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Executive Character Sustainability, Thin Capitalization, Political Connection, and Audit Quality on Tax Avoidance

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Abstract: *Tax avoidance is still a major problem in a country because taxes themselves are important as a supportsystems. Differences in interests that occur between companies and the government are the main reasons for tax avoidance. Taxes are the main source of national revenue, meanwhile taxes for companies are considered something that can reduce company income. This study aims to examine the effects of executive character, thin capitalization, political connections,andaudit quality on tax avoidance. The sample in this study is obtained using a purposive sampling of 73 manufacturing companies listed on the Indonesian Stock Exchange (IDX) in the 2018-2020 periods. The type of data analysis used is multiple regression analysis. The results show that political connections affect tax avoidance, meanwhile executive character, thin capitalization, and political connections do not affect tax avoidance.*

Keywords: Tax Avoidance, Executive Character, Thin Capitalization, Political Connections, Audit Quality

I. INTRODUCTION

Taxes have a strong position in the progress of a country [1]. Tax avoidance, commonly known as tax avoidance, according to [2], is a legal reduction activity by utilizing the provisions in the taxation sector optimally, such as taking advantage of things that have not been regulated as well as weaknesses and deductions that are still allowed in the tax laws. Tax avoidance is divided into two types, namely tax avoidance that is not allowed and tax avoidance that is allowed [3]. Allowed tax evasion has a good purpose without making fake transactions, while tax evasion that is not allowed has a bad purpose by creating false data or intentionally hiding data to reduce the amount of tax that should be paid.

Tax evasion on international companies is commonly referred to as illicit financial flows, which explains prohibition as equal to illegal, which can be seen from the large impact on lower-income countries [4]. Tax evasion schemes areconsidered to have violated the law but are not included in the crime rate. Those who have been proven to do tax avoidance are not always wrong because there are still many provisions in the field of taxation that can encourage companies to avoid tax and the existence of unclear tax boundaries (grey area) can include transactions that are considered complex [5].

Taxes are still considered a scourge for most Indonesians. Differences in interests between the government and companies have caused many Indonesian companies to be reluctant to pay their obligations. This is because, for companies, tax is considered to reduce the amount of income, while for the government, taxes are the main source of national revenue. In 2018, the percentage of receipts was in the value of 92.23%. In 2019, tax growth increased by 1.4%. However, the percentage of tax revenue decreased by 7.72%. The percentage of tax revenue and tax growth increased by 5% and 19.7%, respectively, in 2020, and it can be concluded that the realization of tax revenue is still fluctuating and not fully optimalyet[6]; [7]; [8].

There are several cases of tax evasion that occurred in several countries, including: first, PT. Adaro Energy, Tbk. from Indonesia in 2009-2017, with accusations of tax evasion by means of transfer pricing to a subsidiary in Singapore, Coal Trade Services International. One of the leaders in PT. Adaro, Tbk. who serves as director of the company is a political figure, namely Sandiaga Salahudin Uno [9]. Second, in 2016, IKEA was suspected of committing tax evasion by transferring funds from its stores throughout Europe to its subsidiary in the Netherlands with a value of 1 billion euros over 6 years. Thisresulted in lost tax revenues of 35 million euros in Germany, 24 million euros in France and 11.6 billion euros in the UK [10]. Third, PT. Coca-Cola Indonesia, Tbk. in 2017 was suspected of circumventing taxes, causing an underpayment of 49.24 billion Rupiah, which occurred in the range of 2002-2006. According to Supreme Court Decision No.946/B/PK/PJK/2017 dated June 14, 2017, PT Coca-Cola Tbk is required to pay a 14.2 billion Rupiah tax underpayment [11]. Fourth, the case of Franchisor, which is a coffee shop from the United States (US), stated a loss of 112 million pounds in 2008-2010, which resulted in not paying corporate income tax in 2011, which has been traced in reports to investors. The franchisor stated turnover in 2008-2010 was worth 1.2 billion pounds [12].

Tax evasion is an activity that has both reputational and audit risks. Decisions related to tax avoidance are influenced by the character of an executive. Someone can have a risk-taker character who dares to take risks or someone with a risk-averse character who tends to avoid risk when making a decision. Previous studies have had different results. Research by [13]; [14] find that executive character has a positive influence on tax avoidance. This result is different from [15], which shows that executive character does not affect tax avoidance.

