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**| RESEARCH ARTICLE**

# The Effect of Transfer Pricing, Capital Intensity, and Earnings Management on Tax Avoidance

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**| ABSTRACT**
Taxation is a mechanism for collecting state revenues and an instrument of a country's fiscal policy. However, tax is a burden for the company. So the company's management is interested in maximising profits by avoiding taxation. This study aims to determine the effect of transfer pricing, capital intensity, and earnings management on tax avoidance in manufacturing companies listed on the Indonesia Stock Exchange for the 2015–2019 period. The determination of the research sample was made using the purposive sampling method, with a total sample of 66 companies, to obtain 330 data. The software used is E-views 9. Tax avoidance was proxied by the cash effective tax rate; transfer pricing was proxied by the ratio of related party sales transactions to total sales; capital intensity was proxied by the percentage of total fixed assets to total company assets, and earnings management was proxied by the modified Jones discretionary accrual model. The results show that transfer pricing, capital intensity, and earnings management significantly affect tax avoidance simultaneously or partially.

**| KEYWORDS**

Transfer Pricing, Capital Intensity, Earnings Management, Tax Avoidance

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## 1. Introduction

Taxes are a burden for the company. Company management is interested in maximising profits by streamlining various burdens, including avoiding tax. Tax avoidance is an effort to take advantage of loopholes in the tax law to ease the tax burden without violating the tax law (Abdullah, 2019). Companies often use grey regulations to obtain favourable tax outputs through tax avoidance (Dyreng et al., 2008). One of the company's motives for practising tax avoidance is to increase profits as expected by shareholders, and company managers carry out its implementation (Desai & Dharmapala, 2006).

Tax avoidance is frequently viewed negatively by the tax authorities, even though the action does not violate tax rules (Sari, 2014). Because tax avoidance is an effort to reduce taxes in the grey area of taxation regulations and is not illegal. However, tax avoidance can result in reduced state revenues, especially in the tax sector, resulting in losses for the state.

Illicit funds leaving Indonesia in 2004–2013 totalled 180.71 billion US dollars (Kar & Spanjers, 2015). Furthermore, The State of Tax Justice 2020 revealed that Indonesia suffered a US $4.86 billion loss per year due to tax avoidance activities. This value comes from the US $4.78 billion in corporate tax avoidance, and the remaining US $78.83 million comes from individual taxpayers. The primary purpose of taxpayers avoiding tax by not reporting the actual profit is to reduce the tax burden that should be paid (Cobham et al., 2020).

The above phenomenon aligns with the agency theory. As principal, the Directorate General of Taxes authorises companies to calculate and report their tax payments by referring to the applicable tax laws. But on the other hand, the company's management as an agent is interested in generating the maximum possible profit with the most efficient burdens potential. That's why the company's management will try to minimise all burdens, including tax, by avoiding tax. Several factors influence corporate tax avoidance activities, such as transfer pricing, capital intensity, and earnings management. This can lead to problems with

information asymmetry, such as the chance that company management could do things that are not in the best interest of the Directorate General of Taxes.

## 2. Literature Review

### *2.1 Agency Theory*

An agency relationship is a work contract between the principal and management (agent). Management is given the authority to do the work and decision-making authority on behalf of the principal so that the principal gets the maximum benefit (Jensen & Meckling, 1976). This separation can cause problems, namely the possibility of management taking actions that are not in line with the wishes or interests of the principal due to information asymmetry.

### *2.2 Tax Avoidance*

Tax avoidance is an effort to use loopholes in the tax law to cut down on the number of money taxpayers pay but not break the law (Abdullah, 2019).

