I J A B E R, Vol. 14, No. 13, (2016): 9195-9208

TAX AVOIDANCE IN THE PERSPECTIVE OF AGENCY THEORY: A REVIEW OF LITERATURES

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Abstract: *This paper shows the review of literatures on tax avoidance in the perspective of agency theory. The review encompasses four corporation's characteristics in regards to tax avoidance, including ownership structure, firm size, financial restraint, and corporate governance. This paper also provides the likelihood of further researchers on tax avoidance in the future.*

I. INTRODUCTION

Tax avoidance and evasion are the corporate activities in attempting to reduce the debt or tax burden. There are two related notions concerning on these two activities. First notion deliberates that these two activities indeed differ one another in terms of legality. The tax avoidance is defined as any activities that reduce the legal debt or tax burden and do not violate regulation whereas the tax evasion is defined as any activities that reduce the legal debt or tax burden under the violation of regulation (Bhuiyan, 2012; Chasbiandani & Martani, 2012; Hasseldine &Morris, 2012; Mughal & Akram, 2012; Xynas, 2011). Meanwhile, the second notion deliberates that these two activities do not differ at all in terms of legality (D. Dyreng, Hanlon, & L. Maydew, 2010; Huseynov & Klamm, 2012; Lingenfelser, 2011; Potas, 1993; Sikka, 2010). The presence of these two distinct notions related to both tax avoidance and evasion indicates that there has not yet been a concrete clear-cut definition towards the term *tax evasion*. Interested parties on this tax avoidance concept might perceive this from various aspects.

According to Hasseldine & Morris (2012), tax regulation and tax practice in every stateare different. Distinct parties (i.e. tax officers, tax payers, and NGOs) will use the term *tax avoidance* to describe the different types of tax avoidance behaviors. In UK for instance, tax avoidance is recognized as one specific type of tax payer's behaviors while in New Zealand the term tax avoidance cannot be accepted. This state tends to use the term tax planning despite essentially referring to the same behaviors (Hasseldine & Morris, 2012).

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The decision to take tax avoidance is generally influenced by various complex factors. It can be seen through both economical and psychological approaches (Ibadin & Eiya, 2013). Any tax activities, including tax avoidance, always consider the corporation profits (Editor, 2013; Sari & Martani, 2010). Economically, tax avoidance will definitely offer great profits, especially in terms of tax saving that should be paid to the state and hence saving the corporation's cash. Therefore, it will be profitable for the corporation yet disadvantageous for the state (Hanlon & Heitzman, 2010) and society for decreasing both the state revenues and social welfare.

II. REVIEW OF RELATED LITERATURES

Tax avoidance occurs in many developing countries (Upal, 2015). The practices of tax avoidance are done by not or partially reporting the corporation incomes to decrease the tax burden. These practices are intentionally done by corporations in regards to the decrease of tax burden (Budiman & Setiyono, 2012). Not reporting the corporation incomes is indeed an illegal activity due to the consideration that it indicates an evasion attempt to avoid the tax.

Another way is done through the *transfer pricing* (Bartelsman & Beetsma, 2003). This notion is affirmed by a study conducted by Hashimzade, Huang & Myles (2010) which figures out that tax evasion is done through the fake selling or profits reporting. It signals that there is a similarity between tax avoidance and evasion in terms of decreasing the debt or tax burden and thus creating a bias perspective to distinguish the legal and illegal tax evasion. The legality of these two activities becomes bias leading into the difficulty in differentiating between tax avoidance under the non-violation of regulation in one side and under the violation of regulation in another side (Potas, 1993). The tax avoidance and evasion in terms of economics has same precise impact, which is decreasing the debt or tax burden (Kirchler, Maciejovsky, & Schneider, 2003).

Tax is a profit reduction that is addressed to the corporation or the corporation owners (S. Chen, Chen, Cheng, & Shevlin, 2010; Mangoting, 1999; Sari & Martani, 2010). The tax amount will decrease profits and generally both corporation and corporation owners do not favorably report their incomes. As a result, these parties are apt to evade tax intentionally in order to decrease the tax burden. Owners tend to concede the tax avoidance for it is profitable for them (S. Chen *et.al.*, 2010). The tax paid by corporation to the state is a corporation's wealth transfer towards state. Therefore, the owners mostly and likely agree with management in conducting an aggressive tax (S. Chen *et.al.*, 2010). However, the owners still deliberately consider the risk of this action since it brings the uncertainty in the future related to the possibility of being audited and of the fine payment (Hanlon & Heitzman, 2010). Besides, the reputation consideration also becomes one of several reasons the owners do not agree with tax avoidance. It will lead to the agency issues associated with both corporation's benefits and costs as a result of tax evasion.

2.1. Ownership Structure and Tax Avoidance

The perspective of agency theory confirms that the separation of ownership and corporation control will certainly lead to agency issues including manager's motives not to maximize his performances such as: ignoring his responsibility, enriching his own properties, and *rent extraction* (Badertscher, *et.al.*, 2013). According to Fama and Jensen (1983), a corporation should separate or combine the management decision and decision control related to residual risk sharing to decrease agency costs. As management decision and decision control has been concentrated on small number of decision making, management owners tend to evade risky investment to maintain their portfolios (Fama & Jensen, 1983). Tax avoidance is rather risky activity (Hanlon & Heitzman, 2010; Rego & Wilson, 2011). The risk of tax avoidance comprises borne costs for the corporation, including fee that should be paid for the tax planning service, the risk of being audited, tax fines, and corporation reputation. Therefore, a *risk-averse* manager tends to decrease the risky tax planning whereas a *risk-neutral* authoritative owner tends to agree for implementing tax strategies to increase the value of the corporation (Rego & Wilson, 2011; Simone & Stormberg, 2012).