Thin capitalization also affects tax avoidance because, in thin capitalization, companies prefer to increase debt for operating activities rather than use their share capital. The law allows interest expense as a deductible expense, which is the reason the company reduces the amount of tax by doing thin capitalization. This is supported by the research [3]; [14]; [16] whose research results prove that thin capitalization affects tax avoidance. This result is different from the research of [17], which shows that thin capitalization does not affect tax avoidance.

The next factor influencing tax avoidance is political connections.[18] explain five reasons the connection affects the level of tax aggressiveness.The first is protection, which lowers the risk for businesses compared to those without political ties. The second is the availability of data that enables a more thorough investigation of time series variations through sophisticated tax planning techniques. Third, transparency is not under as much market pressure. Fourth, it can lessen the political repercussions of aggressive taxation. Fifth, due to their influence on risk-taking, political ties may be linked to higher levels of tax aggression.Political connections are considered one of the profitable sources because of the protection from the authorities to reduce transparency in the financial statements. The decrease in transparency in financial statements could be an opportunity for companies to avoid tax.

Audit quality is also one of the factors that influence tax avoidance. Audit quality is a collection of possibilities that can occur as a result of errors or violations found by the auditor when auditing financial statements and reporting them in audited financial statements [19]. Companies that use the services of a qualified auditor are expected to be able to provide guaranteed results on the quality of their tax information. The higher the audit quality, the more the company will not manipulate earnings in the interests of the company [20]. This is contrary to the results of research conducted by [21]; [22], which shows that audit quality does not affect tax avoidance.The results of different studies raise opportunities for conducting panels on tax avoidance, especially in public companies. It is interesting to do research in Indonesia considering that the practice of tax avoidance is still a hot topic.

II. LITERATURE REVIEW AND HYPOTHESES DEVELOPMENT

2.1 Agency Theory

Agency theory can be described as the contract of a person or several people who give authority to other people as agents in making decisions and carrying out company activities [23]. Agency theory arises when shareholders recruit other people to run their companies. Agency theory is a theory that explains the working relationship between company owners and management.

The relationship between agency theory and tax avoidance is that in a company the tax costs are still material. That make the management reduces the company's tax costs. The allocation that should be able to pay taxes is not paid and become an advantage for the company. It can improve company's image in the eyes of investors [3]. The company's image can also decrease if the tax planning undertaken is not appropriate, which results in a loss of investor confidence.

2.2 Tax Avoidance

Tax avoidance is a legal reduction activity by optimally utilizing the provisions in the field of taxation, such as taking advantage of things that have not been regulated and the weaknesses contained in tax regulations and withholdings that are still permitted [2]. Tax avoidance is indeed not included in terms of violating tax regulations, but it is included in one of the activities of active resistance where it will hinder the process of tax collection so that it will result in reduced state revenues. Tax avoidance in this study is measured using the Cash Effective Tax Rate (CETR) as is done [24] in order to know the comparison of cash used as a tax expense with profit before tax in the relevant year. The lower the CETR value, the higher the level of tax avoidance.

2.3 Character Executive

An executive is someone who holds an important position in a company and has a strong role in decision-making. The executive character is divided into two types, risk-taker and risk-averse. Risk takers are more daring in making decisions, meanwhile risk-averse people are less daring in making decisions because they do not like risk [25]. The higher the level of risk taken by an executive, the greater the indication that the person is engaging in tax evasion because he is likely to generate higher profits. This is the opposite of an executive who has a risk-averse character because they tend to avoid risk. This statement is supported by [13] and [14], which state that the executive character has a positive influence on tax avoidance. On the other hand, the results of [26] stated that the executive character is rejected because it does not affect tax avoidance.

H1: Executive character affectstax avoidance.

