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# Income Shifting Strategy as a Reaction of Corporate Tax Rate Reduction and the Role of Auditors

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***Abstract*—This research aims to investigate income shifting strategy carried out by the company as a reaction to the corporate income tax rate decrease. It is conducted by the Indonesian government from 25 % to 22 % in 2020. Furthermore, this study also investigates the influence of audit quality upon the income shifting strategy. In contrast to existing research, this study used the book-tax difference approach to measure of income shifting. By using a sample of 51 public companies listed on the Indonesia Stock Exchange, the following results obtained: First, in 2019 the company performed income shifting in response to a decrease in corporate tax rates. Secondly, auditor quality gave a negative effect on income shifting.**

***Keywords—income shifting, book-tax differences, leverage, audit quality***

## I. Introduction

Compared to other Asian countries, the corporate income tax rate applied by the Indonesian government is still relatively high, namely 25% of the tax base. This rate is 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% [1]. With a corporate income tax rate of 25%, it means that companies in Indonesia must surrender a quarter of their profits to the state, so this tax burden becomes a very significant expenses for the company. The high corporate tax rate is one of the factors that encourage taxpayer to do tax avoidance [2,3].

Through PERPU Number 1 of 2020 concerning State Financial Policy and Financial System Stability for Handling the Covid-19 Pandemic, the government adjusts the corporate income tax rate to 22% which applies in the 2020 and 202l, and to be 20% in the 2022. This policy is then reinforced through Government Regulation (PP) Number 30 of 2020 concerning the reduction of corporate income tax rates for domestic companies. The policy to reduce corporate tax rates is not only one form of tax incentives provided by the government in the face of the Covid-19 pandemic, but actually this tax rate reduction has been planned for a long time by the government with the aim of increasing the productivity and competitiveness of domestic industries.

Socialization of the reduction in corporate income tax rates has been carried out for a long time by the government through the Directorate General of Taxes (DJP) and has also been discussed throughout 2019 through discussions on the draft amendment to tax law (RUU) by the government with the House of Representatives (DPR) and it has been agreed that there will be a reduction in the corporate income tax rate. The socialization of this reduction in tax rates is of course a positive signal for companies as taxpayers. The main issue is whether the corporate income tax rate reduction policy will be used by companies as corporate taxpayers to take tax avoidance. So the research question arises is how the company's management strategy to response the reduction in tax rates?

The decline in corporate tax rates did not only occur in 2020, but in 2010 the government lowered the corporate tax rate from 28% to 25% which took effect in 2010. Warsini [4] found evidence that public companies in Indonesia implemented a tax avoidance strategy through income decreasing in financial reporting for 2 years prior to the enactment of the tax rate reduction in the 2010. Similar research results were also found in other countries when there was a reduction in tax rates such as in China [2], in Korea [5], in France [6], and in Germany [7]. These studies have found that companies undertake an income shifting strategy by arranging financial statements for one period before the enactment of lower tax rates by accelerating expense recognition and delaying revenue recognition.

Each public company in Indonesia have an obligation to publish financial reports that has been audited by public accountant. If public companies in Indonesia are proven to do tax avoidance through earnings management strategies, then the next research question is how the role of external auditors in the income shifting actions carried out by these companies. Based on the perspective of agency theory, Minyoung [8] state that tax avoidance can be minimized by the implementation of good corporate governance that reflected in the existence of an effective supervisory function which is reflected by the effectiveness of both internal and external supervision. The use of qualified external auditors is an effective monitoring mechanism against fraud management. Previous research has proven that tax avoidance is lower in companies that are audited by qualified auditors [9,10].

This study aims to find empirical evidence of whether or not there is tax avoidance through income shifting strategies in public companies for financial statements in 2019, which is one year prior to the enactment of lower corporate income tax rates which take effect in 2020. Another objective is to examine the effect of audit quality on strategy. income shifting. The results of this study are expected to contribute to regulators, especially tax regulators in making policies.

## II. Study Literature and Hypotheses Development

### A. *Income Shifting Strategies as Tax Avoidance Efforts*

Various tax avoidance studies have defined tax avoidance differently. Dyreng et al [11] define tax avoidance as all transaction arrangements that reduce corporate taxes relative to accounting profit before tax. Youngdeok [12] defines tax avoidance as tax savings that arise by taking advantage of legally enforced tax regulations (loopholes) to minimize the amount of tax paid. Meanwhile, Grantley and Richardson [13] state that tax avoidance is an effort to reduce the amount of taxable income by company managers through tax planning in a legal way, utilizing gray areas in illegal ways.

