CHAPTER I

INTRODUCTION

1.1 Background of Study

Tax is considered as the most important or primary source of revenue to support the country's national development and economy, in which according to Article 1 of Law No. 28 Year 2007 on General Provisions and Taxation Procedures, "*tax is a compulsory contribution to the state owed by individuals or entities, which are coercive under the Law, without any direct compensation and shall be utilized for the need of the state for the greater prosperity of the people.*" From this understanding, it is evident that taxes serve a significant purpose and role for the state, and its management must be strictly regulated.

Table 1.1 Indonesia's State Revenues for Year 2015-2019 (Trillion Rupiah)

Source of Revenues		2015	2016	2017	2018	2019
I.	Revenues	1,496.04	1,546.95	1,654.75	1,928.11	1,955.14
	Tax Revenues	1,240.42	1,284.97	1,343.53	1,518.79	1,546.14
	Non-Tax Revenues	354.75	261.98	311.22	409.32	408.99
II.	Grant	6.832	8.99	11.63	15.56	5.49
Total		1,438.89	1,555.93	1,666.38	1,943.67	1,960.63

Source: Badan Pusat Statistik 2015-2019

According to data from the *Badan Pusat Statistik*, the sources of state revenue are tax revenues, non-tax revenues, and grants. According to Table 1.1, tax revenue dominates the state revenue, accounting for an average of 81.28% of total state revenue realization. This data demonstrates how tax revenue dominates

Indonesia's source of income and demonstrates. The significant implications of tax revenue for the state upon the effort by government to upgrade the prosperity and welfare of Indonesian citizens, imply that the government will always seek to maximize the tax levy from people in order to boost the state's revenues.

In determining the amount of tax that taxpayers must pay to the state, there are four mechanisms or systems for tax collection, which are the official assessment system, self-assessment system, semi-self-assessment system, and withholding assessment system (Ilyas & Burton, 2010). According to Direktorat Jenderal Pajak (2016), Indonesia has been adopting the self-assessment system as its tax collection system, which means taxpayers have the opportunity to calculate their own taxes that are obliged to be paid and report it to the tax office or via the government's website of the Directorate General of Tax, while the tax authority’s role in this tax collection process is to monitor the taxpayers' tax-related activities through tax audit procedures.

In comparison to other tax collection systems, the implementation of the self-assessment system is intended to make it easier for taxpayers to report and pay taxes appropriately (Suparnyo, 2012). However, tax avoidance is a problem that occurs as a result of the adoption of this tax collection method. This is due to the fact that the successful implementation of the self-assessment system is heavily reliant on taxpayers who are aware of their obligation, honesty and willingness to pay taxes, and discipline to implement tax regulations, whereas the knowledge of taxpayers to calculate, pay and report tax correctly and completely is still relatively low (Seralurin & Ermawati, 2019). Therefore, it results in an apathy attitude of taxpayers towards tax (Khaerunnisa et al., 2018).

Table 1.2 Targeted and Realization of Tax Revenue 2015-2019

Year	Targeted Tax Revenue (Trillion Rupiah)	Realization Tax Revenue (Trillion Rupiah)	Percentage (%)
2015	1,489.3	1,240.4	83.29
2016	1,539.2	1,284.9	83.48
2017	1,472.7	1,343.5	91.23
2018	1,618.1	1,518.7	93.86
2019	1,786.4	1,546.1	86.55

Source: Data compiled by Writer (2022)

According to Table 1.2 from *Kementrian Keuangan*, the targeted tax revenue from the tax sector tends to increase, but in fact, revenue realization from the tax sector is always lower than the target. Furthermore, it can be seen that the effectiveness of tax collection in Indonesia fluctuates from 2015 to 2019. The government only manages to collect for about 83.29% and 83.48% of projected revenue in 2015 and 2016, respectively, while tax revenue realization has increased significantly in 2017 and continues to increase in 2018, consequently closing the gap to reach its expected target. However, the realization of tax collections dropped in 2019, causing the disparity to widen once again.

The government has not been able to achieve the expected or targeted tax revenue because the government and taxpayers have different interests or perspectives regarding taxation (Fauzan et al., 2019). Taxes, at one side, are regarded as state income, but on the other hand, they are regarded as a burden for corporations since they limit the amount of net income received, hence corporations seeking to maximize profits will attempt to cut down the amount of tax expense.

Taxpayers opportunistic behaviour to increase earnings, as well as the adoption of a self-assessment system that provides taxpayers more control over tax, opens up the possibilities of taxpayers engaging in tax avoidance practices.

