# CHAPTER I

# INTRODUCTION

## 1.1. Background of the Study

State funding comes from a variety of sources, both internal and external. Taxes are one source of state revenue from the internal sector, while foreign loans are a source of revenue from the external sector. Tax receipts continue to be the primary source of revenue for the Indonesian government (APBN). As a result, taxes have always been a priority for the government, as they are the most important component of the State Revenue and Expenditure Budget (APBN). According to the data given by the Central Statistics Agency or *Badan Pusat Statistik* (BPS), tax receipts account for around half of the state's revenue, with the remaining coming from non-taxes and grants. For this reason, taxes play a critical role in Indonesia's economy as it accounts for the biggest proportion of all other sources of income in Indonesia.

**Table 1.1 Realization of State Revenue 2017-2019 (in billions of rupiah)**

| Source of Revenue | 2017 | 2018 | 2019 |
|---|---|---|---|
| Tax | 1.343.529,80 | 1.518.789,80 | 1.546.141,90 |
| Non-tax | 311.216,30 | 409.320,20 | 408.994,30 |
| Grant | 11.629,80 | 15.564,90 | 5.497,30 |

Source: *Badan Pusat Statistik* (2021)

According to Organisation for Economic Cooperation and Development (OECD), in 2019, Indonesia's tax-to-GDP ratio was 11.6%, 9.5 percentage points lower than the Asia and Pacific average of 21%. It was also 22.3 percentage points lower than the OECD average of 33.8% (Organisation for Economic Cooperation and Development, 2021). The low tax ratio demonstrates that public awareness of the importance of paying taxes remains low, as well as the government's ability to investigate tax income streams from diverse economic sectors. In terms of the ideal size of the tax ratio that Indonesia should have, the Director General of Taxes declared that the optimal proportion according to international standards, namely 15% and above (Ministry of Finance of Republic of Indonesia, 2019).

**Table 1.2 Indonesia's Tax Ratio 2017-2019**

| Year | Tax Ratio |
|---|---|
| 2017 | 10,7% |
| 2018 | 11,4% |
| 2019 | 11,6% |

Source: Ministry of Finance of Republic of Indonesia (2019)

The government's execution of tax collection does not always receive positive feedback from businesses, despite the fact that taxes play a vital role in the state's functioning. Because taxes, according to the firm, are a burden that might reduce profitability. The interests of taxpayers and the government are completely contradictory. For the government, large taxes can provide large funds for government administration. Taxpayers, on the other hand, attempt to make as few tax payments as possible in order to lower tax payments and so reduce their economic capability. This difference in interests will lead to noncompliance by taxpayers, who will be more likely to lower the amount of their tax payments, both legitimately and illegally, allowing for tax avoidance possibilities.

Taxes are viewed by the firm as an out-of-pocket charge that has no direct impact on the company's performance. Apart from not making a direct contribution, the company's and government's differing viewpoints and interests have resulted in a slew of tax avoidance schemes. The government tries to collect as much tax as possible from companies or economic actors striving to finance minimal taxation. This disagreement of opinion serves as a model for inappropriately handling taxes. As a result, many taxpayers engage in tax avoidance tactics.

Tax avoidance is described as one of the measures done by taxpayers to lower their tax burden in a lawful and non-violent manner. The method is carried out by taking advantage of flaws in tax rules and regulations to lower the amount of tax owed so that business transactions are not taxed. To increase earnings, businesses attempt to reduce their tax payments as much as possible. Tax avoidance is a type of tax planning that focuses on the process of structuring company and corporate transactions in such a way that tax debts are kept to a minimum while being compliant with tax legislation. Tax avoidance is still deemed legal if it is done within acceptable limitations and in accordance with the law and regulations; otherwise, it is termed tax avoidance. Tax avoidance is a complex and unique problem since, on the one hand, it is not regarded a violation of the law, but on the other hand, it is undesired because it is harmful to the economy.

One of the metrics to measure tax avoidance is Cash Effective Tax Rate (CETR). Cash Effective Tax Rate (CETR) is a cash tax rate that compares the amount of cash spent on tax expenses to earnings before taxes. CETR is the most relevant measurement to describe the actual situation of a corporation in terms of tax avoidance strategies because it considers the taxes that have been paid in measuring tax avoidance. The use of the CETR measurement in measuring tax avoidance is good for describing tax avoidance activities by companies, according to Dyreng et al. (as cited in Sari & Devi, 2018), because the CETR (Cash Effective Tax Rate) is not affected by changes in estimates such as allowances, tax assessment or tax protection. Therefore, in this research, tax avoidance is proxied by Cash Effective Tax Rate or CETR. The higher the CETR presentation level, which is close to the income tax rate of 25%, the lower the degree of tax avoidance by a company, on the contrary, the lower the CETR level, the higher the degree of tax avoidance.