### *2.3 Transfer Pricing*

Transfer pricing is a tool or instrument used by multinational companies to reduce their overall tax liability, resulting in reduced tax revenues in the country where the global company conducts its business operations (Awodiran, 2014). According to Dharmawan et al. (2017) and Lutfia & Pratomo (2018), transfer pricing is a factor that has a significant effect on tax avoidance. The following hypothesis is proposed in this study based on previous research :

**$H_1$: Transfer Pricing has a significant effect on Tax Avoidance**

### *2.4 Capital Intensity*

Capital intensity is an investment activity carried out by a company related to investment in fixed assets (Jusman & Nosita, 2020). In addition, capital intensity is also one of the factors that influence tax avoidance strategies (Kasim & Saad, 2019). Large companies often use accounting procedures to lower profits to pay more taxes. They do this by investing profits in fixed assets, which will be depreciated and cause depreciation burdens at the end of each period to lower company profits. According to Mailia & Apollo (2020) and (Kasim & Saad, 2019) found a significant effect between capital intensity and tax avoidance. The following hypothesis is proposed in this study based on previous research :

**$H_2$: Capital Intensity has a significant effect on Tax Avoidance**

### *2.5 Earnings Management*

Scott (2009) defines earnings management as selecting accounting policies by managers from existing accounting standards and can naturally maximise their utility and market value. Septiadi et al. (2017) state that earnings management is a factor that can affect a company's tax avoidance actions, where the higher the company's earnings management, the smaller the tax burden paid by the company because profit is one of the references in the reference in the calculation of income tax in Indonesia. According to Amidu et al. (2019) and Purba (2018) found a significant effect between earnings management and tax avoidance. The following hypothesis is proposed in this study based on previous research :

**$H_3$: Earnings Management has a significant effect on Tax Avoidance**

The framework of this research can be described as follows:

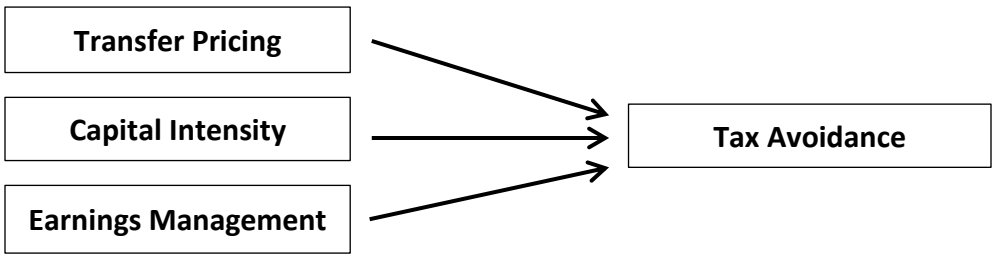


**Figure 2.1 Framework of Thinking**

## 3. Methodology

This research is quantitative and aims to analyse the effect of independent variables, transfer pricing ($X_1$), capital intensity ($X_2$), and earnings management ($X_3$), on the dependent variable, tax avoidance (Y). The population in this study was composed of 185 manufacturing companies in Indonesia, and the research sample was determined using the purposive sampling technique. From the results of the sample screening, 66 companies were identified in the 5-year observation period from 2015 to 2019. The data sources were from the website www.IDX.co.id and the official websites of the sample companies to obtain financial reports and company annual reports. Data analysis was carried out by panel data regression and using the E-views 9 application as a tool to analyse data. There are four stages of research methods: 1) Descriptive statistical analysis; 2) Panel data regression analysis; 3) Classical assumption test, and 4) Hypothesis testing. The operationalisation of variables in this study is as follows :

**Table 3.1 Variable Measurement Scale**

| No. | Variables | Indicator | Measurement Scale |
|---|---|---|---|
| 1 | Tax Avoidance (Y) (Dewinta & Setiawan, 2016) | $\text{CETR} = \frac{\text{Cash Tax Paid}_{i,t}}{\text{Pre} - \text{tax Income}_{i,t}}$ | Ratio |
| 2 | Transfer Pricing ($X_1$) (Yanti & Pratiwi, 2021) | $\text{Transfer Pricing} = \frac{\text{Related Party Sales}}{\text{Total Sales}}$ | Ratio |
| 3 | Capital Intensity ($X_2$) (Kasim & Saad, 2019) | $\text{CAP} = \frac{\text{Total Fixed Assets} - \text{Acc. Depreciation of Fixed Assets}}{\text{Total Assets}}$ | Ratio |
| 4 | Earnings Management ($X_3$) (Dechow et al., 1995) | Discretionary accruals by jones modified model:<br>a) $TAC_{it} = NI_{it} - CFFO_{it}$<br>b) $\frac{TAC_{it}}{TA_{it-1}} = \alpha_1\left(\frac{1}{TA_{it-1}}\right) + \alpha_2\left(\frac{\Delta REV_{it}}{TA_{it-1}}\right) + \alpha_3\left(\frac{PPE_{it}}{TA_{it-1}}\right)$<br>c) $NDA_{it} = \alpha_1\left(\frac{1}{TA_{it-1}}\right) + \alpha_2\left(\Delta REV_{it} - \frac{\Delta REC_{it}}{TA_{it-1}}\right) + \alpha_3\left(\frac{PPE_{it}}{TA_{it-1}}\right)$<br>d) $\text{DA}_{it} = \left(\frac{\text{TAC}_{it}}{\text{TA}_{it}}\right) - NDA_{it}$ | Ratio |