Tax avoidance is a strategy or endeavour to enhance a company's profit while lowering its tax burden or tax obligation. In contrast to tax evasion, it is regarded as a legitimate approach for taxpayers without violating relevant laws by exploiting existing legal loopholes (Dewianawati & Setiawan, 2021). In fact, tax avoidance is highly beneficial for businesses to cut down their tax expenditure while increasing their earnings; yet, in practice, tax avoidance is deemed an unethical conduct because it goes against the intent and purpose of government (Prebble et al., 2013).

According to the rationale above, there are numerous elements that can trigger or influence tax avoidance practices, as previously explored in prior studies incorporating multiple independent variables. These factors include capital intensity, sales growth, deferred tax expense, fiscal loss compensation (Fatkhurrozi & Kurnia, 2021), capital structure (Prabowo, 2020), profitability (Prabowo, 2020), earnings management (Kurniasih et al., 2017), firm size, leverage (Sarpingah, 2020), tax morality, tax culture, good corporate governance (Khaerunnisa et al., 2018).

The factors listed above are the results of tax avoidance research conducted by previous researchers in explaining the aspects that can influence tax avoidance practices by involving numerous independent variables. Tax avoidance is defined as the dependent variable, and its value will be investigated for changes in response to the influence of the independent variable. Writer simply employs a few components in this research by combining independent variables from earlier studies, which include earnings management, deferred tax expense and profitability.

Earnings management has been identified as a common practice in the corporate environment, which is an intervention action made by management to influence financial information in the desired manner and for a specific objective through the implementation of beneficial accounting policies (Eriyanti et al., 2019). This action, which is used to influence earnings figures through estimate or judgement, is motivated by a numerous factor. According to Scott (2015), the desire to lower tax expense is one of the motivations to practice earnings management. This is because earnings management, in general, aims to present the public with earnings information that has been adjusted to the interests of the management or the company in order to obtain profits, while taxes are an expense that can reduce profits earned. Thus, the more aggressive the company is in conducting earnings management, the more aggressive the tax avoidance will be, because the company will tend to keep profits at a particular level, in which company with increasing income levels will adjust income reduction to decrease tax expense.

Another factor that is able to detect tax avoidance is deferred tax expense. Deferred tax expense is the temporary difference caused by different treatment of accounting standards and taxation regulation, which results a negative fiscal correction (Phillips et al., 2003). The difference between accounting standards and taxation regulation can contain tax avoidance since there are income tax consequences due to the impact of deferred tax expense toward the amount of tax payable. When deferred tax expense is recognized, the temporary difference will cause a decrease in taxable income and tax payable in the current year. Therefore, through deferred tax expense, it can detect tax avoidance occurrences.

As for profitability, it is also another important motivator for tax avoidance occurrence because it may impact the amount of tax expense through the perspective of income and expense recognition. Profitability is the primary element to maintain the sustainability of the company. The higher the level of profitability, the greater the income generated by the company. However, since the amount of tax is determined by how much income a company earns, higher income will lead to a higher amount of tax payable (Hariani & Waluyo, 2019). Therefore, companies with high profitability will have the tendency to position themselves in tax avoidance practices to reduce the amount of tax expense.

The practice of tax avoidance by corporations has become a common phenomenon in Indonesia (Midiastuty et al., 2020), and it also involves financial institutions. The banking company itself is the backbone or a critical industry for a state's tax revenue since the banking industry is the third-largest tax contributor sector after manufacturing and merchandising or retail company (Direktorat Jenderal Pajak, 2021), therefore, the inability to preserve banking trust might have a systemic impact and undermine national financial stability. Aside from that, banking is recognized as a public trustee (Sahla & Aliyah, 2016), which is a highly sought-after corporation that is regularly used by citizens for services such as depositing cash, lending funds, and financial investments. Banking companies, like other businesses, must maximize profits in order to strengthen the bank's ability to carry out operations and boost the confidence of shareholders and the public who utilize banking services. However, the company's effort to maximize profits raises the possibility of tax avoidance issues as the amount of tax expense reduces the profits earned. Therefore, in order to maximize profits, companies will try to minimize the tax expense or engage in tax avoidance.