Corporate governance is a framework for guiding and controlling businesses, according to the Organization for Economic Cooperation and Development. Therefore, if a firm has a well-structured corporate governance framework, it will immediately benefit the organization. Having a well-structured corporate governance framework is directly proportionate to complying with a company's tax responsibilities.

According to Sari and Devi (2018), since corporate governance is a determinant of the direction of company performance, it is claimed to be one of the factors of tax avoidance. However, the amount of corporations that engage in tax avoidance demonstrates that Indonesian public companies have not properly implemented corporate governance. Institutional ownership, independent commissioners, and audit committee are utilized as factors in this study to evaluate corporate governance.

A corporation with a high institutional ownership structure will have superior corporate governance because the higher the amount of institutional ownership, the greater the control exercised by institutional shareholders over company management performed by the board of directors. Meanwhile, the higher the proportion of independent commissioners on the board of directors, the more objective the board of commissioners on the board of directors' monitoring is, and the stronger corporate governance in a firm. In addition, a corporation with a large audit committee membership indicates that it has a solid level of transparency over financial reporting and internal control system, such as the efficacy of the external and internal auditors' examinations, as well as compliance with the law in the organization and its activities. The existence of these corporate governance mechanisms would therefore be beneficial in preventing tax avoidance practice.

Another factor that might affect tax avoidance is profitability. Profitability is measured using a variety of ratios, one of which is Return On Assets (ROA). Return on Assets (ROA) is a metric that measures a firm's financial performance; the higher the ROA value that a company can reach, the better its financial performance, the better its asset management, and the higher the profit earned by the organization. When a company makes a high profit, the tax borne by the firm rises in accordance with the increase in company profits, causing the company to engage in tax avoidance to reduce the amount of tax that must be paid.

Tax avoidance is influenced by leverage as well. Leverage is a ratio that determines how much of a company's funding comes from debt. In terms of taxes, if a corporation owes a lot of money in taxes, it will also owe a lot of money in debt. As a result, the corporation will attempt to avoid paying taxes. Debt to Equity Ratio (DER) is a ratio that determines how much of a company's debt is financed and how well it can meet its commitments with its equity. The higher the DER, the higher the ratio of total debt to total equity, implying that the company's external debt load is greater. The corporation will incur interest expenses as a result of the increased debt. Interest expenses will be incurred by companies that finance with debt; the more the debt, the higher the interest charges will be. Hence, the larger the debt, the more likely companies are to engage in tax avoidance practices (Purba, 2020).

This study examines the effect of corporate governance, profitability, and leverage on tax avoidance by looking at a sample of firms listed in LQ45 for five years using the criteria established by the researcher. The LQ45 index consists of fourty five issuers chosen for their high liquidity as well as a variety of other parameters, including market capitalization. The LQ45 index, in general, features companies that serve as a reference index for investors when making investment decisions, as companies on the index are thought to have good company values.

However, according to the findings on the prevalence of tax avoidance of firms listed on the IDX's LQ45 index shows that there have been a couple of examples of tax avoidance. One of the companies in the LQ45 index suspected of tax avoidance is PT Adaro Energy Tbk (ADRO). It is reported that Adaro Energy paid the Indonesian government US$125 million in lower taxes through its Singapore subsidiary coaltrade service between 2009 and 2017. Adaro took advantage of the loophole by selling lower-priced coal to Coaltrade Services International. The coal is then sold at a greater price to other countries. As a result, income taxation in Indonesia is lower. The Indonesian government lost around US$ 14 million each year during that time. Coaltrade's profits in Singapore, which are taxed at an average yearly rate of 10%, increased as a result of the increase in payments. Meanwhile, profits from Adaro's coal trading fees could be taxed at a higher rate in Indonesia, possibly as high as 50% (Friantin & Putri, 2020).

