Detection of Income Shifting Strategy and Determining Factors

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Abstract: The Indonesian government reduces the corporate income tax rate to 22%, effective in 2020 and 2021, and will decrease again to 20%, effective starting in 2022. This research aims to investigate the strategies implemented by public companies in dealing with the corporate income tax rate reduction and the determining factors. By using a sample of 343 Indonesian public companies, this study finds that the mean value of discretionary book tax differences in 2019 is positive and is significantly different from zero. These results prove that Indonesian public companies are implementing an income shifting strategy one year before the lower tax rates are imposed. Furthermore, this study also investigated determinant factors that influence on income shifting. Income shifting strategy is influenced by the company characteristic and the corporate governance mechanism. Using the multiple regression method, this research found that interest expense can produce tax saving so the use of the higher debt in the structure of the company financing can limit income shifting. In terms of the role of the external auditor, this study has not been able to prove the role of the external auditor as an effective monitoring mechanism against opportunistic management to do income shifting.

1 INTRODUCTION

Income taxes is a significant expense for a company. From 2010 to 2019 the Indonesian government imposed a corporate income tax rate of 25%, which means companies are required to give a quarter of their profits to the government. Compared to other Asian countries, the corporate income tax rate applied by the Indonesian government is still relatively higher than other Asian countries, such as: Singapore imposes a corporate income tax rate of 17%, Brunei Darussalam 18%, Thailand, Cambodia and Vietnam at 20%, Laos 24%, and Malaysia 24%. Only the Philippines still applies a higher tax of 30% (The Global Competitiveness Report, 2018).

Nadine (2018) stated that the high corporate income tax rate is one of the factors that encourage taxpayer to do tax avoidance. High tax rates are also an inhibiting factor for a country’s economic growth. Wasylenko (2019) state that the World Bank periodically releases reports on the economic performance of developing countries and finds that countries with lower marginal tax rates have higher economic growth rates.

The Indonesian government try to develop economic growth and to increase investment in various ways. One of an effective way is through the provision of tax incentives. The economic slowdown occurring 2019, globally and worse by the pandemic covid-19 affect all countries in the world. As happened in other countries, the covid-19 pandemic has had a tremendous impact on the business sectors in Indonesia. The Covid19 pandemic has threatened economic stability due to the decline in productivity of various affected sectors. Therefore, through Government Regulation Number 30 of 2020 (PP 30/2020), the government provides incentives in the form of lowering corporate income tax rates for domestic corporate taxpayers in the form of public companies.

The government provides incentives tax to Indonesian public companies in form of the reduction corporate income tax rates to 22% into effect in 2020 and 2021, and will decline to 20% in 2022. The policy to reduce corporate income tax rates is a positive signal for public companies as taxpayers. How does company management respond to the policy to reduce tax rates? Research in various countries has found evidence that taxpayers respond to lower tax rates by implementing income shifting strategies in an effort to reduce the amount of tax burden that must be paid. These studies are: Tao Zeng (2018) in China, Won-Wook Choi and Hyun-Ah Lee
(2013) in Korea, Grubert and Altshuler (2016) in France, Brandstetter (2017) in Germany. The income shifting strategy that is carried out is to adjust commercial profit and fiscal profit. The income shifting strategy can be done by delaying revenue recognition and accelerating the recognition of expenses in the fiscal year one year before lower tax rates are imposed. Referring to the results of previous research, this research predicts that “Indonesian public companies are suspected of implementing an income shifting strategy in the one year period prior to the enactment of a lower tax rate”

If it is proven management of public companies do income shifting strategy so the next question is which factors influences income shifting strategy? What factors affecting tax avoidance depends on the underlying theory. Referring to the theory of capital structure (Ross, Westerfield, and Jaffe, 2015) said that companies using debt in the capital structure have lower the tax charges than others. Previous studies found evidence that leverage have negative effects on tax avoidance (Lin, Tong, and Tucker, 2014). Another previous research by Kovermann (2018) also proved that tax evasion behaviour are lower in company with the higher level of leverage. Referring to the capital structure theory and the results of previous research, then this research is suggesting that the company with higher debt was lower income shifting.

Tax avoidance studies have also found widespread evidence of their underlying motives, and the implications of tax avoidance (Hanlon and Heitzman, 2010). The conventional view holds that management conducts tax avoidance for efficiency purposes. This has an impact on improving the prosperity of the owner, but the agency theory perspective developed by Desai and Dharmapala (2007) states that management could avoid taxes to make personal gain. Therefore, the development of tax avoidance research further considers corporate governance mechanisms, and it is evident that tax avoidance and its implications are influenced by corporate governance mechanisms.

Based on the perspective of agency theory, Nemis and Cetenak (2012) state that audited financial statements are a monitoring mechanism to provide financial information to users. The quality of the information contained in these statements is strongly influenced by the quality of the audit that can be determined by two factors namely: (1) the auditors’ capabilities in running the audit process, and (2): their independence from their clients. Richardson, Taylor, and Lanis (2015) state that the quality of auditors has a crucial role in reducing agency problems that arise due to conflicts between management and owners.

