

The effect of family ownership on aggressive tax avoidance in Indonesia

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Abstract

The aim of this study aim is to analyse the effect of family ownership structure on aggressive tax avoidance in Indonesia. This research uses panel data from annual reports of listed manufacturing companies on the Indonesian Stock Exchange from 2011 to 2017. The model of aggressive tax avoidance measurement in this research uses the Effective Tax Rate (ETR). The results of this research indicate that the family ownership structure has a negative effect on (lowers) aggressive tax avoidance. Most Indonesian manufacturing companies have family ownership in their capital structure and this result shows that company owners use their power to manage tax planning activities.

Key words: family ownership, aggressive tax avoidance, Effective Tax Rate (ETR)

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1. INTRODUCTION

Aggressive tax avoidance involves management action to reduce income tax by tax planning activities (Richardson, Taylor & Lanis, 2013; Lanis & Richardson, 2011; Chen et al., 2010; Hanlon & Slemrod, 2009; Frank, Lynch & Rego, 2009). Aggressive tax avoidance covers legal tax planning activities, or legal tax planning that might be close to a 'grey area', and illegal tax planning activities (Richardson et al., 2013). Those tax planning activities which are close to a grey area present an attractive strategy for management and shareholders to boost their profit through decreasing their tax expenses, even though those actions might be harmful for the company's viability.

Aggressive tax avoidance is risky activity, as shown by Boone, Khurana and Raman (2013), Rego and Wilson (2012), Chen et al. (2010), Hilary and Hui (2009), Gasper and Clore (1998), Miller and Hoffmann (1995), Malinowski (1925), and can be costly, as explained by McGuire, Wang and Wilson (2014). As a consequence, management may not take this risk in managing a company's finance. Other reasons why some companies do not carry out aggressive tax avoidance include the risk in terms of sanction or significant cost, protection of the company's image in practising appropriate business ethics and maintaining the good corporate governance, and assuming that aggressive tax avoidance is equivalent to tax evasion (Chen et al., 2010).

Those risks motivate concentrated ownership companies not to carry out aggressive tax avoidance. This is in line with the findings of Badertscher, Katz and Rego (2013) that the marginal cost of tax avoidance and ownership separation affect tax avoidance action and managers who are less attracted to risky investment will avoid such activities (Fama & Jensen, 1983). Similarly, as stated by Chen et al. (2010), non-financial firms tend to be more aggressive towards tax avoidance than family firms.

Within family firms, a unique issue which has been found related to agency theory is that a greater conflict exists between majority stockholder and minority stockholders and, conversely, a smaller conflict exists between principal and manager. Moreover, Chen et al. (2010) document that the comparable level of tax avoidance tendency between family firms and non-family firms depends on benefits and the higher cost which may arise from aggressive tax action. Family firms prefer to pay higher tax (not carrying out tax avoidance) to paying fines and the possibility of ruining their family reputation.

The presence of a firm's founder as majority stockholder affects a firm's level of aggressive tax action. As noted, in terms of aggressive tax action, family firms bear higher potential benefits and higher costs than non-family firms (Chen et al., 2010). Dyreng, Hanlon and Maydew (2010) uncover that a firm's individual executives have a significant role on the level of firm's tax avoidance. A family firm's majority votes give control to the family as a whole (spouse, parents, children or the heirs) and a least one of the family representatives will be involved in the firm's management or administration (Chen et al., 2010).

This study has been motivated by the existence of the aggressive tax planning phenomenon in Indonesia. There are some tax aggressive cases that have been pursued by the Directorate General of Taxes in recent years, involving, for example, Asian Agri, Bumi Resources, Adaro, Indosat, Indofood and Kaltim Prima Coal (KPC) (Kuswandi, 2015; Panggabean, 2014). Those companies have concentrated ownership of their capital structure. The novel issue examined by the study is that most of the companies

which have been exposed in terms of the aggressive tax avoidance issue are manufacturing companies. As revealed by the Directorate General of Taxes there is a disparity between income and tax payments in manufacturing companies. This derives from low tax payment obedience, and the effects of the underground economy and tax avoidance tendency (Sudiarta, 2016).