Another tax avoidance indication was suspected on the LQ45 index members, namely PT Bank Central Asia Tbk (BCA). This lawsuit comes from BCA's protest to the Directorate General of Taxes' tax rectification. BCA believes that the IDR 6.78 trillion fiscal profit should be decreased by IDR 5.77 trillion as a result of the rectification. Regarding asset transfer transactions, including guarantees amounting to Rp 5.77 trillion, which was carried out through a sale and purchase process with the *Badan Penyehatan Perbankan Nasional* (BPPN), as stated in the Sale and Purchase Agreement and Delivery of Receivables No. SP-165/IBRA/0600, BPPN managed to get asset recovery worth Rp 3.29 trillion. Meanwhile, the Directorate General of Taxes sees this case as the abolition of non-performing loans (NPLs). BCA claims that if this is referred to as the write-off of NPLs, the balance of bad debts will be on BCA's balance sheet as the company's assets. Then, after BCA's assets were transferred to BPPN, in 2003, there was evidence from BPPN that there was collateral that was collected in the amount of Rp 3.29 trillion that belonged to BPPN and did not belong to BCA. Due to the fact that BCA had completed a transaction to transfer assets to BPPN, BCA claimed that they had not broken any tax laws. However, a review of data from BCA's financial records indicates that income tax was underpaid between 2001 and 2008. BCA pays only approximately 20-22%, and it was barely 1.23% in 2001. In fact, corporate taxpayers with income above IDR 100 million are subject to a 30% tax rate under Law No. 17/2000 on income tax (Pangaribuan, 2018).

PT Bumi Resources Tbk (BUMI) was investigated for a tax avoidance case in 2007. This corporation and its subsidiaries, PT Kaltim Prima Coal (KPC) and PT Arutmin Indonesia, are accused of evading 2.1 trillion dollars in taxes. The Director General of Taxes has listed PT Bumi Resources' finance director and PT Kaltim Prima Coal's director as suspects in this case. PT JAPFA Comfeed Indonesia Tbk’s income tax was also examined by the Director General of Taxes, who discovered that the company underpaid 23.9 billion rupiah in income tax in 2014 (Laluhu, 2020).

An indication of tax avoidance was also recently discovered at PT Aneka Tambang Tbk (ANTM). The corporation was suspected of evading import duty and income tax by importing gold worth IDR 47.1 trillion using improper Harmonized System (HS) codes. This method is frequently carried out to avoid paying import duties by misrepresenting gold bullion as gold nuggets, which are exempt from duty (Timorria, 2021).

There are various perspectives on how institutional ownership, independent commissioners, and audit committees may have played a role in the aforementioned tax avoidance cases. It is possible that these companies have a poor institutional ownership structure, which leads to a lack of supervision and accountability over their management, resulting in dishonesty and misconduct. In the absence of independent commissioners and audit committee, the quality assurance system and decision-making objectivity may be called into question. The existence of an audit committee is pivotal in an organization. Audit committee plays a big role in consolidation of financial control within a company since it serves as a body that ensures the quality of any information and reports given by the firm, especially financial disclosure in the annual report (Setiany, Hartoko, Suhardjanto, & Honggowati, 2017). Therefore, audit committee may reduce the incidence of fraud and irregularities in financial reporting. Another reason these firms may avoid paying taxes is because they seek to decrease their tax liability as a result of their large business profitability. Finally, these firms may also avoid paying taxes as a result of high interest expenditures incurred from large company debt.

Previous research linking institutional ownership, independent commissioners, audit committee, profitability, leverage, and tax avoidance among others is found by Rahmawati, Wijayanti, and Masitoh (2018), a research on 11 mining sectors companies which found that institutional ownership, independent commissioners, and audit committee have insignificant effect on tax avoidance, while profitability and leverage have negative significant effect. While the research conducted by Dewi (2019) that examined 115 banking sectors companies concluded that institutional ownership and independent comissioners had a positive significant effect on tax avoidance, while audit committee did not affect tax avoidance. On the contrary, Saputri and Husen (2020) who examined 9 manufacturing companies, discover that independent commissioners and institutional ownership had an insignificant effect on tax avoidance, while audit committee had a significant effect on tax avoidance. Meanwhile, the study by Aris and Agustina (2017) who manufacturing companies, found that there was a positive significant effect between leverage on tax avoidance while the firm size did not. Another research conducted by Barli (2018) who examined 34 property and real estate companies, concluded that there was a positive significant effect between leverage on tax avoidance while the firm size did not. Based on these studies, it appears that independent commissioners, institutional ownership, audit committee, profitability, and leverage are able to influence tax avoidance. However, the results of thses studies are still inconclusive.