In the tax avoidance theory developed by Scholes et al [14], it is stated that tax avoidance can be done with various strategies and one of them is by means of income shifting. Income shifting strategies can be done in several ways, such as:

- Income shifting through transfer pricing policies. Jansky and Prats [15] found evidence that multinational companies in developing countries significantly carry out income shifting through transfer prices between subsidiaries by shifting income to companies in countries with lower tax rates and shifting expenses to companies in countries with higher tax rates. This finding is in line with the results of Outslay and Persson [16] research for multinational companies in the US.

- Income Shifting through issuance of debt securities, Kathleen and Uytbergen [17] find evidence that public companies in Belgium tend to shift profits from one period to the next in response to capital reserves. Dharmapala and Riedel [18] found that the existence of tax incentives affects the policy of European multinational companies to determine the location where bonds will be issued, and because bond interest is a deductible expense, companies tend to choose the location to issue bonds in countries with high tax rates.

- Income Shifting from one period to another, Zeng [2] stated that if the tax rate is constant or decreases over time, taxpayers prefer to delay the recognition of income and accelerate the recognition of costs so that they are taxed as low as possible. Various studies have proven that companies use income shifting strategies when they announce a reduction in tax rates. Scholes et al [14] find evidence that public companies in Indonesia have carried out tax planning through income decreasing in financial reporting for 2 years prior to the imposition of a reduction in tax rates on tax reform in 2008. The same research results were also found in many countries such as: in China [2,19] in Korea [5].

Based on the concept of income shifting strategy and the result of prior research, the first hypothesis developed in this research is:

H1: Public companies in Indonesia are suspected of doing income shifting on financial statements for the year ended 2019 as a response to the reduction of corporate tax rates that became effective in 2020.

### B. *The Role of External Auditor in Tax Avoidance*

Based on the perspective of agency theory, Nemis and Cetenak [20] 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. Audit quality can be determined by two factors: the auditors' capabilities in running the audit process, and their independence from their clients. The auditors' capabilities relate to their ability to find violations in the client's financial statements, while their independence is related to their freedom to report any violation.

Audit quality is difficult to assess, so much of the previous research has used industry specialization audits as a measure of audit quality. Auditors who concentrate on specific industries and perform certain audit procedures are able to acquire better knowledge of business and their clients' industries, thereby increasing their ability to conduct audits and work more effectively [8].

Based on the perspective of agency theory, Dharmapala and Riedel [18] state that tax avoidance can be minimized by the presence of good corporate governance. Good corporate governance is reflected in the existence of an effective supervisory function which is reflected by the effective supervision of the independent board of commissioners, the use of qualified external auditors, the presence of institutional investor ownership, and a diffuse share ownership structure. The examination of the impact of audit quality on tax avoidance has found that audit quality negatively affects tax avoidance [8-10,21,22].

Industry-specialized auditors are considered to have more knowledge (knowledge spill over) of the client's business condition, thus improving the ability to detect non-conforming book-tax transactions showing management efforts to avoid tax expenses [8]. More specifically, auditors who are more familiar with tax-reported financial issues will limit aggressive tax reporting or have the potential to limit aggressive financial reporting related to the purpose of tax regulation, thus producing a better internal control mechanism and the possibility to improve the quality of financial statements. Therefore, the second hypothesis proposed in this research is:

H2: Public companies that are audited by qualified auditors tend to be lower in income shifting

## III. RESEARCH METHODS

The research population are public companies listed on the Indonesia Stock Exchange until 2020. The sample selection criteria are defined as follows: 1). consumer good industry sub-sector companies, 2). have complete financial report data for analysis needs. The analytical unit uses the firm, with analysis year of 2019. Financial data and auditors, were obtained from The Indonesia Capital Market Institute (TICMI) which has indeed been collaborating with PNJ, especially D4 Financial Management Study Program. The data used were quantitative data taken from the company's financial reports and annual reports for 2018 and 2019.

