The Effect of Company Size, Tax Haven, and Foreign Ownership on Thin Capitalization Practices with ROA as a Control Variable

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The practice of thin capitalization is a form of international tax avoidance. The trick is to hoard debt to be calculated as a tax-deductible expense. This design arises because tax provisions distinguish the treatment between interest and dividends. This research examines how the size of a company, tax haven, and foreign ownership affect thin capitalization and uses Return on Asset (ROA) as a control variable. Listed on the IDX are companies from the manufacturing sector for the years 2018 to 2022, which comprise the population for this study. The research sample selection used the purposive sampling method and obtained a sample of 275 samples that met the criteria and data processing using the SPSS 25 application. This study shows the results: company size has a positive effect on thin capitalization, tax haven has a negative effect on thin capitalization, foreign ownership has no effect on thin capitalization and ROA as a control variable has no effect on thin capitalization.

Keywords: Company Size; Tax Haven; Foreign Ownership; ROA; Thin Capitalization; Tax Avoidance

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INTRODUCTION

In designing the financing structure for their business, they have various financing schemes, generally with capital, loans or both. The use of financing structures must be made various considerations, one of which significantly affects taxation. Generally, corporate taxpayers look for loopholes to minimize the tax burden in their business activities in Indonesia and other countries. Few foreign taxpayers look for loopholes in minimizing the tax burden, one of which is considered challenging to detect. This is the practice of thin capitalization based on the need for thin capitalization cases revealed. The Directorate General of Taxes (DGT) states that many foreign companies in Indonesia are exempt from paying taxes despite their high profits.

The practice of thin capitalization is a form of international tax avoidance (Waluyo & Doktoralina, 2018; Masri et al., 2019). The trick is to hoard debt to be calculated as a tax-deductible expense. This design arises because tax provisions distinguish the treatment between interest and dividends. In tax calculations, interest paid is considered a deductible expense, but dividends are not tax-deductible. Thin capitalization also applies when capital loans are provided in disguise and exceed the prescribed limits (Mardan, 2017).

Multinational companies often use this concept. This financing can be in equity participation or funds from shareholders or other parties. For companies, debt financing is more favorable. Dividends from equity participation are subject to double taxation, while interest payments are only taxed once when received by the lender. Farrar and Mawani (2008) explain that a business is said to practice thin capitalization if the proportion of debt is relatively higher than equity in the financing. To identify the existence of thin capitalization practices, one of them uses DER (debt to equity ratio); generally, in various countries, the DER limit is 3:1 or 2:1. In Indonesia, the maximum DER limit is 4:1 as stipulated in the Minister of Finance Regulation No.169/PMK.010//2015.

There are several phenomena of thin capitalization practices in Indonesia that have been revealed in the TJN report said that the cigarette company British American Tobacco (BAT) is suspected of practising tax avoidance in the form of thin capitalization with the design of intercompany loans through BAT's subsidiary in Indonesia, namely PT Bentoel Internasional Investama Tbk (RMBA) with a scheme to divert some of its income out of Indonesia through loans between group companies around 2013 and 2015 amounting to USD 434 million and USD 549 million in 2015. This case was revealed when PT Bentoel repaid its loans in 2016.

Based on the above phenomena and background, the researchers are looking to carry out a study titled "The Effect of Company Size, Tax Haven, and Foreign Ownership on Thin Capitalization Practices with ROA as a Control Variable (manufacturing companies listed on the Indonesia Stock Exchange in 2018-2022).

Several differences exist between this study and previous research, namely not using multinational variables because these variables are used as sample selection criteria, and previous studies cannot prove any influence on the dependent variable. The variables of audit committee size, tax uncertainty, effective tax rate, fixed asset intensity, and foreign directors were not selected for research because they have a negative effect and are less related to thin capitalization. Then, manufacturing industry companies listed on the IDX from 2018 to 2022 were selected for this study. This research is significant, considering that the practice of thin capitalization is included in one of the ways to do tax avoidance, and only a few cases are revealed.

