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Transfer pricing and tax avoidance: Moderating role of audit quality

Ilham Illahi[a*], Nini Sumarni[a], Zikrawahyuni Maiza[b]
[a]Faculty of Islamic Economics and Business, Universitas Islam Negeri (UIN) Sjech M. Djamil Djambek Bukittinggi, Indonesia
[b]Faculty of Education, International Islamic University Malaysia, Malaysia

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ABSTRACT

Transfer pricing can confer advantages to companies, such as enhancing their business competitiveness and facilitating internal fund transfers. However, in practical application, companies also exploit transfer pricing for the purpose of tax avoidance, aiming to minimize their tax liabilities. Consequently, this practice has been observed to have adverse implications for the state, specifically in terms of reduced tax revenue. To explore the impact of transfer pricing on tax avoidance, researchers undertook an empirical examination. They introduced the variable of audit quality as a moderator to assess its influence on the relationship between transfer pricing and tax avoidance. The study focused on a sample of manufacturing firms listed on the Indonesia Stock Exchange, employing a purposive sampling technique. To ascertain the effects of transfer pricing variables on tax avoidance and the moderating influence of audit quality, the researchers conducted multiple linear regression tests. The findings of the study indicate a positive association between transfer pricing and tax avoidance. This research provides valuable contributions that companies engaging in transfer pricing practices are, indeed, employing them as a form of tax avoidance strategy, aiming to minimize their corporate tax obligations. However, the study does not provide evidence supporting the notion that the quality of auditors can mitigate transfer pricing undertaken for the purpose of tax avoidance.

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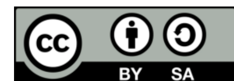

Corresponding Author:

Ilham Illahi
Department of Sharia Accounting
Faculty of Islamic Economics and Business
UIN Sjech M. Djamil Djambek Bukittinngi, Indonesia
Email: ilham.illahi88@gmail.com

INTRODUCTION

Contemporary business operations extend beyond national borders, encompassing multiple countries. This access is facilitated by the phenomenon of globalization, which facilitates the efficient distribution of goods, services, capital, and labor (Khoirul Huda et al., 2017; Rogers & Oats, 2022).

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The benefits derived from the ease of globalization have fostered the proliferation of multinational corporations across diverse nations (Kohlhase & Wielhouwer, 2023). These corporations establish subsidiary entities in foreign jurisdictions, thereby engendering advantages for each host country (Rathke et al., 2021). The expansion of multinational companies contributes to the stimulation of economic activity, as it generates employment opportunities and facilitates capital flow (Hemling et al., 2022). Significantly, the presence of these multinational entities enables governments to garner tax revenues from their profits. Furthermore, tax receipts can be derived from the import and export of goods by each multinational enterprise, thereby augmenting the fiscal resources available to the state (Ftouhi & Ghardallou, 2020).

Cross-border business transactions conducted by multinational companies will certainly provide opportunities for these companies to develop. But on the other hand, this can be done by multinational companies to avoid taxes (Otusanya, 2011). This tax avoidance can occur because multinational companies have subsidiaries in various countries with different terms and tax rates (Clausing, 2003). When a country's tax rate is too high compared to other countries, multinational companies in that country will try to minimize their tax burden. This is in line with the findings of Slemrod (2001) which revealed that multinational companies will use a set of methods to minimize corporate taxes. One of the ways used by multinational companies in reducing their tax burden is through transfer pricing. Transfer pricing carried out by multinational companies will affect the company's profit before tax (Liu et al., 2017). The company's profit before tax is smaller because they deliver products to subsidiary companies based on certain prices that are lower than they should be. This action makes the parent company's profit smaller than it should be so that the tax liability of the multinational company also becomes smaller. In the end, the tax received by the country where the multinational company is domiciled also becomes smaller. The result of transfer pricing carried out by multinational companies is a problem faced by all countries because these activities can erode tax revenues in a country (Sebele-Mpofu et al., 2021).