The purpose of this research is to gain a holistic understanding on the effect of family ownership on tax avoidance aggressiveness of Indonesian manufacturing companies over the period 2011-2017. The contributions of this study are: (1) advancing tax literature, particularly for estimating the effect of family ownership towards tax aggressive action of listed manufacturing companies over the period 2011-2017, and (2) improving the understanding of the effects of family ownership on aggressive tax action necessary for the government to make policy on tax issues and providing suggestions for the Directorate General of Taxes in order to detect companies carrying out tax aggressive activity.

This research successfully reveals that family ownership affects tax avoidance aggressiveness. Arguably, most Indonesian manufacturing companies have family ownership in their capital structure and the owner has the full power to carry out tax planning activity. The remainder of this article is organised as follows: section 2 provides a literature review on theoretical issues and hypothesis development; section 3 sets out the research method; section 4 provides results and discussion, and finally section 5 sets out the conclusion and directions for future research.

2. PRIOR RESEARCH AND HYPOTHESIS DEVELOPMENT

2.1 Agency theory

The main theory used in this research is agency theory. Hendriksen and Van Breda (1992) define agency theory as directed to the contractual relationship between agent and principal. Where an agent works for a principal, then the principal should pay the agent in return. Jensen and Meckling (1976) document agency as a contract where one or more principals use another party or agent to manage the company. Within agency theory, a principal includes a stockholder or owner who provides facilities and capital to operate a firm.

Agency theory assumes every individual is motivated by their own prosperity and interest. Principals will be driven by the motives to enrich their own position through dividend payouts or an increase in the stock price, while agents are motivated by the effort to enrich their position through higher compensation. Conflict of interest arises where a principal has insufficient information regarding agent performance, which causes incapability of the principal in terms of controlling the agent's activities. Meanwhile an agent will possess greater information related to self capacity, work environment, and the entire company.

That phenomenon leads to what is termed asymmetric information. Asymmetric information and conflict of interest encourage the agent to hide some unrevealed information from the principal and reveal untrue information to the principal, specifically the information related to agent's performance measurement.

The level of agency issues varies from one firm to another. According to Chen et al. (2010), the comparison in the level of tax aggressiveness between family firm and non-family firm depends on the benefit effect or cost that may be apparent from those tax

aggressive activities to the firm owner in the case of family owners, or the effect received by managers in the case of non-family firms.

2.2 Aggressive tax action

Tax is a significant cost for the firm and diminishes cash flow for the firm and stockholder. This provides an incentive for the company to diminish the tax through tax aggressive activities (Chen et al., 2010). This study follows the definition of aggressive tax activity of Frank et al. (2009), as an action that aims to lower taxable profit through tax planning whether categorised as tax evasion or not. While not all activities contravene the law, the greater the chance taken by the firm of doing so the more aggressive the practice carried out by the form will be considered to be. Chen et al. (2010) and Desai and Dharmapala (2006) state there are both advantages and disadvantages of tax aggressive activity. According to Chen et al. (2010) the advantages are:

1. Efficiency in the amount of tax paid by the company to the government, so that the cash portion of earnings retained by the owner or manager is maximised.
2. The opportunity for a manager to conduct rent extraction, i.e., the condition where the manager carries out action which does not maximise the owner's interest, in terms of arranging aggressive financial reports, taking over a company's resources or assets for private interest, or engaging in such transactions with special relatives.

Conversely, Desai and Dharmapala (2006) stipulate some disadvantages of aggressive tax action as follows:

1. A possibility of the company to incur a financial sanction or penalty and a drop in its stock price.
2. A fall in the stock price as the result of a negative assumption on the part of stockholders, that aggressive tax action involves rent extraction that may disserve the stockholder.

This research uses Effective Tax Rate (ETR) as the proxy of aggressive tax measurement since this proxy is often used in various tax studies and it is consistent with Indonesian tax regulations (Astuti & Aryani, 2016). In Indonesia, only one tax burden is recognised, which is the income tax expense, as compared with the United States which has more types of applicable tax burden such as current federal tax expense and current foreign tax expense. The ETR is estimated by dividing income tax expense by earnings before tax, acquired from the income statement. Income tax expense is the sum of current tax expense and deferred tax (Chen et al., 2010).