2.4 ThinCapitalization

Thin capitalization is the formation of a capital structure with a combination of debt and equity that is greater than the capital [27]. Thin capitalization is more directed at funding business operations that prefer debt compared to owned capital. As the value of debt increases, the interest payable to creditors will also decrease, which will reduce the value of taxable profit, it makes the tax liability also be decreased. This strategy is then used by the company to avoid tax by increasing the debt-to-equity ratio [28].The rules regarding thin capitalization in Indonesia are regulated in [29], which is set at a maximum of four to one (4:1). This statement, with the results of research capitalization by [3]; [14]; [16], are able to prove that thin capitalization has an effect on tax avoidance.

H2: Thin capitalization affectstax avoidance.

2.5 Audit Quality

Audit quality is a collection of possibilities that can occur as a result of errors or violations found by the auditor when auditing financial statements and reporting them in audited financial statements [19]. Audit quality is one of the important factors in choosing the services of an auditor that the results obtained become higher quality. Companies need auditors to ensure the quality of information related to tax regulations. Audit quality is measured using the attitude of professionalism, integrity, accountability, and transparency [30].

Audit quality itself become a benchmark in assessing the credibility of a company's financial statements. Auditors who have good quality tend to maintain or even improve their performance, integrity, and transparency in order to maintain their image as auditors. The results of research conducted by [30] show that audit quality has no effect on audit quality. This is contrary to the results of research conducted by [19], which states that audit quality affects tax avoidance.

H3: Audit quality affectstax avoidance.

2.6 Political Connections

Political connections within the company are companies that haveacertain affinitywithpoliticians and the government. Political connections are considered one of the profitable sources because of the protection from the authorities to reduce transparency in the financial statements. [31] states that power is used in the process of increasing economic status in a group as a regulatory requirement.

Political connections basically have both positive and negative sides. The negative side is shown by the results of research obtained by [32], which states that companies whose leaders have political connections have a lower performance about 37% compared to companies that have no political connections at all. The results of the study are measured using the company's stock return. The positive side of having political connections is having easy access in terms of lower taxes, debt financing, and wider marketing access.

Political connections, according to [33], is measured by analyzing the main shareholders, company leaders, and the board of commissioners who have a relationship as a member of the minister, parliament, government official, or have a relationship with politicians or political party. Research conducted by [34]; [35]; [36] has the result that there is an influence caused by political connections on aggressive tax evasion. This result is also supported by research conducted by [37], which says that political connections can strengthen the effect of tax audit effectiveness on tax avoidance.

H4: Political connection affectstax avoidance.

III. METHOD

3.1 Population and Sample

The population in this study is manufacturing companies that have been listed on the Indonesia Stock Exchange (IDX) in the 2018-2020 periods, as many as 73 companies. The sampling technique in this research is using purposive sampling on the assessment of certain characteristics that are adapted to this research. Certain characteristics use in sampling are: (1) Manufacturing companies that listed on the IDX during the 2018-2020 period; (2) Companies have a fiscal year that ends on December 31; (3) Companiesare having and presenting data related to research variables; (4) Companies are not incurring losses and using rupiah currency between 2018 and 2020.The results of the sampling that meet the criteria of 73 companies with a total research sample of 219 financial statements are then outliers as many as 22 financial statements and the total sample use after the outlier is 197 data.

3.2 Variable Measurement

The variables of this study are measure using various measurements. The variable measurement are:

- Tax Avoidanceis the dependent variable that is calculated through the company's Cash Effective Tax Rate (CETR) by dividing the cash that has been spent on tax costs by profit before tax.The formula for calculating CETR is:

$$\text{CETR} = \frac{\text{Tax Expense}}{\text{Profit Before Tax}}$$

- Executive Characteris an independent variable that is identified using the company's risk [38]. Corporate risk reflects the standard deviation of earnings, either under-planned or over-planned. The higher the value obtained from the deviation of earnings, the greater the risk the company will face. The company's risk ratio, according to [38], is calculated by the standard deviation of EBITDA divided by the company's total assets using the formula:

$$\text{RISK} = \sqrt{\frac{\sum_{T-1}^{T}\left(E - 1/T\sum_{T-1}^{T} E\right)^{2}}{T-1}}$$

E is EBITDA, which isdivided by the total assets of the company. The greater the company risk indicates that the executive character is a risk taker, meanwhile the smaller the company risk indicates that the executive character is risk averse [24].