Table 1.3 Earnings Management, Deferred Tax Expense, Profitability and Tax Avoidance in Banking Companies Listed on the Indonesia Stock Exchange for year 2015-2019

Company	Year	Earnings Management	Deferred Tax Expense	Profitability	Tax Avoidance (ETR)
		(%)			
PT Bank Negara Indonesia (Persero) (BBNI)	2015	-11.82	-0.17	1.80	20.28
	2016	-30.08	-0.01	1.89	20.22
	2017	0.35	0.02	1.94	19.78
	2018	6.97	-0.03	1.87	23.86
	2019	9.44	-0.03	1.83	19.93
PT Bank Pembangunan Daerah Jawa Barat dan Banten (BJBR)	2015	-9.29	-0.01	1.56	21.82
	2016	-20.93	0.04	1.13	21.22
	2017	2.96	-0.01	1.05	25.77
	2018	5.25	0.02	1.29	19.86
	2019	15.72	0.07	1.27	20.90

Source: Prepared by Writer (2022)

Several factors that have been studied by previous researchers that can detect tax avoidance practices, among others, are earnings management, deferred tax expense and profitability. From the figure above, there were fluctuations in the Effective Tax Rate (ETR) during 2015 and 2019 from the two banking companies as part of the oldest banking companies listed on the Indonesia Stock Exchange that contributed to national development. The two companies tend to pay taxes below the mandatory tax rate of 25% from the 5-year observation period which indicates tax avoidance practices. This is explained by the fact that the lower the effective tax rate, the lower the tax payments made by the corporation, or, in other words, the greater the likelihood that the company is engaging in tax avoidance (Tang, 2020).

Earnings management is one of the variables that impact the practice of tax avoidance. Earnings management is measured using discretionary accruals because discretionary accruals are an estimate-based approach that is difficult to detect (Gomes, 2012). According to Sulistyanto (2014), the value of discretionary accruals can be either negative or positive. A negative value implies that the corporation is managing earnings by income minimization, while a positive value implies that the corporation is managing its earnings through income maximization. This can be explained as follows: the bigger the percentage of earnings management, whether moving upward (positive) or downward (negative), the greater the discretionary management has in managing earnings that serve as a benchmark in determining tax payable. As PT Bank Negara Indonesia (Persero) Tbk's earnings management increased to 0.35% in 2017 and PT Bank Pembangunan Daerah Jawa Barat dan Banten Tbk's earnings management increased to 5.25% in 2018, these companies show a decrease in effective tax rate. From the review of the financial statements of PT Bank Negara Indonesia (Persero) Tbk and PT Bank Pembangunan Daerah Jawa Barat dan Banten Tbk, the writer found that the upward movement of earnings management was reflected from the increase of earnings before tax in PT Bank Negara Indonesia (Persero) Tbk, indicating income maximization from an increase in the amount of interest and sharia income from Rp. 43,768,439,000,000,- in 2016 to Rp. 48,177,849,000,000,- in 2017. Whereas the upward movement of earnings management for PT Bank Pembangunan Daerah Jawa Barat dan Banten Tbk in 2018 was reflected from the increase in earnings before tax due to an increase in the amount of interest and sharia income from Rp. 11,487,572,000,000,- in 2017 to Rp. 11,914,209,000,000,- in 2018, as well as decreased of tax expense to 384,648,000,000,- in 2018 from Rp. 420,560,000,000,- in 2017. Since earnings before tax are inversely related to effective tax rate while tax expense is directly related to effective tax rate, therefore earnings management can reflect tax avoidance indication. This is supported by the previous research from Kurniasih et al. (2017) which stated earnings management had a significant influence on tax avoidance. Conversely, the research conducted by Henny (2019) concluded that tax avoidance cannot be detected through earnings management.

On the other hand, there is deferred tax expense that can indicate tax avoidance. The temporary difference between pre-tax income and taxable income is referred to as deferred tax expense (Purnamasari, 2019), which means that recognizing a significant amount of deferred tax expense will lead to a significant gap between pre-tax income and taxable income. This might indicate that company is conducting tax avoidance because the greater the value of deferred tax expense, the greater the value of pre-tax income from taxable income, and pre-tax income is inversely related to the effective tax rate. Based on Fatkhurrozi & Kurnia (2021) research, there is a significant influence of deferred tax expense towards tax avoidance. As shown in Table 1.3, there was increasing percentage of deferred tax expense followed by a decreasing percentage in the effective tax rate in PT Bank

Negara Indonesia (Persero) Tbk from 2016 to 2017 and PT Bank Pembangunan Daerah Jawa Barat dan Banten Tbk from 2017 to 2018. Based on data from the two companies' financial statements, the increase in percentage of deferred tax expense was due to a decrease in the value of allowance for impairment losses on loans of PT Bank Negara Indonesia (Persero) Tbk and PT Bank Pembangunan Daerah Jawa Barat dan Banten Tbk for 44.29% and 10.19%, respectively, so that the value of taxable income is lower compared to pre-tax income. Meanwhile, Suciarti et al. (2020) discovered that deferred tax expense has no significant influence on tax avoidance.