Some previous studies on tax aggressiveness include: Chen et al., 2010; Hanlon & Heitzman, 2010; Dyreng et al., 2010; Lanis & Richardson, 2012; Frank et al., 2009; Rusydi & Martani, 2014; Hidayanti, 2013; Sari & Martani, 2010; Prasista & Setiawan, 2016; Rusydi, 2013; Tiaras & Wijaya, 2015; Utami & Setyawan, 2015; Hanna & Haryanto, 2016; Hadi & Mangoting, 2014; Adisamartha & Noviyari, 2015.

2.3 Family ownership

As a developing country, a feature of Indonesia is that most companies have a family as the major stockholder in their capital structure. Stock ownership in developing countries

is mostly dominated by families, as in the case of Indonesia (Hidayanti, 2013). Family ownership is every firms where have major stockholder. Family stock ownership within a firm means that the stockholder has a particular incentive structure. A family stockholder bears strong influence within the company and has sound motives to manage the company itself (Anderson, Mansi & Reeb, 2003).

Chen et al. (2010) assert that a gap does exist between family firm owner and non-family firm manager. First, a family firm owner has higher ownership than a company executive (CEO) so that a family ownership bearer exerts higher thrift on tax payment. Moreover, a family firm has at least one family member on its board of directors. Sirait and Martani (2014) posit the presence of the gap between family stock bearer and common stock holder in term of the two characteristics of family attention on company viability and family reputation and the company.

2.4 The effect of family ownership on tax aggressive action

Prior research finds a correlation between ownership structure and aggressive tax avoidance (Badertscher et al. 2013; Desai & Dharmapala, 2006). Inconsistency in those prior research results has encouraged researchers to carry out research in related areas. Sari and Martani (2010) carry out research on firm ownership characteristics, corporate governance and aggressive tax action and argue that family firms tend to be positively correlated to aggressive tax planning. Whether a family firm is more active concerning aggressive tax planning compared to a non-family firm depends on the benefits or the cost that might be borne by the family owner in the case of a family firm or manager in the case of a non-family firm relating to aggressive tax planning.

Rego and Wilson (2012), Zhang (2012) and Chen et al. (2010) have found a negative effect of family ownership on aggressive tax avoidance. Chen et al. (2010) and Rego and Wilson (2012) document that family firms are less aggressive than non-family firms on tax avoidance issues. Compared to a non-family firm, a family firm is more willing to pay higher tax than to pay a sanction or fine and face the bad reputation as the result of a fiscal audit. Moreover, Chen et al. (2010) state that aggressive tax analysis indicates that family firms have a coefficient level and negative *t* score that indicate a negative effect (Chen et al., 2010). In accordance with Chen et al. (2010), the proposed hypothesis of this study is:

H1: family ownership negatively affects (lowers) firm aggressive tax activity.

3. RESEARCH METHOD

3.1 Data and sample

The sample for this research is financial statements and annual reports of listed manufacturing firms during the period 2011-2017. Financial data is obtained from the Indonesian Stock Exchange website, www.idx.co.id. The sampling method is purposive sampling, where a sample is taken according to determined criteria. Those criteria are: (1) subjects are listed manufacturing firms over the period 2011 to 2017; (2) those firms consistently publish their complete financial data over the period 2011 to 2017; (3) the Indonesian Stock Exchange meets the complete related data needs for required variables over the period 2011-2017; (4) firms use Indonesian rupiah (IDR), in order to equalise the analysis; where a firm reports its data in foreign currency, there is a conversion of those amounts to rupiah; (5) firms have no losses, since a loss firm does not pay the tax;

(6) firms have an ETR score less than 1 ($ETR < 1$). By those criteria, we eliminate firms that do not fit the criteria. Then we have 194 observations of 31 firms.

