



## Tax Avoidance & Corporate Risk: An Empirical Study in Manufacturing Company

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### ABSTRAK

Penelitian ini bertujuan untuk menguji apakah kegiatan tax avoidance (penghindaran pajak) yang dilakukan perusahaan mempengaruhi resiko perusahaan. Pengukuran tax avoidance dilakukan dengan menggunakan rumus cash effective tax rate, sedangkan resiko perusahaan diukur dengan menggunakan volatilitas tingkat pengembalian saham. Selain itu, penelitian ini juga menguji hubungan cash effective tax rate dengan volatilitas tax rates masa depan. Hasil penelitian ini menunjukkan bahwa tax avoidance yang dilakukan oleh perusahaan akan berpengaruh terhadap resiko perusahaan dan juga terhadap volatilitas tax rates masa depan. Diharapkan hasil penelitian ini dapat berguna bagi para pengambil keputusan, baik bagi manajer perusahaan yang hendak melakukan kegiatan tax avoidance, maupun bagi investor dalam pengambilan keputusan investasi.

**Kata kunci:** tax avoidance; effective tax rate; resiko perusahaan; volatilitas tingkat pengembalian saham.

### ABSTRACT

The purpose of this research is to test whether a company tax avoidance activity would affect the corporate risk. Tax avoidance measurement is done by applying cash effective tax rate formula, while the volatility rate of stock return formula is used to measure corporate risk. This research also testing the connection between cash effective tax rate and future tax rate volatility. This research shows that tax avoidance activity would impact both corporate risk and future tax rate volatility. Hopefully, the result of this research would help the decision makers such as the company's managers who plans to do tax avoidance and the investors in making investment.

**Keywords:** tax avoidance; effective tax rate; corporate risk; volatility rate of stock return.

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### INTRODUCTION

Tax in Indonesia is the biggest contributor to national income. In the 2019 Indonesia Government Budget (*Anggaran Pendapatan dan Belanja Negara—APBN*), national income from tax revenue is Rp1.786,4 T, when

from non-tax revenue is Rp378,3 T.

The government's Tax Directorate General, keeps trying to achieve the tax revenue target. The taxation spectators said that the less optimal tax revenue was caused by tax avoidance practice (Wiyarti, 2015).

According to the statement of Minister of Industry, Airlangga Hartanto, the manufacturing industries were the biggest contributors to tax revenue in Indonesia (Reily, 2017). The contribution from manufacturing industries is Rp224,95 T, when from trading industries Rp134,74 T, finance industries Rp 104,92 T, construction industries Rp 35,4 T, information & communication industries Rp32,19 T, mining industries Rp31,66 T and other industries Rp156,19 T. Other than that, manufacturing industries consistently bringing significant multiplier effect to Indonesia's economy. As the biggest tax contributors, the manufacturing sector's tax revenue realization rate in 2017 grows 16,63% compared to the previous year (Reily, 2017). The less optimum realization was the result of many companies doing the tax avoidance practice (Wiyarti, 2015).

Tax avoidance is an activity done to minimize the tax liability without compromising the existing law by utilizing the gaps in taxation law (Suandy, 2011). According to Darussalam, the unclear (hardly defined) definition between tax planning and tax avoidance was one of the cause of many tax avoidance practices by many companies in

Indonesia. The unclearly defined procedures between those two, opens the opportunity for companies to do tax avoidance.

The company's interest in doing tax avoidance were based on that the tax avoidance practice is not breaking/compromising the laws and minimize the company's tax liability. Low tax liability favored by companies as it maximized the wealth of shareholders which create a positive look in the investor's eye, but the tax avoidance practices could lead into misleading information given to the investors. The utilization of taxation laws gap combined with the freedom of tax payers to provide its own tax calculation report, resulting the uncertain future. The different perception between the tax officer and the tax payer on whether a liability is deductible or not, could create tax debts in the future. When a company were too aggressive in doing tax avoidance, the future tax uncertainty rate would become higher (Dyrenge, Hanlon, & Maydew, 2019). This uncertainty could lead into future higher tax liability.