Previous research that examined the influence of the audit quality on tax avoidance, we found it is not conclusive. The test results by Heltzer, Mindak, and Shelton (2012) found no significant evidence of auditor influence on tax avoidance. But another research has proven that tax avoidance is lower in companies that are audited by qualified auditors (Kanagaretan, Höglund and Sundvik, 2019). Referring to the corporate governance mechanism theory and the results of previous research, then this research is suggesting that the quality of auditing lower income shifting.

This study aims to find empirical evidence whether Indonesian public companies implement income shifting strategies to respond to tax rate reduction policies, and also find empirical evidence whether income shifting strategies are influenced by the level of leverage and the quality of the audit. The results of this study are expected to contribute to the development of tax avoidance research. Our research should be useful to regulators attempting to reduce corporate misfeasance, to investors in being more careful when using earnings report information and paying attention to corporate and institutional characteristics when investing.

2 METHODOLOGY

From 664 Indonesian public companies listed on the Indonesian Stock Exchange (IDX) up to 2019, we determine the following selection criteria: 1) Non financials industry because this industry is strictly-regulated industry; 2) Non real estate and constructions industry because this industry has their own accounting rules, for example revenue recognition; 3) Non mining industry because they have different tax arrangements to other industries (lex-specialist); 4) Availability of financial data and other data required to measure all the variables used in this research. The final sample of 343 firms represents 51.89% of all observations.

There are two models used to answer the research questions. The value of income shifting is calculated using the book-tax differences approach, referring to Tang and Firth (2012), the formula used is as follows:

\[ BTD_i = \alpha_i + \alpha_1TAX_i + \alpha_2FIAS_i + \alpha_3SALES_i + \alpha_4OI_i \]  

Operational Variables of Model (1)
BTDi = book-tax differences is the difference between commercial profit and fiscal profit, TAX is the tax expenses, FIAS is the fixed asset value, SALES is the sales value, OIN is other income. The independent variable of model (1) is the component that causes the difference between commercial profit and fiscal profit. Income shifting value is the value of discretionary book-tax differences (DBTD) which is calculated using the residual value or error of the equation. Testing the significance of the value of income shifting using the mean different analysis.

The second model to test the effect of leverage and audit quality on income shifting uses the following model:

\[ \text{INSFi} = \alpha_0 + \alpha_1\text{LEV}_i + \alpha_2\text{AUDIT}_i + \alpha_3\text{SIZE}_i + \epsilon_i \]  

Operational variable of Model (2):
INSF is the value of income shifting, LEV is debt to assets ratio, AUDIT is the quality of external auditors measured using industry specialization, is a dummy variable = 1 if the auditor controls the industrial market share ≥ 30%, and is worth 0 if the other is. SIZE is the size of the company as a control variable measured by the value of the natural logarithm (Ln) of the company’s total assets. The independent variable of model (2) is the variable that affects tax avoidance. The analysis used a significance t-test. The financial reports data sourced from IDX website www.idx.co.id and annual report data sourced from the Indonesian public company website.

3 RESULTS AND DISCUSSIONS

Table 1 presents the descriptive statistics, which provide an overview of the sample profiles and research variables. The mean value of the INSF variable is 0.2725, which means that on average, the sample companies did income shifting in 2019. In this study, income shifting was calculated using discretionary book-tax differences (DBTD). A positive DBTD value indicates that the company has reported a higher commercial profit than fiscal profit. High commercial profits will get a good assessment for investors, and lower fiscal profits will have an impact on lower tax paid. The mean value of variable LEV is 0.4635 indicates that on average the use of debt on Indonesian publics funding structure is significantly high at 46.35%. AUDIT is measured by an industry specialization audit, with an average value of 0.3835, indicating that 38.35% of the observed firms are audited by industry-specific auditors.

Table 1. Descriptive statistics

<table>
<thead>
<tr>
<th>Variable</th>
<th>Maximum</th>
<th>Minimum</th>
<th>Mean</th>
<th>Stddev</th>
</tr>
</thead>
<tbody>
<tr>
<td>INSF</td>
<td>0.9346</td>
<td>-0.1452</td>
<td>0.2725</td>
<td>0.1995</td>
</tr>
<tr>
<td>LEV</td>
<td>0.8263</td>
<td>0.1699</td>
<td>0.4635</td>
<td>0.1919</td>
</tr>
<tr>
<td>AUDIT</td>
<td>1</td>
<td>0</td>
<td>0.3835</td>
<td>0.2472</td>
</tr>
<tr>
<td>SIZE</td>
<td>1.0743</td>
<td>18.3002</td>
<td>8.8123</td>
<td>4.1715</td>
</tr>
<tr>
<td>N</td>
<td>343</td>
<td></td>
<td></td>
<td></td>
</tr>
</tbody>
</table>

One sample compare mean t-test used to verify whether Indonesian public companies do income shifting before the lower corporate income tax rate is implemented. Testing result is presented in table 2.