Source: Data processed by researchers in 2022

## 4. Results and Discussion

### *4.1 Descriptive Statistical Analysis*

**Table 4.1 Descriptive Statistical Results**

| | PP | TP | IM | ML |
|---|---|---|---|---|
| Mean | 0.551093 | 0.165152 | 0.353193 | -0.016064 |
| Median | 0.279940 | 0.020904 | 0.328684 | -0.017560 |
| Maximum | 31.78402 | 0.945000 | 0.796561 | 0.329528 |
| Minimum | -0.417455 | 0.000000 | 0.001194 | -0.368196 |
| Std. Dev. | 1.901296 | 0.268815 | 0.166838 | 0.077898 |
| Skewness | 13.99621 | 1.622490 | 0.260639 | 0.299245 |
| Kurtosis | 224.0926 | 4.258825 | 2.404289 | 6.544112 |
| Jarque-Bera | 682900.9 | 166.5749 | 8.615797 | 177.6352 |
| Probability | 0.000000 | 0.000000 | 0.013462 | 0.000000 |
| Sum | 181.8606 | 54.50001 | 116.5537 | -5.300962 |
| Sum Sq. Dev. | 1189.310 | 23.77412 | 9.157657 | 1.996418 |
| Observations | 330 | 330 | 330 | 330 |

Source: Eviews 9, 2022

The minimum score for tax avoidance (PP) of -0.417455 was found in DPNS in 2019, while the highest score was at VOKS in 2015, which is 31.78402. The maximum score for transfer pricing (TP) of 0.945000 was found in TOTO in 2015, and the minimum value of 0.0000 which indicates that there are no sales transactions to related parties in the company, was contained in 69 sample data, one of which is ADES in 2015-2019. The lowest score for capital intensity (IM) of 0.001194 was found in STAR in 2019, and the highest score was at SMBR with a value of 0.796561 in 2016. The lowest score for earnings management (ML) of -0.368196 was found at BIMA in 2015, and the highest value of 0.329528 was found in HMSP in 2015.

### *4.2 Panel Data Regression Analysis*

### *4.2.1 Chow Test*

**Table 4.2 Chow Test**

| Effects Test | Statistic | d.f. | Prob. |
|---|---|---|---|
| Cross-section F | 1.093464 | (65,261) | 0.3091 |
| Cross-section Chi-square | 79.477513 | 65 | 0.1068 |

Source: E-views 9, 2022

The value of the cross-section F probability obtained is 0.3091 > 0.05, so the Common effect model is better than the Fixed Effect Model.

### *4.2.2 Hausman Test*

**Table 4.3 Hausman Test**

| Test Summary | Chi-Sq. Statistic | Chi-Sq. d.f. | Prob. |
|---|---|---|---|
| Cross-section random | 3.235584 | 3 | 0.3567 |

Source: E-views 9, 2022

The Chi-Square probability value obtained is 0.3567 > 0.05, so the Random Effect Model is better than the Fixed Effect Model.

### *4.2.3 Lagrange Multiplier Test*

**Table 4.4 Lagrange Multiplier Test**

| | Test Hypothesis | | |
|---|---|---|---|
| | Cross-section | Time | Both |
| Breusch-Pagan | 0.044847 | 0.182658 | 0.227504 |
| | (0.8323) | (0.6691) | (0.6334) |

Source: E-views 9, 2022

The probability of Breush-Pagan's cross-section is 0.8323 > 0.05, so the common effect model was chosen. Based on the test results in this study, the most suitable model is the Common Effect Model.