Companies that doing tax avoidance considered to be not transparent because they did not provide the real revenue/ profit information. This activity creates the opportunity for managers to hide the

negative information about the company that could mislead the investors and devalued the company's worth (Desai & Dharmapala, 2006, 2009). The tax's uncertainty and bad company's transparency would escalate the company's risk. As stressed by Kim, Li, & Zhang (2011), aggressive tax avoidance practices could result the downfall of share price. Based on those facts, the researchers interested in researching the impact of the tax avoidance practice to the manufacturing companies' risks in Indonesia.

#### **LITERATURE REVIEW AND HYPOTHESIS FORMULATION**

Tax avoidance practice freely applied by the tax payers because the self-assessment system in Indonesia giving the full freedom and trust for the tax payers to calculate, to pay and reporting their tax liabilities. This system asked a greater responsibility from the tax payer (responsibility of tax payer awareness to fulfill their duty, awareness on how aggressive a company doing tax avoidance). Lim (2011) said that tax avoidance is the company's effort to make lower their tax liability. It can be done by taking advantage of tax rules legally. Other than that, the unclearly defined terms between tax avoidance and tax planning making this becoming a

common practice. This phenomenon emerges as both the tax avoidance and tax planning have the same purpose which is producing efficient tax liability without compromising the law (Suandy, 2011) . Balakrishnan et al. (2019) said that the more aggressive a company doing the tax planning, the more apparent that they are doing tax avoidance practice.

Moreover, Waluyo (2013) and Mardiasmo (2016) defines that tax avoidance practice is a legal deducting attempt by applying the tax policies optimally, one of those is by using some certain costs allowed to reduce the income tax. The more type of costs allowed to become subtractor, the lesser the company's tax liability. This grey area in taxation law, such as whether a type of cost allowed or not to become subtraction element would result uncertainty in the future (Dyrenge, Hanlon, & Maydew, 2008; Guenther, Matsunaga, & Williams, 2017). The uncertainty based on the difference of perception between the tax payer and the tax officer mentioned above. Every item claimed by the company as subtractor might not be approved by the tax officer, this condition resulting the company's tax liability grow bigger. The more aggressive a company in doing tax avoidance, the bigger uncertain tax payment condition a company faced

in the future, in other words, the company's cash flow would also become impacted because of the uncertain tax payment liability. The uncertainty of this future tax liability stated by Guenther et al. (2017) as the future tax rates volatility. The higher rate of future company's tax liability would also accelerate its tax rate volatility. The first hypothesis of this research:

H<sub>1</sub>: Tax avoidance impacts the future tax rates volatility.

Stated in Agency Theory (Eisenhardt, 1989; Jensen & Meckling, 1976), the difference of prominence/objectives between the agents (managers) and the principal (owner) resulting the asymmetric information in the company. Principal mostly demand that the business growth shown in high profit while managers usually demands higher incentive based on that high profit without considering the company's condition in the eye of investors or the company's future condition. One practice used by the company's managers to accomplish the goal is by doing tax avoidance because by doing so the tax liability become smaller and the company's profit looks high.

Balakrishnan, Blouin, & Guay (2019) stated that the more aggressive a company in doing tax avoidance, the

more complex the reports made by the company. This condition caused by all tax planning done by the company in effort to deduct the tax liability. Moreover, the company tends to hide and cover the bad information from the investors eye (Desai & Dharmapala, 2006), and as the result, the company becoming less and less transparent.

Kim et al. (2011) stated that a company who was not transparent in doing tax avoidance practice would jeopardize the continuity of the company itself. Tax avoidance done by the company in effort to deduct the tax liability or to maximize profit. The more aggressive, the more a manager becoming an opportunist, in the end the company would do profit manipulation. Of course, the company would conceal this, and in a certain period, this would lead into the downfall of the company's shares price and bigger bankruptcy risk.

