tax avoidance.

Based on the description and the introduction that have been discussed previously, this study seeks to answer the following questions:

1. Does transfer pricing aggressiveness have positive influence on tax avoidance?
2. Does firm size have positive influence on tax avoidance?
3. Does profitability have positive influence on tax avoidance?
4. Does tax haven utilization have positive influence on tax avoidance?

1.3 RESEARCH OBJECTIVES AND BENEFITS

The purpose and contribution of this research are as follows:

1.3.1 Research Objectives

Based on the problem statement above, the aims of this study are to:

1. Analyze the influence of transfer pricing aggressiveness as determinant factors of tax avoidance.
2. Analyze the influence of firm size as determinant factors of tax avoidance.
3. Analyze the influence of profitability as determinant factors of tax avoidance.
4. Analyze the influence of tax haven utilization as determinant factors of tax avoidance.

1.3.2 Research Benefits

The expected benefits from this study are as follows:

1. This study is expected to contribute to the literature of the theories related to the subject of this study; so that the reader will understand well about Transfer Pricing Aggressiveness, Firm Size, Profitability, and Tax Haven Utilization as Determinants of Tax Avoidance.
2. Practical Contribution
   a. For Accounting Practitioners and Regulators

      This study is expected to give stakeholder an overview of tax avoidance efforts in Indonesia. This study is also expected to provide valuable information about the major determinants of tax avoidance to policymakers and regulators, so that the regulators can develop existing policy and regulation.

   b. For Company Management

      This research is expected to contribute to the multinational company especially for those who do the transfer pricing and utilize tax haven countries to be more attentive to the information given. Accordingly, the company can make the consideration of the company to implement the transfer pricing based on arm's length principle without doing any abuse.

   c. For Further Researcher

      This research is expected to add insight and knowledge to be used as an additional reference for similar studies and further research.

1.4 OUTLINE OF THE RESEARCH

This study refers to some previous researches on the topic of transfer pricing aggressiveness and tax avoidance which is based on predetermined outline of the research that will facilitate the discussion in writing. This research is divided into five chapters consisting of:

CHAPTER I: INTRODUCTION

This chapter contains an explanation which attempts to give an overview of the description of the problem and the contents of the topic in this research. This chapter consists of the background of the research, problem statement that will be discussed in next chapter, benefit and objectives of this research, and outline of the research.

CHAPTER II: LITERATURE REVIEW

This chapter reviews the relevance of the theories that will be used in variables and concept explanation as explanatory material in this research. Furthermore, the chapter describes some previous studies, framework that underlies the hypothesis that will be tested in this research. This chapter also contained by explanation of variables included the independent variables, the dependent variables, and control variables.

CHAPTER III: RESEARCH METHODOLOGY

This chapter describes the definition of variables, determination and selection of the sample population, types and source of data, data collection methods, data analysis methods and tools that used in the research.

CHAPTER IV: RESULTS AND DISCUSSION

This chapter explains and describes object used in this study, data analysis, and interpretation of the statistical results from the research hypothesis tested.

CHAPTER V: CONCLUSION

This chapter contains the final conclusions and limitations of the research conducted, and also the suggestion that might be considered for further research in future.