A number of scholarly investigations have explored the topics of tax avoidance and transfer pricing. For instance, Taylor and Richardson (2012) conducted a study revealing a significant association between transfer pricing and tax avoidance. Similarly, Pangaribuan et al. (2021) discovered that transfer pricing exerts a simultaneous impact on tax avoidance. The findings of their research demonstrate that transfer pricing not only confers advantages to companies but can also be employed by multinational corporations as a means to decrease their tax liabilities, thereby resulting in a reduced tax burden compared to what would be expected in their home countries. The aforementioned studies collectively indicate that transfer pricing activities undertaken by companies can have detrimental effects on national economies, as companies exploit transfer pricing for the purpose of tax avoidance, leading to a reduction in the overall tax revenue generated by the respective countries. Consequently, a strategic approach is necessary to prevent multinational companies from utilizing transfer pricing as a tool for tax avoidance. One such strategy involves conducting audits (Chan et al., 2015). According to the research conducted by Chan et al. (2015), the scrutiny of transfer pricing activities by multinational companies through audits can incentivize these companies to refrain from engaging in tax avoidance practices. Drawing upon the background information and insights derived from previous studies, the present research aims to investigate the phenomenon of transfer pricing in relation to tax avoidance within the context of Indonesia. Furthermore, the study incorporates the variable of audit quality as a moderating factor to examine whether higher audit quality mitigates tax avoidance by multinational corporations through their transfer pricing activities.

Literature Review

Agency Theory

The manager (agency) is encouraged by the owner (principal) to run the company in order to increase the value of the company. In running the company, the manager uses the company's resources with the ultimate goal of benefiting the owner. In this condition, there is a conflict between the manager and the business owner which is also known as agency conflict. The principal then instructs the agent to carry on business as usual according to his instructions by providing much higher compensation than usual (Lee et al., 2015). Therefore, managers look for ways to increase the performance and value of the company in order to obtain the compensation promised by the owner. In this case one of the factors that need to be considered is the net profit. A company that has good performance can be seen by increasing profits which is the view of owners and investors. On the other hand, net profit was also affected by operating expenses which resulted in a decrease. The tax burden is one of the expenses that causes a decrease in profits (Dwi Putra et al., 2019) Therefore, managers think about steps to minimize the tax burden, one of which can be done through tax avoidance. This condition triggers a conflict of interest between company managers and owners. The owner will be disadvantaged if the increase in profits is obtained from tax avoidance because profits from the company's operating activities boost the company's growth. If managers focus on increasing profits from tax avoidance, the company's growth can experience a slowdown.

Tax Avoidance

Tax avoidance is a form of corporate action to minimize taxes paid to countries that do not violate any provisions (Khoirul Huda et al., 2017). This tax avoidance is a form of taxpayer disobedience that is triggered by the level of tax rates, the possibility of being caught or known by the tax examiner and the risk preferences of the taxpayer (Hanlon & Heitzman, 2010). Countries that have low tax rates, less stringent inspection levels and taxpayers who have a preference for risk takers will have a high level of tax avoidance. Furthermore, tax avoidance can occur because there are different rules relating to accounting and tax-related rules. This condition results in differences in recognizing a transaction both in terms of accounting rules and tax rules. Even though this tax avoidance action does not violate the rules, it must not be mitigated because tax avoidance can erode the tax revenue received by a country (Sebele-Mpofu et al., 2021).

The trigger factor for this tax avoidance is the tax rate (Hanlon & Heitzman, 2010). High tax rates in a country can trigger multinational companies to think of ways to minimize the taxes paid. This is because if the tax rates are too high, the taxes paid to the state will be large and this will certainly reduce the company's profits. In addition, tax avoidance occurs due to the interests of company managers who aim to seek personal gain (Desai & Dharmapala, 2006). Managers in several companies receive bonus amounts depending on the profits they earn. If the tax burden paid is small, the company's after-tax profit will be large so that the bonuses received by managers will also be large. The tax burden is considered the biggest cost incurred by the company, so managers take action to reduce their tax obligations (Gaaya et al., 2017). This condition triggers tax avoidance in the company. In Indonesia, this tax avoidance can occur because the tax system uses a self-assessment system. This system gives authority to taxpayers to calculate and pay their taxes (Muhammadi et al., 2016). This system also applies to companies in Indonesia, companies calculate taxes on business transactions that they carry out and then pay them to the state. This system can provide two possibilities for multinational companies in Indonesia, namely reporting and paying taxes correctly on their business transactions or reducing the taxes that should be owed.