### *4.3 Classical Assumption Test*

### *4.3.1 Multicollinearity Test*

**Tabel 4.5 Multicollinearity Test**

| | TP | IM | ML |
|---|---|---|---|
| TP | 1.000000 | 0.002664 | -0.046909 |
| IM | 0.002664 | 1.000000 | -0.081178 |
| ML | -0.046909 | -0.081178 | 1.000000 |

Source: Eviews 9, 2022

Based on the results of the multicollinearity test, the correlation coefficient between the independent variables is less than 0.80. So it can be concluded that there is no correlation between the independent variables.

### *4.3.2 Heteroscedasticity Test*

**Table 4.6 Heteroscedasticity Test**

| Component | Unweighted Common Effect Model | Weighted Common Effect Model |
|---|---|---|
| Probability F Statistic | 0,690029 | 0,000000 |
| Determination Coefficient | -0,004680 | 0,217706 |
| Probability t Statistic | 0 variable < 0.05 | 3 variables < 0.05 |

Source: Eviews 9, 2022

Based on the test results in the table above, the selected model is the Weighted Common Effect Model. The Weighted Common Effect Model probability showing a value of 0.0000 is less than 0.05, so there is no heteroscedasticity problem.

### *4.3.3 Autocorrelation Test*

Autocorrelation is a condition with a correlation between observations, time series and cross-sections. Panel data naturally contains both of these. Therefore, the autocorrelation test is ignored (Ghozali & Ratmono, 2013).

### *4.4 Hypothesis Test*

**Tabel 4.7 Weighted Common Effect Model**

| Variable | Coefficient | Std. Error | t-Statistic | Prob. |
|---|---|---|---|---|
| C | 0.526812 | 0.030797 | 17.10571 | 0.0000 |
| TP | -0.238582 | 0.026762 | -8.914954 | 0.0000 |
| IM | -0.242133 | 0.076468 | -3.166444 | 0.0017 |
| ML | -0.338574 | 0.138342 | -2.447371 | 0.0149 |
| Weighted Statistics | | | | |
| R-squared | 0.224840 | Mean dependent var | | 2.439147 |
| Adjusted R-squared | 0.217706 | S.D. dependent var | | 2.732742 |
| S.E. of regression | 1.625586 | Sum squared resid | | 861.4647 |
| F-statistic | 31.51941 | Durbin-Watson stat | | 0.971427 |
| Prob(F-statistic) | 0.000000 | | | |
| Unweighted Statistics | | | | |
| R-squared | -0.002240 | Mean dependent var | | 0.551093 |
| Sum squared resid | 1191.974 | Durbin-Watson stat | | 1.263746 |

Source: Eviews 9, 2022

**Y = 0,526812 – 0,238582 TP – 0,242133 IM – 0,338574 ML + e**

#### 4.4.1 *Coefficient of Determination Test (Adjusted $R^2$ Test)*

Based on the test results, the adjusted $R^2$ value is 0.217706, which means the ability to explain the independent variable to the dependent variable contained in the model is low and contributes to the dependent variable by 21.77%. The remaining 78.23% are other independent variables that the researcher did not examine.

#### *4.4.2 Simultaneous Test (F Statistic Test)*

The results of the F test showed that the Prob (F-statistic) was 0.0000 < 0.05, with an error rate of 5%, which means that the model is fit. So, transfer pricing, capital intensity, and earnings management significantly affect tax avoidance simultaneously.

#### 4.4.3 *Partial Test (t-Test*)

1. The coefficient value of transfer pricing is -0.238582 with a significance value of 0.0000 < 0.05, so $H_0$ is rejected, and $H_1$ is accepted. This means that transfer pricing has a significant effect on tax avoidance.
2. The coefficient value of capital intensity is -0.242133 with a significance value of 0.0017 < 0.05, so $H_0$ is rejected, and $H_2$ is accepted. This means that capital intensity has a significant effect on tax avoidance.
3. The coefficient value of earnings management is -0.338574 with a significance value of 0.0149 < 0.05, so $H_0$ is rejected, and $H_3$ is accepted. This means earnings management has a significant effect on tax avoidance.