Another factor presumed to cause tax avoidance is profitability. According to Putra et al. (2020), profitability has a significant influence towards tax avoidance. When the level of profitability of PT Bank Negara Indonesia (Persero) Tbk increased to 1.94% during 2016-2017 and PT Bank Pembangunan Daerah Jawa Barat dan Banten Tbk increased to 1.29% during 2017-2018, the effective tax rate of both companies decreased. The fluctuation of profitability showed the companies attempt to minimize the tax burden. Furthermore, from the financial statement of PT Bank Negara Indonesia (Persero) Tbk and PT Bank Pembangunan Daerah Jawa Barat dan Banten Tbk, the increase in profitability corresponded to the net income, which was reflected in the increasing amount of revenue in both companies, particularly in interest and sharia income, and another indicating factor for this occurrence was the unfluctuating expenses at PT Bank Negara Indonesia (Persero) Tbk and the decrease in expenses at PT Bank Pembangunan Daerah Jawa Barat dan Banten Tbk. This implies an attempt to reduce the tax expense and eventually led to an increase in net income, which means that companies with increased profitability are trying to minimize tax expense as reflected in the declining percentage of effective tax rate to maximize net income. Therefore, companies with high profitability are more likely to engage in tax avoidance than those with low profitability. However, this result contradicts Umar et al. (2021) research, which found that tax avoidance is not influenced by profitability.

Based on the explanation of the background of the problems above and the findings of previous studies that show differences of results between one researcher and another, the writer is interested in researching and assisting in the development of an understanding of whether the factors of earnings management, deferred tax expense and profitability simultaneously and partially affect the tax avoidance, so the title raised in this research is **"The Impact of Earnings Management, Deferred Tax Expense and Profitability towards Tax Avoidance in Banking Companies Listed on the Indonesia Stock Exchange"**.

1.2 Problem Limitation

Based on the identification of problems in the context of study, the writer determines the following problem limitation:

1. The research object focuses on banking companies listed on the Indonesia Stock Exchange.
2. The independent variables in this research involve earnings management using the Modified Jones Model, deferred tax expense, and profitability

using Return on Assets, while the dependent variable involves tax avoidance using the Generalized Accepted Accounting Principle Effective Tax Rate.

3. The data for this research ranges from 2015 to 2019.

1.3 Problem Formulation

The problems formulated in this research are as follows:

1. Does earnings management partially have a significant impact towards tax avoidance in banking companies listed on the Indonesia Stock Exchange?
2. Does deferred tax expense partially have a significant impact towards tax avoidance in banking companies listed on the Indonesia Stock Exchange?
3. Does profitability partially have a significant impact towards tax avoidance in banking companies listed on the Indonesia Stock Exchange?
4. Do earnings management, deferred tax expense and profitability simultaneously have a significant impact towards tax avoidance in banking companies listed on the Indonesia Stock Exchange?

1.4 Research Objective

The objectives of this research are as follows:

1. To ascertain whether earnings management partially has a significant impact towards tax avoidance in banking companies listed on the Indonesia Stock Exchange.

2. To ascertain whether deferred tax expense partially has a significant impact towards tax avoidance in banking companies listed on the Indonesia Stock Exchange.

3. To ascertain whether profitability partially has a significant impact towards tax avoidance in banking companies listed on the Indonesia Stock Exchange.

4. To ascertain whether earnings management, deferred tax expense and profitability simultaneously has a significant impact towards tax avoidance in banking companies listed on the Indonesia Stock Exchange.

1.5 Benefit of Research

1.5.1 Theoretical Benefit

The writer expects the following theoretical benefits from this research:

1. This research is expected to improve understanding about tax accounting, particularly those relating to factors that have an impact on tax avoidance, as well as to provide reinforcement on the outcomes of prior research on the implementation of theories that have been evaluated.

2. This research can be used as a foundation or guideline for potential future research and development with the same topic.

1.5.2 Practical Benefit

The followings are the expected practical benefits of this research:

1. This research is expected to provide a more thorough understanding of the factors that influence tax avoidance actions, such as earnings management, deferred tax expense and profitability. If supporting empirical evidence is obtained, this research can provide advice to company management on tax avoidance issues, allowing them to be maintained properly.
2. This research is expected to offer investors with information to help them in considering their investment decisions after understanding and comprehending the factors that can impact tax avoidance in banking companies listed on the Indonesia Stock Exchange.
3. This research is expected to provide insights to the government in evaluating tax policies and examining company taxes to maximize potential state revenue derived from the tax sector.