Transfer Pricing

Transfer pricing is an activity of goods or services transactions carried out between subsidiary companies and parent companies or between subsidiary companies that are members of multinational companies (Lin & Chang, 2010). Furthermore, (Pangaribuan et al., 2021) transfer pricing is also associated with company transaction activities to other companies that have a related party where this relationship leads to the parent company to the subsidiary company or vice versa. In business practice can provide benefits for the company. Companies can improve their business competitiveness and gain flexibility over internal fund transfers. However, on the other hand, transfer pricing can also be used to reduce the amount of tax paid by companies (Lin & Chang, 2010). This means that transfer pricing can also be used by companies to avoid taxes. The use of transfer pricing for tax avoidance can certainly erode revenue in a country (Sebele-Mpofu et al., 2021). And in the end it can be seen that the transfer pricing motivation has a positive charge, namely to increase the company's business and also has a negative charge, namely to reduce the company's tax burden. Companies avoid taxes through transfer pricing by setting lower transfer prices to subsidiaries whose countries have low tax rates (Lin & Chang, 2010). This action results in a transfer of profits from the parent company with high taxes to a subsidiary with a lower tax rate. As a consequence, the parent company's profit becomes smaller, which is then followed by a smaller amount of taxes. In addition to the method above, (Lin & Chang, 2010) described another method related to transfer pricing carried out by companies, namely the parent company setting a higher transfer price for goods or services to subsidiaries whose tax rates in their countries are higher than those of the parent company. The transfer price causes the parent company's production costs to be higher, which in turn results in lower profits and taxes paid.

Audit Quality

Audit quality holds great importance as it plays a crucial role in mitigating conflicts of interest that may arise between company management and external shareholders. By ensuring a high level of audit quality, potential agency problems can be addressed, promoting transparency, accountability, and trust in financial reporting. The effective reduction of such conflicts enhances the alignment of interests and fosters a healthier relationship between management and shareholders (Guenther et al., 2017). An aspect of corporate governance called audit quality restrains manager behavior, prevents accounting fraud, and fraudulent behavior (Deangelo & Masulis, 1980). The quality of an audit is linked to an auditor's capacity to prevent and minimize harmful practices, questionable accounting violations, and significant irregularities when compared to auditors of lower quality. Because of the unobservable nature of audit quality, auditors use various signals, such as their reputation, to effectively communicate and demonstrate their level of quality. These signals serve as indirect indicators for stakeholders, providing insight into perceived trustworthiness (Francis et al., 1999).

Hypothesis Development

Transfer pricing activities were initially aimed at boosting profit growth for multinational companies but recently the use of transfer pricing has been used for other motivations, namely reducing taxes paid to the state. This phenomenon is proven by the research of Lin & Chang (2010) that one of the motivations of companies to carry out transfer pricing is for tax avoidance. Companies carry out these activities by transferring products or services at lower prices to countries with low tax rates. Several researchers such as (Suhendra, 2020; Pangaribuan et al., 2021) found that transfer pricing has a positive effect on tax Avoidance. This research proves that transfers are used by multinational companies to reduce taxes that will be paid to the state, multinational companies transfer products to subsidiaries with lower taxes. The transfer price for the product sent is set higher, resulting in higher

production costs for the subsidiary company which in turn results in lower profits and taxes paid (Lin & Chang, 2010).
H_1: Transfer pricing has a positive effect on tax avoidance

Users of financial statements need quality financial reports. This is because financial reports must contain reliable information for making decisions by users of financial statements. On the other hand, conflicts of interest that occur between principals and agents (managers) can trigger a decline in the quality of financial reports. The agency theory viewpoint confirms that audit quality plays an important role in minimizing conflicts of interest between management and external shareholders. An aspect of corporate governance called audit quality restrains manager behavior, prevents accounting fraud, and fraudulent behavior (Deangelo & Masulis, 1980). For minimizing conflict of interest, an external auditor is required to provide an impartial opinion on the company's financial accounts (Guenther et al., 2017). In addition, external auditors evaluate whether their clients take an aggressive tax attitude which can be detected by the tax authorities as a gray area. One of the factors that affect the quality of financial statements is the quality of auditors.