LITERATURE REVIEW

Company Size Effect on Thin Capitalization

Fauzan (2019) said the possibility of a company needing more capital increases with size, and this is possible because there is an effort to get more profit yearly. In enlarging the company, additional capital is needed to support its business activities. When providing capital financing, the incoming investment is usually in the form of shares, and in return, the company pays dividends to investors. Companies can increase their assets by using investment or debt. Companies with high total assets tend to generate more stable and higher profits than companies with lower total assets. According to Nugroho and Suryarini (2018), the underlying relationship between company size and thin capitalization is that large companies will use tax efficiency to obtain significant income with a small tax deduction.

As an agent, management is interested in maximizing profits and will likely look for ways to avoid taxes legally. The government/DJP can conduct an audit or monitoring, which includes examining the company's capital structure, analyzing the debt-capital ratio, and examining transactions between countries. In conducting the audit/monitoring, the principal will rely on the audited report.

Several previous studies, such as Taylor and Richardson (2013), Nugroho and Suryarini (2018) and Sumarta et al. (2021), examined the determinants of thin capitalization, proving that The size of a company has a positive impact on thin capitalization practices.

H1: Company size has a positive effect on thin capitalization practices.

The Effect of Tax Haven on Thin Capitalization

Tax havens are countries that provide relief to taxpayers from other countries, such as low or 0% corporate income tax. Furthermore, according to Gravelle (2015), tax haven countries lack transparency, guaranteeing the confidentiality of customer banking transactions, lack information exchange, and quickly obtaining legal entity status.

Both domestic and international governments are concerned about doing business with tax haven countries. Multinational companies with parents or affiliates in various countries, especially tax haven countries, make the possibility of company involvement in tax avoidance practices smaller, especially thin capitalization practices. That is because companies minimize their tax burden by transferring the results of their operations or conducting production or operations in tax haven countries to minimize the tax burden.

Multinational companies have a greater tendency to have more resources, increased accessibility to financial markets, and diversification of risks through their presence in various countries, including tax haven countries. Agents between domestic and foreign companies want to maximize their profits and minimize the tax burden in each country. Meanwhile, the principal responsible for implementing Indonesian tax regulations wants to impose the maximum possible tax burden by the rules and actual financial conditions.

The company can also transfer its income and assets to tax haven countries. By minimizing the tax burden through tax haven countries, the company does not need to conduct thin capitalization because the company has benefited from activities in tax haven countries. Then, thin capitalization will make the interest expense even more significant. So, the greater the number of affiliates, subsidiaries, or groups in tax haven countries, the lower the tendency of companies to conduct thin capitalization.

According to Sismi and Martani (2022), companies in tax haven countries have a low, thin capitalization value. According to him, this is because there is a downward trend in tax avoidance practices, including thin capitalization, the country where the company is established has established appropriate tax regulations, normalization of expenses after having high levels of debt in previous years, and management pays more attention to its corporate reputation.

Previous studies such as Sismi and Martani (2022) examining the factors that influence thin capitalization provide evidence that tax haven has a negative effect on thin capitalization practices.

H2: Tax Haven has a negative effect on thin capitalization practices.

The Effect of Foreign Ownership on Thin Capitalization

Hananto et al. (2021) prove that this phenomenon is carried out by companies financed through a large amount of debt from their parent companies located abroad. Research by Kinney and Lawrence (2000) on Hananto et al (2021) found that companies with large amounts of foreign ownership tend to practice tax avoidance. Based on this research, the thin capitalization phenomenon is caused by geographical flexibility, which encourages business owners to change tactics to seek profits. The results of Hananto et al. (2021) successfully provide evidence that a large percentage of foreign ownership has a positive influence on thin capitalization. Hananto shows that when there are companies with a large number of foreign investors, they tend to carry out thin capitalization.

The role of agents (management) acting in the interests of foreign owners leads to differences in motivation and preferences between foreign owners and company management that can influence decisions regarding the selection of the company's capital structure and the use of thin capitalization strategies. The government/DJP may seek to limit the practice of thin capitalization to protect national interests. At the same time, management may optimize the capital structure by taking advantage of the tax benefits of foreign debt. This conflict of interest may lead to agency problems, where management may only partially represent the government's interests as the principal.