Moreover, the aggressive tax avoidance practice would create bigger difference between accountable profit (commercial) and fiscal profit. This condition triggered by many fiscal corrections attempts to achieve the most minimal fiscal profit. The outcomes of those actions, the profit's quality shown to the investors becoming unrealistic. Ayers, Laplante, & McGuire (2010) found that the

bigger the difference between commercial profit and fiscal profit would even lessen the company's profit quality. Even though that the profit shown to the investors looks big (result of aggressive tax avoidance act) the profit's quality is not as good as it seems. This condition makes a bad company's reputation in the eyes of investors. Lev & Nissim (2004) said that taxable income showed the future stock return, and Goh, Lee, Lim, & Shevlin (2016) who is said that the more aggressive tax avoidance, the more company have a very high score of cost of equity. Further, taxable income can be used as a measure in predicting uncertainty of future corporate performance (Dhaliwal, Lee, Pincus, & Steele, 2017). Based on those mentioned above the second hypothesis would be:

H<sub>2</sub>: Tax avoidance affects the corporate risk.

## **METHOD**

Sample were taken from all of the manufacturing companies population listed in Indonesia Stock Exchange (IDX) based on nonprobability sampling approach using purposive sampling method. Consideration aspects used by the reseachers are:

- a) The company is a listed manufacturing company in IDX

and publisized their audited financial statement consistently from the year 2016-2017.

- b) Providing both annual report and complete sustainability during 2016-2017
- c) The company is not being suspended or delisting during 2016-2017
- d) The company has complete report on tax payment, profit before tax and investment returns.
- e) The company using Indonesian Rupiahs in reporting their financial statement.

The data collecting technic is from the of Indonesia Stock Exchange website database.

## **Definition of Operational Variables**

The independent variable in this research is tax avoidance. Tax avoidance defined by Hanlon & Heitzman (2010) as taxation planning activity in effort to explicitly reduce the tax liability. The more activities or efforts done by the company to reduce its tax liability, reflects the aggressiveness of the company in doing tax avoidance practice. Tax avoidance uses Cash Effective Tax Rate (CETR) proxy which formulated by comparing the cash reserve expended to pay tax with the profit before tax (Dyreng et al., 2008;

Hanlon & Heitzman, 2010; Hanlon & Slemrod, 2009). According to Dyreng et al. (2008), CETR is the best proxy to measure the short time tax avoidance. Bigger CETR rate shows less aggressive tax avoidance practice done by the company. CETR formula:

$$CETR = \frac{\text{Tax Payment}}{\text{Profit before Tax}}$$

Dependent variable in this research is the company's risk. According to Guenther et al. (2017), the company's risk reflects the uncertainty of the future that it has to overcome. This uncertainty relates to all aspects that could causing loss or putting the company in an unprofitable state. The company's risk uses volatility proxy of investment/ share returns. The volatility rate of investment returns acquired from deviation standard calculation of investment returns rate for 12 months per period.

This research also testing the influence of tax avoidance on the future tax rates volatility. Future tax rates volatility stated by (Guenther et al., 2017) as the uncertain nominal of tax that must be paid by the company in the future. The higher the future tax rates volatility, the more uncertain the company's tax payment would be. Future tax rates volatility acquired by deviation standard calculation of annual CETR.

**RESULT AND DISCUSSION**

Sample used in this research has fulfill all the mentioned criteria of purposive sampling. There are 71 companies with the period of 2015-2017. Pooled data 71x3 = 213 data has fulfilled all the classic assumptions. The result of hypothesis test was as follows:

Table 1. Hypothesis Test Result

Dependent Variables		R Square	Sig.	Unstandardized Coefficients B
Tax Rates Volatility	Constant / Regression	0.171	0.000	0.057
	Tax Avoidance			0.238
Corporate Risk	Constant / Regression	0.110	0.014	1.976
	Tax Avoidance			0.015

Based on the result above, it is concluded that Sig. value for tax rates volatility variable is 0.000. The value of sig. < α (0.05) shows that there is a

positive impact of tax avoidance to tax rates volatility.