- Thin Capitalizationis the formation of a capital structure with a combination of debt and equity that is greater than the capital [27]. The company increasethe experience of thin capitalization if the ratio of the resulting debt ratio is higher than the formula:

$$\text{MAD} = \frac{\text{Average of Debt}}{\text{Company Safe Harbour Debt Amount (SHDA)}}$$

Note :SHDA = (Average Total Assets-Debt not related to Interest) x 80%

- Political Connectiondeterminesusing a dummy scale where 1 means the company has political connections meanwhile 0 means the company has no political connections.The criteria use in measuring political connections are adapted from research conducted by [33], if a company has one of the following characteristics:
  - There is one director or commissioner who is a member of the board, cabinet member, government official, or member of a political party (including the military).
  - One director or commissioner is a former board member, cabinet member, or government official (including military service).
  - There is at least one shareholder who is a member of a political party, has a relationship with a politician and/or official, or is a former government official (including the military).
- Audit Qualityis a collection of possibilities that can occur as a result of errors or violations found by the auditor when auditing financial statements and reporting them in audited financial statements [19]. The indicator uses for this study is dummy variable where a value of 1 means the company is audited by the Big Four CPAs, namely Price Waterhouse Cooper (PWC), Deloitte Touche Tohmatsu, KPMG, Ernst & Young (E & Y), and a value of 0 means the company is not audited by the Big Four CPAs.

3.3 Data Analysis Model

This study aims to determine the relationship and influence between the independent variable and the dependent variable. The multiple linear regression test equations in this study are:

$$\mathrm{CETR} = \mathrm{a} + \mathrm{b}_1\mathrm{KE} + \mathrm{b}_2\ \mathrm{TC} + \mathrm{b}_3\ \mathrm{KA} + \mathrm{b}_4\ \mathrm{KP} + \mathrm{e}$$

Note:
CETR = Tax Avoidance
KE = Excecutive Character
TC = Thin Capitalization
KA = Audit Quality
KP = Political Connection

IV. RESULT AND DISCUSSION

Table 1. Descriptive Statistics

Variable	Total	Minimum	Maximum	Mean	Standard Deviation
Excecutive Character (KE)	197	0.00	0.24	0.0376	0.03830
Thin Capitalization (TC)	197	0.10	22.47	0.7460	1.81768
Audit Quality (KA)	197	0.00	1.00	0.2944	0.45694
Political Connection (KP)	197	0.00	1.00	0.4822	0.50096
Tax Avoidance (CETR)	197	0.00	0.54	0.2524	0.06621

Source: Data processed, 2022

Based on Table 1, the number of data samples taken is 197 manufacturing companies that are listed on the IDX in 2018-2020. The executive character (KE) shows a minimum value of 0.0 and a maximum value of 0.24. The average value ofKE variable is 0.0376 with a standard deviation of 0.03830. Thin Capitalization(TC) shows a minimum value of 0.10 and a maximum value of 22.47. The average of thin capitalization variable is 0.7460 with a standard deviation of 1.81768. Audit Quality (KA) shows a minimum value of 0.00 and a maximum value of 1.00. The average of audit quality variable is 0.2944 with a standard deviation of 0.45694. Political Connection(PC) shows a minimum value of 0.00 and a maximum value of 1.00. The average of political connection variable is 0.4822 with a standard deviation of 0.50096. Tax Avoidance (CETR) shows a minimum value of 0.00 and a maximum value of 0.54. The average of tax avoidance variable is 0.2524 with a standard deviation of 0.06621.

Table2. Classic Assumption Test Results

Variable	Multicollinearity Test Result		Heteroscedasticity Test Result
	Tolerance	VIF	
Excecutive Character (KE)	0.983	1.018	0.553
Thin Capitalization (TC)	0.985	1.015	0.751
Audit Quality (KA)	0.819	1.221	0.212
Political Connection (KP)	0.806	1.240	0.353
Run Test (Asymp. Significance 2-tailed)	0.075		