Table 2. One sample t-test of income shifting

<table>
<thead>
<tr>
<th>One-sample t-test</th>
<th>variable</th>
<th>mean</th>
<th>Sig.(2-tailed)</th>
</tr>
</thead>
<tbody>
<tr>
<td>2019 INSF</td>
<td>0.2725</td>
<td>0.02446</td>
<td></td>
</tr>
<tr>
<td>N = 343</td>
<td></td>
<td></td>
<td></td>
</tr>
</tbody>
</table>

The result of different test shown that mean of income shifting in 2019 is significantly different from zero with a significance level below 5%. This result is consistent with the conjecture that companies shifted taxable income in the year preceding the corporate income tax rate decrease. The results of this study are in line with previous research in other countries such as: in Korea by Won-Wook Choi and Hyun-Ah Lee (2013), in China (Tao Zeng, 2018), in French (Grubert and Altshuler, 2016), and in Germany by Brandstetter (2017). The income shifting strategy can be done by setting up accounts that have different treatment between generally accepted accounting standards (GAAP) and tax regulations. These accounts include: fixed asset accounts related to depreciation expense, tax expense paid, differences in recognition of sales or income, and recognition of other income.

Further testing conducted to determine factors that affect income shifting. Factors affect considered in this study is the level of leverage and quality of the audit. The testing used the multiple regression model and the testing result is presented in the following table 3.

The results show that the coefficient of LEV is -0.1039 significant based on the p-value lower than 10%. This is consistent with this research prediction that the bigger the use of debts in the capital structure of company will the lower income shifting by the company. The results of this research are in line on
the capital structure theory presented by Ross, Westerfield, and Jaffe (2015). The greater use of debt in financing benefits of tax saving, because the higher interest expense as a deduction taxable income. Hence the use of higher debt can restrict the management to perform the act of tax avoidance. These results support the results of previous studies conducted Lin, Tong, and Tucker (2014).

The relation between aggressive financial reporting and audit quality on income shifting. The results of this research failed to support the role of the external auditor as an effective monitoring mechanism against opportunistic management actions.

Table 3. Regression result

<table>
<thead>
<tr>
<th>Independent Variable</th>
<th>prediction</th>
<th>INSF as dependent variable</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td></td>
<td>coefficient</td>
</tr>
<tr>
<td>Constant</td>
<td>0.4228</td>
<td>0.000</td>
</tr>
<tr>
<td>LEV</td>
<td>-0.1039</td>
<td>0.062*</td>
</tr>
<tr>
<td>AUDIT</td>
<td>-0.0033</td>
<td>0.733</td>
</tr>
<tr>
<td>SIZE</td>
<td>-0.0148</td>
<td>0.068*</td>
</tr>
<tr>
<td>N = 343</td>
<td>Adj R² = 0.1484</td>
<td></td>
</tr>
</tbody>
</table>

INSF = income shifting, LEV = leverage, AUDIT = audit quality, SIZE = firm size

Financial reporting is not independent from the role of auditors. External auditor’s services not only limited in the financial audit services but also includes tax services. To understand the role of external auditors in aggressive tax behaviour, this research examines the effect of audit quality on the income shifting. Audit quality is difficult to assess, so much of the previous research has used auditor size and/or reputation as a proxy for audit quality. However, with the emergence of financial reporting scandals from companies audited by KAP Arthur Anderson, such as Enron and Dynegi Corporation, the use of auditor reputation as a measure of quality may not reflect actual audit quality (Heltzer, Mindak, and Shelton, 2012).

By using industry-specialized auditors the results of this study have not been able to prove the effect of audit quality on income shifting. The p-value of coefficient AUDIT is 0.733 is higher than level of α = 10%. The results of this research failed to support the agency theory which states quality audit is able to act as an effective monitoring mechanism against opportunistic action by managers (Richardson, Taylor, and Lanis, 2015). This finding is also not in line with the results of previous studies which found that audit quality reduces tax avoidance (Kanagaretnam, Lee, and Lim, 2016; Höglund and Sundvik, 2019).

We include SIZE as a company characteristic control variables. SIZE is measured by the natural logarithm of the total assets of firm i. And the results show that the size of the company significantly negatively influence income shifting. The result of this research supports the political hypothesis theory states that large companies liable to be public interest so they kept reputation.

4 CONCLUSIONS

Using sample of 343 Indonesian public companies, this research has found evidence that the tax rate reduction policy has been responded by public companies as tax payers by implementing an income shifting strategy in one year before the lower tax rate is effectively enforced. Income shifting strategy is influenced by the company characteristic and the corporate governance mechanism. The results of this research consistently find that interest expense can produce tax saving so the use of the higher debt in the structure of the company financing can limit income shifting. In terms of the role of the external auditor, this study has not been able to prove the role of the external auditor as an effective monitoring mechanism against opportunistic management actions.

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