Previous studies such as Sumarta et al. (2021) and Hananto et al. (2021), which examined the determinants of thin capitalization practices, found evidence that company size positively affects thin capitalization practices.

H3: Foreign ownership has a positive effect on thin capitalization practices.

RESEARCH METHOD

This study uses quantitative research and secondary data from financial statements and annual reports from 2018 to 2022 published on the Indonesia Stock Exchange and the company's website. The present study used purposive sampling, and the research sample comprised multinational manufacturing companies. The sampling criteria are (1) manufacturing companies that consistently publish annual reports throughout 2018 to 2022, (2) manufacturing companies with a percentage of foreign investors of 20% or more from 2018 to 2022, (3) manufacturing companies that do not experience capital deficiencies during the 2018-2022 period. Based on the sample selection criteria, 275 research samples were obtained, and there were a total of 55 manufacturing companies listed on the Indonesia Stock Exchange during the research period that met the criteria to be used as research objects.

The following are the dependent, independent, and control variables and their calculations in this study:

Table 1. Operational Definition of Variables

Variable	Indicator	Scale
Thin Capitalization	$\text{DER} = \frac{\text{Liabilities}}{\text{Equity}}$	Ratio
Company Size	Company Size = Ln(Total Assets)	Ratio
Tax Haven	Score 1 is given to company that have at least one subsidiary or branch company or affiliate in tax haven country, and score 0 otherwise.	Nominal
Foreign Ownership	$\text{Foreign Ownership} = \frac{\text{Amount of Foreign Shareholding}}{\text{Amount of Shares Outstanding}} \times 100$	Ratio
ROA (Return on Asset)	$\text{ROA} = \frac{\text{Net Profit}}{\text{Total assets}} \times 100$	Ratio

RESULTS AND DISCUSSION

Descriptive Statistics Analysis

This analysis aims to provide an overview or description of data seen from the average value (mean), maximum, minimum, and standard deviation. The following table shows the results of descriptive statistical analysis. Thin capitalization has a minimum value of 0.0580, and it was owned by PT Bentoel Internasional Investama Tbk in 2018, which means that this company is not indicated to practice thin capitalization. The maximum value of 17.2106 was owned by PT Central Proteina Prima Tbk in 2019, which means that this company is indicated to practice thin capitalization.

The company's size has a minimum value of 25.6091, and it will be owned by PT Lionmesh Prima Tbk in 2022. The maximum value is 33.6552, owned by PT Astra International Tbk. in 2022. Tax Heaven has a minimum value of 0 and is owned by 25 companies, which means that they do not have affiliated companies in tax haven countries. The maximum value of 1 is owned by 30 companies, which means they have affiliated companies in tax haven countries. Foreign ownership has a minimum value of 20.0000 and was owned by PT Jembo Cable Company Tbk in 2022, which means the lowest foreign ownership value is 20%. The maximum value is 99.9600, which is owned by PT Bentoel Internasional Investama Tbk in 2022, which means the highest foreign ownership value is 99.96%.

Table 2. Descriptive Statistics Analysis

Descriptive Statistics

	N	Minimum	Maximum	Mean	Std. Deviation
Thin Capitalization	275	,0580	17,2106	1,218014	1,4479935
Company Size	275	25,6091	33,6552	29,209251	1,6840183
Tax Heaven	275	0	1	,55	,499
Foreign Ownership	275	20,0000	99,9600	64,875211	25,3519986
ROA	275	-40,1425	92,0997	5,347376	11,3913073
Valid N (listwise)	275				

Classic Assumption Test

After the transformation and outlier samples, the number of samples decreased by four, so the current number of samples is 271 from 275 initial samples before outliers.

The normality test shows the Monte Carlo sig value after outliers is 0.145>0.05, and it is said that the data is normally distributed; the histogram graph and normal plot show that the data is usually distributed.