Source: Data processed,2022

In this study, the normality test using the Central Limit Theorem(CLT) test is the assumption that normality can be ignored if the number of observations is large enough (n > 30). The number of observations in this study amounted to 189, which means > 30. This indicates that the data is normally distributed and can be referred to as a large sample. Based on Table 2, the multicollinearity test results show that the VIF value for the independent variable KE is 1.018, the TC variable is 1.015, the KA variable is 1.221, and the KP variable is 1.240. The tolerance value for the KE variable is 0.983, the TC variable is 0.985, the KA variable is 0.819, and the KP variable is 0.806. The conclusion obtains that there is no multicollinearity because all variables in this study have tolerance values > 0.1 and VIF 10. This study dosenot show heteroscedasticity symptoms because all variables had significant values > 0.05. The KE variable has a significat value of 0.553; the variable TC has a value of significance of 0.751; the variable KA has a value of significance of 0.212; and the KP variable has a significance value of 0.353. This study tests the autocorrelation with the Run Test methods. Table 2 obtain the value of asymptotic sig. (2-tailed) of 0.075, which means there is no autocorrelation because the significance value is more than 0.05.

Table 3. Hypothesis Testing Results

Variable	Reggresion Coefficients	Significance	Description
Excecutive Character (KE)	-0,174	0,158	H1 rejected
Thin Capitalization (TC)	0,002	0,548	H2 rejected
Audit Quality (KA)	0,013	0,256	H3 rejected
Political Connection (KP)	-0,027	0,010*	H4 accepted
Constant	0,267		
Adjusted R^2	0,033		
F value	2,647	0,035	

*Significance at 0,05

Source: Data processed,2022

This test uses multiple regression analysis with the following equation:

$$\mathrm{CETR} = 0{,}267 - 0{,}174\mathrm{KE} + 0{,}002\mathrm{TC} + 0{,}013\mathrm{KA} - 0{,}027\mathrm{KP} \quad + \mathrm{e}$$

The results of the F test is2.647 with a significance level of 0.035. This regression model is feasible in the next analysis because the significance level of the F test results is > 0.05. This regression model can be used to predict the independent variables of executive character (KE), thin capitalization (TC), audit quality (KA), and political connection (KP) and the model is fit to tax avoidance (CETR).

Hypothesis testing of the executive character variable obtains a significance level of 0.158, which means that the executive character does not affect tax avoidance because the significance value is >0.05 and H1 is rejected. The executive character has a regression coefficient value of -0.174, which means that if the value of the executive character increases, the value of tax avoidance will decrease.

Hypothesis testing of the thin capitalization variable is obtained a significance of 0.548, which means that thin capitalization does not affect tax avoidance because the significance value is >0.05 and H2 is rejected. Thin capitalization has a regression coefficient of 0.002, which means that if the value of thin capitalization increases, the value of tax avoidance will also increase.This means that if the company increases the amount of the company's debt, the company will increase the tax base. These results are in line with the research of [17].

Hypothesis testing of the audit quality variable is obtained a significance level of 0.256, which means that audit quality does not affect tax avoidance because the significance value is >0.05 and H3 is rejected. Audit quality has a regression coefficient value of 0.013, which means that if the value of audit quality increases, the value of tax avoidance will also increase.This is in line with the results of research conducted by [21]; [22]; [40], which found that audit quality has no effect on tax avoidance.

Hypothesis testing of the political connection variable obtained a significance level of 0.010 which means that political connections affect tax avoidance because the significance value is< 0.05 and H4 is accepted. Political connection has a regression coefficient value of -0.027, which means that if the value of political connection increases, the value of tax avoidance will decrease. This result proves that politically connected companies can be an opportunity to practice tax avoidance. This finding also supports the findings of [39], which state that there are overlapping policies between public and private that show assistance in the form of corporate tax relief. This result is in line with research by [34], which shows that there is an influence caused by political connections on aggressive tax avoidance.

V. CONCLUSION

The results show that executive character, thin capitalization and audit quality have no effect on tax avoidance, whereas political connections affect tax avoidance. It is showed that political connections has an affect on tax avoidance by reducing the tax that should be paid by the companies. This research is still conducted in the short-term periods, further researches are needed to explore the tax avoidence in mid-term or long-term periods.Another research can explore other variables that affect tax avoidance and increase the number of samples and populations that make the dataset used is more extensive.

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