Related to external auditors who audit financial statements based on the results of several studies (Gaaya et al., 2017,Sikka & Willmott, 2013) are grouped into big 4 and non big 4. Big four KAPs are considered to have the ability to produce better audit quality than with KAP Non Big Four. This is because the big four KAPs have the knowledge, experience and reputation that can be used to find fraud in the financial statements of the companies being audited. With the advantages possessed, the big four KAPs are able to detect transfer pricing transactions used for tax avoidance carried out by companies, so that if there is an inspection from the tax authority, the big four KAP clients do not find any problems with regard to transfer pricing used for avoidance tax. Research by Rizqia & Lastiati (2021) found that audit quality has a negative effect on tax Avoidance. These findings indicate that audit quality can reduce tax avoidance activities carried out by companies.
H_2: Audit quality moderate the relationship between transfer pricing and tax avoidance

RESEARCH METHOD

This research is a quantitative research by analyzing secondary data. Quantitative research is research that emphasizes theory testing through research variables with numbers and conducting statistical data analysis. The population in this study are manufacturing companies listed on the Indonesia Stock Exchange for the period 2016 – 2019. Sampling in this study used a purposive sampling method to obtain data in accordance with the research criteria. The dependent variable in this study is tax avoidance. Tax avoidance is an attempt by a company to reduce or minimize the company's tax burden. Tax avoidance in this study is proxied using ratios effective tax rates (ETR). The ETR in this study only uses the main model used (Lanis & Richardson, 2012) namely the income tax expense divided by the company's pre-tax income. The ETR ratio is measured by the following calculation:

$$ETR = \frac{\text{Income Tax Expense}}{\text{Income Before Tax}} \qquad (1)$$

Audit quality is associated with the auditor's ability to prevent and mitigate fraudulent practices as well as questionable accounting violations and material deviations compared to low quality auditors. Audit quality cannot be observed, so the auditor tries to communicate its quality through signals such as reputation (Francis et al., 1999). The use of the Big Four Public Accounting Firm to audit a company is good news for the public that the audited financial statements are of high quality (Audit Quality in this study is measured using public standards. The audit quality variable in this study was measured using the dummy variable.

RESULTS AND DISCUSSION

Result

Classical Asumptions Test

The normality test aims to test whether the data is normally distributed or not. The normality test in this study used the Kolmogorov-Smirnov statistical test. If the significance value is > 0.05, the data has a normal distribution. Based on the test it can be seen that the Kolmogorov-Smirnov statistical test value is 1.312 and Asymp. Sig. (2-tailed) of 0.064, it can be concluded that the data is normally distributed. Judging from the Asymp value. Sig. (2-tailed) which is greater than 0.05. The multicollinearity test aims to test whether the regression model has a correlation between the independent variables. A good regression model is that there is no correlation between the independent variables. If the tolerance value is > 0.10 and the VIF value is < 10.00, then multicollinearity does not occur. Based on the test, it is known that in the coefficient section, the VIF value for accounting education level, business size and length of business does not exceed 10 and the tolerance value is close to 1, therefore the research variable is considered free from multicollinearity symptoms in the regression model, so it meets the data analysis requirements.

The heteroscedasticity test aims to test whether the regression model has an inequality of variance from one residual observation to another. A good regression model is that there is no heteroscedasticity From the results of heteroscedasticity processing carried out with the Glejser test, it shows that the significance value of the heteroscedasticity test results above as a whole has a significance level of > 0.05, which means that there is no correlation between the size of the data and the residuals so that when the data is enlarged it does not cause an increase in residuals (errors). The Durbin-Watson test (D-W) is a test to detect autocorrelation symptoms. The decision making of whether there is autocorrelation can be seen from the following provisions: In theory, if the D-W value is below -2, it means that there is a positive autocorrelation. If the D-W value lies between -2 to +2, it means there is no autocorrelation. Furthermore, if the D-W value is above +2, it means that there is a negative autocorrelation. Based on the SPSS output results above, a D-W value of 1.099 is obtained, which means that there are no autocorrelation symptoms.