3.2 Variable definition and measurement

Aggressive tax activity

The Effective Tax Rate (*ETR*) is calculated as income tax expense to earning before tax, obtained from the actual income statement. Income tax expense is the total current tax and deferred tax. A low ETR indicates income tax expense is less than earning before tax. The *ETR* formula of Lanis and Richardson (2012) is presented as follows:

$$ETR = \frac{\text{Income tax expense}}{\text{Earnings before tax}}$$

Independent variables

For family ownership, this research follows Chen et al. (2010) to articulate the family ownership definition. Prakosa (2014) stipulates that, for all individuals and firms owned by individuals and firms that have ownership listed (ownership of more than 5% of ownership structure should be listed), family is the individuals connected as heirs or through marriage. This research articulates family ownership as the proportion of family ownership (Chen et al., 2010).

Control variables

Control variables aim to control the effect of profitability, firm's leverage and firm size, and therefore this research takes into account return on assets (*ROA*), leverage (*LEV*) and firm size (*SIZE*) in the regression model.

Profitability describes financial performance of the firm in terms of gaining profit from their assets, known as return on assets (*ROA*). *ROA* is an indicator that describes financial performance of the firms. *ROA* defines the ability of the firms to gain profit through their assets. *ROA* is formulated by following Lanis and Richardson (2012):

$$ROA = \frac{\text{Earnings before tax}}{\text{Total Assets}}$$

Leverage is level of liability to finance their operation. Leverage defines the level of risk measured by comparing the firm's total expenses to total assets. Leverage is the ratio which estimates whether long term liability or short term liability is used to finance firm assets (Waluyo & Basri, 2015). Leverage is estimated as follows:

$$LEV = \frac{\text{Total Liabilities}}{\text{Total Assets}}$$

Size is the proxy to measure the firm's size by using algorithm of the firm's total assets (Rusydi, 2013). The use of natural logarithm (Ln) aims to mitigate excessive data fluctuation without affecting the proportion of the actual real score (Waluyo & Basri, 2015).

$$SIZE = Ln(\text{Total Assets}).$$

3.3 Data analysis technique

Collected data is analysed using Eviews 08 software. The regression model is presented as below:

$$Tax\ Agg_{it} = \beta_0 + \beta_1 FAMILY_{it} + \beta_2 ROA_{it} + \beta_3 LEV_{it} + \beta_4 SIZE_{it} + \varepsilon_{it}$$

where:

$Tax\ Agg$ = Tax Avoidance (ETR)

$FAMILY$ = Family ownership

ROA = Return on assets (profitability)

LEV = Leverage

$SIZE$ = Firm size

ε = Random error

We then conduct a two-test procedure for the regression analysis: F test for model testing and t test for hypothesis testing.

4. RESULT AND DISCUSSION

4.1 Result

Model testing for dependent variable proxied by Effective Tax Rate (ETR), family ownership as independent variable, and three control variables (ROA, Leverage, Size) is presented as follows:

(a) Selecting estimation model

(1) Chow test

Table 4.1. Chow Test Result

Effect Test	Statistic	d.f.	Prob.
Cross-section F	2.926671	(30,119)	0.0000
Cross-section Chi-square	85.104914	30	0.0000

Source: processed secondary data, 2018

The Chow test proposes to determine regression model by common effect method or fixed effect method. On Table 4.1 above, the score for the probability of cross section F is less than 5% is 0.0000, so the null hypothesis (H_0) is rejected. In other words the best model for this research based on the Chow test is fixed-effect.

(2) Hausman test

Table 4.2 Hausman Test Result

Test Summary	Chi-Sq. Statistic	Chi.Sq.d.f.	Prob.
Cross-section random	2.535784	4	0.6382

Source: processed secondary data, 2018

The Hausman test proposes to determine the most appropriate model between fixed effect and random effect. Table 4.2 presents a probability score that is 0.6382 which is more than 5% so H_0 is accepted. It implies the fittest model for panel data analysis is a random effect model. Based on the Chow test and Hausman test, the fittest model for panel data analysis is random effect.