Company's Tax avoidance practice can be done in many ways. The most common practice is by

utilizing the grey area of taxation law. The categorizing scheme of revenues into three types of revenue such as stated in clause 4 subsection 1 (revenue subject to taxation), clause 4 subsection 2 (revenue with final taxation) and clause 4 subsection 3 (revenue aside from taxation object), also expenses categorization on clause 6 subsection 1 (deductible expense) and clause 9 subsection 1 (non deductible expense) in Income Tax Law no. 36 of 2008 about deductible expense and non deductible expense in order to get the taxable income, allows the company to manage/ categorizing every revenue and its related expenses to become more favorable in terms of tax deduction. The more revenue/income that classified into revenue aside from taxation object or the more expenses classified as non deductible expense, the more aggressive the company doing tax avoidance practice. The other example would be as the company could choose the most tax deduction favorable cutback method. The company could manipulate the profit statement by implementing this method.

The problem emerge as there are some grey area in interpreting each clause and subsection in taxation law. The difference in interpreting the matters is not only happening

between the tax payers but also among the tax officer and especially between the tax payer and the tax officer. When taxation check occurs, all the tax avoidance practice done would usually counterstrike resulting bigger tax liability as the tax checker would recorrect the fiscal financial report of the tax payer. In other words, the more tax avoidance practice done by the company, increases the chance of re correction by tax checker and resulting bigger tax liability than before.

The result is inline with the research conducted by Dyreng et al. (2019) and Guenther et al. (2017) that the more aggressive a company in doing tax avoidance practice, the bigger risk of uncertainty would be faced by the company in the future tax payment, or in other words, the company's cashflow would also experience some uncertainty related to its tax payment liability. The uncertainty on future tax payment stated by Guenther et al. (2017) as future tax rates volatility.

To test the second hypothesist, the company's risk Sig. dependent variable value is 0.014 shows that sig. value <  $\alpha$  (0.05), can be assumed that there is a positive impact of tax avoidance to the company's risks. Aggressive tax avoidance practice is not always a good thing to do as it

produce smaller tax liability. The uncertainty caused by the already mentioned grey area, could lead into higher tax liability plus the fines and interests. It is very possible that the company failed to pay the tax liability plus the fines and interests. In the end this situation would increase the company's risk of falling into bankruptcy higher. This kind of situation is not good in the eyes of investors. The investors would feel unconfident when seeing a company that doing tax avoidance too aggressively.

The result inline with the research conducted by Kim et al. (2011), which states that aggressive tax avoidance practice would have positive impact on the risk of the share price downfall. Moreover, (Ayers et al. (2010) discover that the bigger the diiference between the commercial profit and fiscal profit would drop down the quality of the company's profit. Even though the stated profit to the investors looks bigger (as the result of aggressive tax avoidance practice), the actual profit quality is not as good as it looks. This condition creating a very bad image value in the eyes of investors.

## **CONCLUSION, IMPLICATION AND LIMITATION**

The purpose of this research is is to find out the influence of *tax avoidance* practice to the company's risk and *tax rates volatility*. Based on the conducted tests, this research explains that there is true influence of *tax avoidance* practice to the company's risk which states that the company were being not transparent on conducting *tax avoidance* would lead to the bigger risk faced by the company. Other than impacting the company's risk, *tax avoidance* would also influencing the uncertainty level of the company's future tax liability, in other words the company's cashflow would also affected by the uncertainty of tax payment liability. The uncertainty of the future tax payment stated by Guenther et al. (2017) as future *tax rates* volatility.

This research's result can be used as consideration for companies in deciding to conduct the *tax avoidance* practice. Companies hopefully can see the impacts/ consequences of doing the *tax avoidance* practise to the company's risk and future *tax rates* volatility in effort to keep the investor's interest in doing safe investment in the company.



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