The rationale for this study is important for two reasons. First, tax avoidance is defined as a firm's failure to comply with the regulation by reporting profits properly and exploiting accounting loopholes to reduce the amount of tax paid by the company. Second, concerns such as corporate governance, profitability, leverage, and tax avoidance are extremely interesting topics to debate in Indonesia, given that the country uses a self-assessment system for tax payments, allowing taxpayers to engage in tax planning. Based on the findings of the preceding description of the problem, it appears that many companies in Indonesia still engage in tax avoidance, regardless of whether they are high-performing or not. For this reason, the researcher is interested in examining the effect of corporate governance (specifically institutional ownership, independent commissioners, and audit committee) on tax avoidance practices. Apart from that, the researcher will also investigate the relationship between profitability and leverage towards tax avoidance. Hence, the title of this research will be "**The Influence of Institutional Ownership, Independent Commissioners, Audit Committee, Profitability, and Leverage on Tax Avoidance in The LQ45 Index Listed on Indonesia Stock Exchange**".

## 1.2. Problem Limitation

There are some limitations to this study that future researchers should consider in order to get better research outcomes. The focus of this research is to investigate and evaluate the effects of institutional ownership (variable X1), independent commissioners (variable X2), audit committee (variable X3), profitability (variable X4), and leverage (variable X5) on tax avoidance (variable Y). The writer limits the indicator for profitability to Return on Asset (ROA), while the indicator for leverage to Debt to Equity Ratio in this study (DER). Also, the writer exclusively employs the Cash Effective Tax Rate (CETR) to measure the dependent variable of this study, which is tax avoidance. Given the constraints of this investigation, the findings may not be generalizable to other studies with other settings.

## 1.3. Problem Formulation

Based on the above background, the problem to be investigated in this study is as follows:

a. Does institutional ownership have influence on tax avoidance of LQ45 index companies listed on Indonesia Stock Exchange?
b. Do independent commissioners have influence on tax avoidance of LQ45 index companies listed on Indonesia Stock Exchange?
c. Does audit committee have influence on tax avoidance of LQ45 index companies listed on Indonesia Stock Exchange?
d. Does profitability have influence on tax avoidance of LQ45 index companies listed on Indonesia Stock Exchange?
e. Does leverage have influence on tax avoidance of LQ45 index companies listed on Indonesia Stock Exchange?
f. Do institutional ownership, independent commissioners, audit committee, profitability, and leverage have simultaneous influence on tax avoidance of LQ45 index companies listed on Indonesia Stock Exchange?

## 1.4. Objective of the Research

The following research objectives define what this study attempts to accomplish:

a. To find out and analyze whether institutional ownership has influence on tax avoidance of LQ45 index companies listed on Indonesia Stock Exchange.
b. To find out and analyze whether independent commissioners has influence on tax avoidance of LQ45 index companies listed on Indonesia Stock Exchange.
c. To find out and analyze whether audit committee has influence on tax avoidance of LQ45 index companies listed on Indonesia Stock Exchange.
d. To find out and analyze whether profitability has influence on tax avoidance of LQ45 index companies listed on Indonesia Stock Exchange.
e. To find out and analyze whether leverage has influence on tax avoidance of LQ45 index companies listed on Indonesia Stock Exchange.
f. To find out and analyze whether institutional ownership, independent commissioners, audit committee, profitability, and leverage have simultaneous influence on tax avoidance of LQ45 index companies listed on Indonesia Stock Exchange.

## 1.5. Benefit of the Research

The findings of this study should be useful to readers both conceptually and practically. The following are some of the most relevant outcomes of this study.

### 1.5.1. Theoretical Benefit

Theoretically, this study should provide useful information and expand existing understanding about the relationship between corporate governance, profitability, leverage, and tax avoidance as well as the practice. Also, this study can potentially be used as a reference for future researchers who are interested in conducting similar research.

### 1.5.2. Practical Benefit

The following are some of the expected practical outcomes of this study:

a. Investors

   The conclusions of this study could be beneficial information for investors in assessing and analyzing the performance of listed firms, specifically the LQ45 index companies, when making investment decisions. Hence, with the information presented in this study, investors will be able to identify companies in the LQ45 index that meet their investment criteria.

b. Government

This study is likely to be useful to the Indonesian government in developing laws and regulations to control and minimize tax avoidance.