Coefficient of Determination

Based on the results of the analysis of the coefficient of determination (R2) listed in table 8, it is known that the significance value of the Adjusted R square is 0.786, which means that the ability of the independent variable to explain the dependent variable is 78.6%, the remaining 11.4% is explained by other variables that are not explained by this research. So that with the addition of moderating variables it can reduce the influence on the dependent variable.

Hypothesis Result

Table 1 present the results of hypotheses testing in this study.

Table 1. Hypothesis Testing

H	Independent Variable → Dependent Variable	B	Std Eror	Beta	P-Values	Result
H1	Transfer Pricing -> Tax Avoidance	,867	,036	,904	0,027	Supported
H2	Transfer Pricing*Audit Quality -> Tax Avoidance	-,038	,055	-,038	0,837	Not Supported

According to Table 1, the X1 coefficient value is 0.867 with a significance of 0.000 obtained from the results of the regression test on the model. This research proves that transfer pricing has a positive effect on tax avoidance. Based on the results of the tests performed, hypothesis 1 is accepted.

The X2 value indicates that it is 0.014 with a significance value of 0.508. The coefficient X1 X2 is -0.038 with a significance of 0.486. These results indicate that the interaction between transfer pricing and audit quality cannot reduce the level of tax avoidance so that the hypothesis for H2 is rejected.

Discussion

Based on the hypothesis test results, transfer pricing has an effect on tax avoidance. These results are in accordance with research ((Sikka & Willmott, 2013). Companies usually use transfer pricing to minimize the tax burden that must be paid. Transfer pricing is usually done by selling a group of goods and services at a price below the market price, then transferring the profits to a group of companies registered in countries with lower tax rates. The higher the tax rate of a country, the more likely a company is to do tax avoidance, because tax for companies is seen as a burden that will reduce profits. This is in line with agency theory, according to Jensen and Meckling that company managers will try to achieve maximum profits so that managers can get intensive compensation for performance in running the company without considering the risks faced. The results of this study strengthen the results of Otusanya, (2011), and Amidu et al. (2019)

Auditor quality is not able to moderate the relationship between transfer pricing and tax Avoidance. This illustrates that audit quality cannot prevent tax Avoidance through transfer pricing. This phenomenon occurs because external auditors who audit financial reports only ensure the feasibility of financial statements and compliance with financial accounting standards. Not focusing on tax avoidance by companies. Furthermore, the legality of lawful tax avoidance according to the rules makes the auditor not consider tax avoidance as a violation committed by the company so that when the external auditor audits the company's financial statements, tax Avoidance is not considered a problem.

CONCLUSION

The results of hypothesis testing indicate that transfer pricing has a significant effect on tax avoidance. An increase in corporate transfer pricing activities will also have an impact on tax avoidance by multinational companies. The findings in this study identify transfer pricing activities carried out by companies as motivated to reduce taxes through tax avoidance. The role of auditor quality was not found to moderate the relationship between transfer pricing and tax avoidance. This phenomenon occurs because external auditors who audit financial reports only ensure the feasibility of financial statements and compliance with financial accounting standards. Not focusing on tax avoidance by companies. Furthermore, the legality of lawful tax avoidance according to the rules makes the auditor not consider tax avoidance as a violation committed by the company so that when the external auditor audits the company's financial statements, tax avoidance is not considered a problem.

This study is not exempt from certain limitations. Among the limitations encountered, one notable restriction is the narrow focus on Indonesia as the research scope. However, it is important to acknowledge that transfer pricing phenomena predominantly involve multinational corporations engaged in cross-border operations. Transfer pricing practices arise primarily as a result of countries' tax policies that emphasize taxation, thereby giving rise to transfer pricing activities. To address this limitation, future research endeavors are recommended to incorporate cross-country data, which would enable a more comprehensive examination of the subject matter. Furthermore, another limitation of this study pertains to the application of the Effective Tax Rate (ETR) as a proxy for tax avoidance. The suitability of ETR as an accurate representation of the extent of tax avoidance remains a topic of ongoing debate and scrutiny within the scholarly community.

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