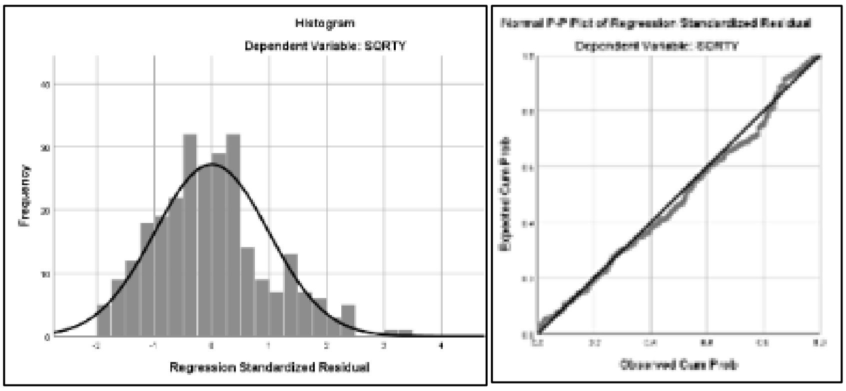

Figure 1. Histogram Graph and Normal Plot

The multicollinearity test on variables X1, X2, X3 and Z has a tolerance value > 0.10 and VIF <10, so there is no multicollinearity. Then, in the autocorrelation test, sig 0.762 > 0.05 said there is no autocorrelation.

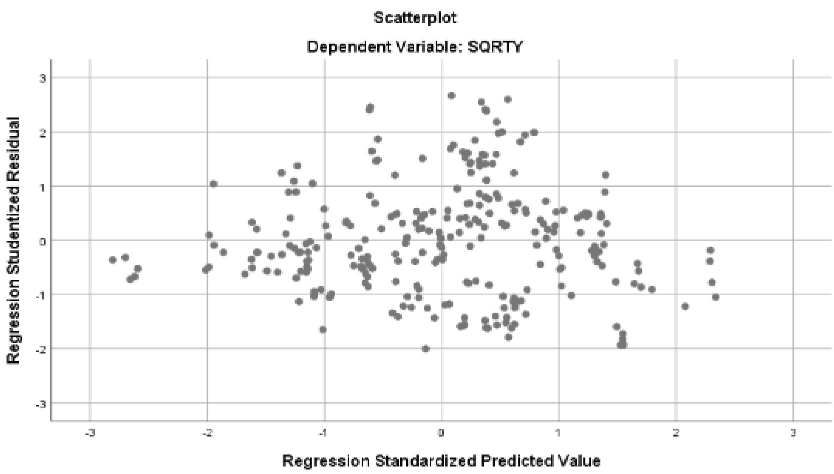

Figure 2. heteroscedasticity Test

The heteroscedasticity test based on the scatter plot shows that the points are scattered randomly, concluding that homoscedasticity occurs.

Multiple Linear Regression Analysis

The multiple linear regression equation is obtained as follows:

Y = -1,977 + 0,596 - 0,145 - 0,006) - 0,015

The constant value in the multiple linear regression test is -1.977, which means that if variable X (independent) is 0 or none (constant), then variable Y (dependent), namely thin capitalization, will decrease by 1.977. When the coefficient value on the variable shows a positive number, every 1-point increase in a variable, assuming that other independent variables are constant, can cause a decrease in the thin capitalization variable. Meanwhile, suppose the coefficient value on the variable shows a negative number. In that case, every 1-point decrease in a variable, assuming other independent variables are constant, can cause a decrease in the thin capitalization variable.

Model Fit Test

Based on the SPSS test, the adjusted R square value is 0.059 or 5.9%, which means that the variables in this study can influence 5.9% on the thin capitalization variable. In comparison, other variables outside this study influence the remaining 94.1%.

In the F statistical test, the results of F count are 5.236> 2.4055797 (F table) with a sig value of 0.000 <0.05, so it is concluded that the variables of company size, tax haven, foreign ownership and ROA together affect the thin capitalization variable.