The value of income shifting is calculated using the book-tax differences approach, referring to [23] the formula used is as follows:

$$BTDit = \alpha i + \alpha 1TAXit + \alpha 2FIASit + \alpha 3SALES + \alpha 4OINit + + \varepsilon it \quad (1)$$

### A. Operational Variables of Model (1)

BTDit = book-tax differences are 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 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 model to test the effect of audit quality on income shifting uses the following model:

$$INSFit = \alpha 0 + \alpha 1AUDITit + \alpha 2SIZEit + \varepsilon it \quad (2)$$

### B. Operational Variable of Model (2)

INSF is the value of income shifting, AUDIT is the quality of external auditors measured using industry specialization, is a dummy variable = 1 if the auditor controls the industrial market share ≥ 15%, 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

## IV. RESULTS AND DISCUSSION

IDX Statistics show that up to March 2020 there were 697 public companies listed on the Indonesia Stock Exchange. This number includes 9 sectors in which the consumer goods subsector contains 58 companies. The consumer goods subsector was chosen as the subject of this research because the industry in this subsector is quite stable compared to other sectors. Even in the current situation of the Covid-19 pandemic, the growth of this sector is quite stable because this consumer goods subsector industry provides goods that are widely used or consumed by the community for their daily needs. After selecting a sample of 58 companies according to the criteria, 51 companies were selected as the final sample. Table 1 presents the descriptive statistics, which provide an overview of the sample profiles and research variables.

TABLE I. DESCRIPTIVE STATISTICS FOR THE RESEARCH VARIABLES

| Variable | Maximum | Minimum | Mean | Stdev |
|---|---|---|---|---|
| INSF | 1.3346 | -0.1452 | 0.1725 | 0.1095 |
| AUDIT | 1 | 0 | 0.2835 | 0.2472 |
| SIZE | 1.0743 | 18.3002 | 8.8123 | 4.1715 |
| N | 51 | | | |

The mean value of the INSF variable is 0.1725, 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.

This research use one-sample t-test to compare the mean value of the variable INSF is significantly different from zero to prove whether the company is actually doing income shifting in 2019. Testing result is presented in table 2.

TABLE II. ONE SAMPLE T-TEST OF DISCRETIONARY BOOK-TAX DIFFERENCES

| One-sample t-test | variable | mean | Sig.(2-tailed) |
|---|---|---|---|
| 2019 | INSF | 0.1725 | 0.04046 |
| N = 51 | | | |

The result of different test shown that discretionary book-tax differences 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 income shifting strategy can be done by setting up accounts that have different treatment between generally accepted accounting standards (PABU) 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. The results of this study are in line with previous research in other countries such as: in China [2], in Korea [5], in France [6], and in Germany [7].

The second test is carried out to determine the effect of audit quality on income shifting controlled by firm size.

Results of the multiple regression are reported in table 3 is as follow:

TABLE III. REGRESSION RESULT

| Variable | prediction | coefficient | p-value |
|---|---|---|---|
| Constant | | 0.42279 | 0.000 |
| AUDIT | - | -0.10391 | 0.062* |
| SIZE | +/- | 0.00188 | 0.248 |
| N = 51 | | Adj $R^2$ = 0.31484 | |

From the regression results, the coefficient of AUDIT is negative and significant based on the p-value less than 10%. This is in accordance with the prediction that the public companies which audited by auditor specialization industry have the lower income shifting. These results support agency theory which states that a qualified external auditor is able to act as an effective supervisory mechanism against management discretion. This result is in line with [9].

The results of this study actually find evidence that industry specialization auditors generally have broad knowledge and competence on the situation in the industry so that they are able to detect management fraud related to tax avoidance. Qualified auditors also pay close attention to risk factors, auditors tend not to accept risks due to fraud committed by their clients. While the SIZE variable was used as a control variable, but the results were not significant

## V. CONCLUSION

Based on the test results and the above discussion, it can be concluded that when the government policy reduces income tax rates, the company's management will respond by shifting income to act so as to reduce the burden of taxes to be paid to the state. This finding implies that in the short term the policy of reducing tax rates can have an impact on decreasing state revenue, although in the long run it will have an impact on increasing the productivity and competitiveness of companies. Tax avoidance may be lower in companies that are audited by auditors who have industry specialization.

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