### *4.5 Discussion*

#### *4.5.1 The Effect of Transfer Pricing on Tax Avoidance*

Based on the results of statistical tests, it shows that transfer pricing proxied by related-party sales transactions has a significant effect on tax avoidance. This proves that the greater the difference in tax rates and the higher the sales volume to related parties, the smaller the company must pay. The results of this study are in line with agency theory. Namely, management utilises sales to related parties located in countries with lower tax rates to get more profit and reduce taxes that should be paid. The company's management can regulate transfer prices to associated parties by referring to the arm's length principle. However, companies often take advantage of loopholes in the rules to transfer profits between companies by making transactions with related parties at different tax rates in other countries. Transfer pricing carried out by multinational companies is to sell goods below the market

price or a set fair price and buy them above the market price to minimise the tax burden (Nugroho et al., 2018). The results of this study are in line with Jacob (1996) and Lutfia & Pratomo (2018).

#### *4.5.2 The Effect of Capital Intensity on Tax Avoidance*

The statistical tests indicate that capital intensity has a significant effect on tax avoidance. Capital intensity is a measurement of a company's fixed-asset investment effectiveness. The results of this study are in line with agency theory, where management, as an agent, may have the motivation to act inconsistently with the interests of shareholders. Company management uses idle funds to procure fixed assets (Dharma & Ardiana, 2016). The company's increasing investment in fixed assets, which is growing, will increase the depreciation expense borne by the company. The company's management can use the depreciation expense to benefit from reducing taxable profit. This shows that companies with a large proportion of fixed assets tend to avoid tax because there is a decrease in profits that comes from the depreciation of fixed assets, resulting in a lower tax burden to be paid. Also, Mailia & Apollo (2020) and Kasim & Saad (2019) align with this study.

#### *4.5.3 The Effect of Earnings Management on Tax Avoidance*

The Statistical tests indicate that earnings management significantly affects tax avoidance. These results are in line with agency theory. Namely, management is interested in optimising earnings by performing earnings management to influence the amount of tax paid by the company. Companies often use earnings management practices for tax avoidance to minimise income by recognising marketing costs and research and development costs more quickly. Septiadi et al. (2017) found that earnings management is a factor that can affect a company's tax avoidance actions, the higher the company's earnings management, the smaller the tax burden paid by the company because profit is one of the references in the income tax calculation in Indonesia. In addition, Waluyo (2018) finds that companies tend to use taxes efficiently by maximising costs to reduce income by using debt. This research aligns with Wang & Chen (2012) and Darma et al. (2019).

## 5. Conclusions and Suggestions

### *5.1 Conclusions*

Based on the research results, it can be concluded that transfer pricing proxied by related-party sales transactions has a significant effect on tax avoidance in manufacturing companies listed on the Indonesia Stock Exchange. The more important the difference in tax rates, and the higher the volume of sales to related parties, the smaller the tax that the company must pay. Capital intensity as proxied by the ratio of net fixed assets to total assets significantly affects tax avoidance. Companies with a large proportion of fixed assets tend to avoid tax because the depreciation expense can be a deduction from the tax cash that the company must pay. As proxied by Discretionary Accruals, Earnings Management has a significant effect on tax avoidance. This shows that the higher the company's earnings management, the lower the tax paid by the company.

### *5.2 Suggestions*

Further research is expected to add other variables that are indicated to affect tax avoidance, but have not been included in this study and use samples of other sector companies to find out indications of tax avoidance from sectors other than manufacturing. Furthermore, the company should avoids sales transactions to related parties whose transfer pricing is not governed by the arm's length principle, investments in fixed assets that are too large, and earnings management as tax avoidance factors. The management also needs to increase their knowledge of taxation to avoid sanctions for illegal tax avoidance practices that can damage the company's reputation in the eyes of shareholders. For regulators to pay attention to companies that have transactions with related parties, the proportion of fixed assets and earnings management but with a low level of tax payment can be considered in determining tax policies related to tax avoidance in Indonesia.

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