DISCUSSION

Company Size on Thin Capitalization

The test results prove that the hypothesis that company size positively influences thin capitalization is proven by hypothesis testing. Thus, H1, which states that company size positively influences thin capitalization, is accepted. The bigger a company, the more capital it needs for operating and non-operating activities. Capital obtained can be through investment or loans/debt. The results of this study are consistent with research conducted by Taylor and Richardson (2013), Nugroho and Suryarini (2018), Tambunan (2019), Sumarta et al. (2021), Hananto et al. (2021) and Widhyawati and Sari (2021) found in their studies that company size has a positive impact on thin capitalization. The more companies with significant assets, the greater the tax savings and debt interest on thin capitalization (Nugroho and Suryarini, 2018).

Tax Haven on Thin Capitalization

The test results prove that tax haven negatively affects thin capitalization, evidenced by hypothesis testing, and H2 is accepted. This research shows that tax haven has a negative effect on thin capitalization. Because the company has minimized the tax burden through tax haven countries, domestic taxation is affordable, and there is no need for thin capitalization. This study's results align with and strengthen research conducted by Sismi and Martani (2022), which states that tax haven has a negative effect on thin capitalization. However, this result contradicts the research of Nugroho and Suryarini (2018) and Sumarta et al. (2021), which state that tax haven positively affects thin capitalization.

Foreign Ownership on Thin Capitalization

The test results prove no effect of foreign ownership on thin capitalization, evidenced by testing the hypothesis that the tax haven variable has a significance value of 0.670> 0.05 and t count -0.427 < t table 1.650646 and stated H3 is declined, which means foreign ownership has no impact on thin capitalization. Many foreign parties who invest heavily in domestic companies do not always aim to do tax avoidance in their business activities; the majority of them want to expand their business so that they can reach many countries, try to be professional in running their business and maintain the company's image by not doing thin capitalization. The research findings are consistent with the study by Gouwvara and Susanty (2023), which asserts that foreign ownership does not influence thin capitalization. However, the study's results contradict and weaken the research of Hananto et al. (2021) and Sumarta (2021), which state that foreign ownership positively influences thin capitalization.

CONCLUSION

This research examines how the size of a company, tax haven, and foreign ownership affect thin capitalization and uses ROA as a control variable. Listed on the IDX are companies from the manufacturing sector for the years 2018 to 2022, which comprise the population for this study. Company size has a positive effect on the tendency to practice thin capitalization. The result show that tax haven has a negative effect on the tendency to practice thin capitalization. Foreign ownership does not affect the tendency to practice thin capitalization.

The sample size of this study is limited to manufacturing sector companies by PMK No.169 of 2015 and reduced research sample criteria by as many as 94 company samples. The research period is only for five years. In the test results, the coefficient of determination (R2) is only 0.059 or 5.9%. The independent variables studied can only explain 5.9% of their influence on the dependent variable; variables outside the study explain the remaining 94.1%. There are data outliers, and some company data has a DER limit exceeding 4:1, so it only covers some of the data that has been collected.

Suggestion and Research Implications

It is hoped that future researchers can expand the sampling criteria and extend the research period beyond five years. Future researchers can add or replace previously studied variables and calculate thin capitalization using methods other than DER

The findings of this study are consistent with those of previous investigations. However, the results can strengthen the hypothesis of previous research, which states that company size has a positive effect on thin capitalization. Tax haven has a negative effect on thin capitalization. However, it weakens the results of previous studies because foreign ownership does not affect thin capitalization. The results of this study can also provide new directions for theory development and further research in the context of thin capitalization.

For companies, management should be careful in managing their debt to minimize risk and maintain a healthy balance between equity and debt. Management should further consider using capital structure as a tax reduction strategy. Company management must also ensure transparency in financial reporting and comply with tax regulations. As for regulators, DGT or the government as a regulator needs to tighten the supervision of companies in Indonesia because there are indications of utilizing thin capitalization as a financial strategy to optimize taxes. Several recent studies related to thin capitalization and its relationship to tax avoidance can be seen in a study conducted by Clemente-Almendros & Gonzalez-Cruz (2023), Hidayat et al., (2023), Anindita et al., (2022), Dhawan et al., (2020), Tsindeliani et al., (2021), and also Bandiyono & Murwaningsari (2020).

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