(b) Regression result of ETR model with random effect

Table 4.3. Regression result of ETR model

Independent Variable	Dependent variable ETR		
	Coefficient	t-Statistic	Prob
C	0.313202	8.153197	0.0000
FAMILY	-0.026674	-1.712895	0.0450**
ROA	-0.288582	-4.454517	0.0000
LEVERAGE	0.017466	0.495533	0.6210
SIZE	-6.11E-05	-0.052376	0.9583
R-squared		0.139144	
Adjusted R-squared		0.116034	
F-Statistic		6.020875	
Prob (F-statistic)		0.000161	

** : level of significance at 5%

Source: processed secondary data, 2018

As presented in Table 4.3, the random effect analysis result of R^2 is 0.139144. This indicates that the dependent variable is explained by the independent variable to the extent of 13.91% and the other 86.09% is explained by the other untested variables. The F -statistic score analysis pre-determined as low the probability of the fit of the model used in this research, where the independent variables significantly affect dependent variable. Based on the regression analysis above, the F -statistic score is 6.020875 with a probability score of 0.000161. It indicates that family firm ownership and three control variables (profitability, leverage, and size) simultaneously affect aggressive tax activity.

The testing result on the effect of family ownership on ETR indicates a negative score, that is -0.026674 and the probability score of family ownership is 0.0450. It indicates the probability score of family firms is less than α (5%), which means that family ownership significantly affects ETR, so H_1 is supported. This research reveals that family ownership affects manager action on aggressive tax activity of the firms.

In terms of ETR testing by control variable, ROA denotes a negative coefficient score of -0.288582. Later on, the probability score implies 0.0000 which is less than α (1%), which means that ROA negatively affects aggressive tax activity. Moreover, the control variable of leverage indicates a positive coefficient score of 0.017466, while its probability is less than α (1%, 5%, and 10%) which means leverage significantly affects aggressive tax activity. The last control variable, size, shows a negative coefficient score of -6.11E-05, and its probability score is 0.9583. Those scores indicate that the probability score is higher than α (1%, 5%, 10%), which means size insignificantly affect aggressive tax activity.

4.2 Discussion

The result of this research is in line with the findings of Rego and Wilson (2012), Zhang (2012) and Chen et al. (2010), and contrary to those of Utami and Setyawan (2015), Hanna and Haryanto (2016) and Sari and Martani (2010) which indicate insignificant results. It derives from the theory that the owners of family firms can fully use their

power in relation to the firm's tax planning activities (Fatharani, 2012). Another argument is based on reputation/image, in that the good reputation of the family and firms will be damaged if aggressive tax activities are revealed, and the fines that may come for aggressive tax action.

The result of this research is consistent with real conditions in Indonesia. Online media reports have documented that then Finance Minister Bambang Brodjonegoro gave as the reason for presenting awards to four cigarette companies, namely HM Sampoerna Tbk, PT Gudang Garam Tbk, PT Djarum Tbk and PT PDI Tresno, not their large excise tax payments but each company's allegiance in term of tax payment (Wiyanti, 2016). Of those four, one is a member of the Djarum Group which is owned by the 2nd ranked richest family firm in Indonesia, the Hartono family firm, while Robert Budi Hartono and Michael Bambang Hartono, the children of the Djarum founder, at the same time are the largest stockholders of Bank Central Asia (BCA) (Gideon, 2015). This suggests that a family firm can be considered more obedient in terms of tax payment as part of their effort to protect their good reputation and family image from tax sanctions because of aggressive tax action.

5. CONCLUSION, LIMITATIONS, AND SUGGESTIONS FOR FUTURE RESEARCH

This study aims to test the effect of family ownership on aggressive tax action using profitability, leverage, and size as the control variables. According to the data analysis of 31 listed manufacturing firms, over the period 2011-2017 with 194 observations, this research approves that family ownership negatively affects (lowers) tax avoidance action as measured by the Effective Tax Rate (ETR).

The limits of this research are:

(1) a limited sample, involving only manufacturing firms meeting sample criteria, and thus the result could not be generalised for other sectors. It is proposed for future research to use a larger sample of all listed firms on the Indonesian Stock Exchange, by using a sampling technique based on the income tax tariff applied for all firms.

(2) this research solely analyses one variable, i.e. family ownership, affecting aggressive tax action. It is suggested for future research to take into account other independent variables to explore the significance of various factors affecting tax avoidance.

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