A manager as decision-making agency while demonstrating tax avoidance will thoroughly consider both its advantages and drawbacks. The advantages of demonstrating tax avoidance might 1) decrease tax burden that should be paid to the state, 2) provide (either direct or indirect) profits for manager in form of stakeholder's compensation, and 3) provide great chances for manager to do *rent extraction* (S. Chen, *et.al.*, 2010). Despite these advantages, a manager who strives to maintain his portfolios unlikely agrees to tax avoidance due to the possibility of being audited by tax officers as well as the decrease of stock values as a result of the recognition of other stakeholders towards the tax avoidance. Generally, non-authoritative stakeholders are spreading out on a wide range of international as well as individual ownership that unlikely agree to the decrease of stock values.

There are several studies assessing on corporation's characteristics (Huseynov & Klamm, 2012; Tommy Kurniasih & Naria M. Ratna Sari, 2013; Lanis & Richardson, 2012; Tronsoco & Vergana, 2010; Watson, 2012) and corporate ownership (Badertscher, P. Katz, & Rego, 2013; S. Chen, *et.al.*, 2010; Desai, 2008; Minnick & Noga, 2010; Moore, 2012). The corporation ownership has significant influences on corporation decision-making, including the decision about taxation. The pattern of corporation ownership has a direct influence on tax avoidance (Desai, 2008) and a corporation with concentrated-ownership has a greater chance of tax avoidance due to the high number of profits earned by authoritative stakeholders compared to the necessary savings. A study conducted by Sari and Martani (2010) presents the positive correlation between family ownership andaggressive tax.In another side, the probability of this aggressive tax happened in family ownership remains lower than non-family ones because of the consideration on corporation's

reputation (S. Chen, *et.al.*, 2010). Furthermore, a corporation with concentrated-ownership and high control is unlikely involved in tax avoidance (Badertscher, *et.al.*, 2013). Meanwhile, Moore (2012) who investigates the correlation between institutional ownership with the variability of *book-tax difference* figures out that institutional ownership has negative correlation with *book-tax difference.* This finding indicates that the presence of institutional ownership becomes an effective managerial monitoring. However, another study on the correlation between corporation ownership and inconsistent tax avoidance reveals that tax avoidance is rather specific and determined by varied factors and interactions (Hanlon & Heitzman, 2010). Meanwhile, foreign ownership has significant influence on corporation taxation (Chang, Hsiao, & Tsai, 2013) by rearranging profit report from subsidiaries to affiliated corporations located in *tax-haven* countries.

2.2. Firm Size and Tax Avoidance

The agency theory on political cost hypothesis proclaims that large corporations bear higher political costs compared to the smaller ones. The political cost is reflected in the tax payments or in the higher rate of effective tax (Zimmerman, 1983). A large corporation has greater capability in obtaining high profitability. Ergo, the government gives particular attention and monitoring on this corporation. It triggers the corporation to look for effective strategies to decrease the tax burden. In other words, large corporation is apt to demonstrate tax avoidance (Kim & Limpaphayom, 1998).

The firm size is a concrete measurement of corporation's financial success in one period. The attempt on maintaining and increasing this will lead to the pressure. The bigger corporation size, the more difficult the maintenance will be. Besides, the enormous size of corporation will attract government's interest on corporation taxation (Tommy Kurniasih & Maria M. Ratna Sari, 2013). It encourages corporation to either be obedient or demonstrate tax avoidance. The attempt on maintaining or increasing corporation's profits is likely done through tax avoidance.

The study on tax avoidance associated with firm size (Kim & Limpaphayom, 1998) shows the negative correlation between corporation size and tax avoidance. It contradicts the Zimmerman's finding (1983) which figures out that there is a positive correlation between firm size and tax avoidance in America. In accordance with Zimmerman's finding, Wu, *et.al.* (without year) discovers the positive correlation between firm size and effective tax rates on private-controlled corporation. In another side, Salamon and Siegfried (1977) argue that larger corporate has greater economic as well as political capabilities compared to smaller one due to the ability of larger corporation to demonstrate tax avoidance. Porcano's finding (1986) confirms the Salamon's and Siegfried theory (1977) stating that there is a correlation between firm size and ETR by using current income tax ratio towards pre-tax profits and extraordinary items. A study conducted by James, *et.al.* (2001),

which uses data from experiment laboratory to estimate the impact on the compliance of fiscal instruments, indicates that tax compliance will correspondingly increase with the profit increase and audit probability, and will decrease with the increasing tax rates.

Zimmerman (1983) assumes that larger corporation has more political visibility and is more likely audited by tax officers compared to smaller one. The larger corporations in Europe tend to pay higher tax rates than smaller ones. In contrast, larger corporations in German, Ireland, and Poland pay smaller tax rates. It is based on the assumption that larger corporation will be more likely able to extract preferential tax from government (Hellman, Jones, and Kauffman, 2002; Schiffer & Weder, 2001). According to Grubert, Goodspeed, and Swenson (1993), a new corporation relatively pays smaller tax rates due to establishment cost and has a negative correlation (i.e. in Portugal and UK). It seems consistent with older corporation due to *tax expertise* interaction with fiscal authority and has greater bargaining power due to their legitimacy.

2.1. Financial Constraints and Tax Avoidance

The theory of financial accelerator framework agency explains that financial state makes a corporate evades the tax (Tronosco & Vergara, 2010). Financial factors that draw the corporate's attention are budgeting and investment (Farzzari, Hubbard, & Petersen, 1988). The investment decision depends on the corporate's financial factors such as the availability of internal finance, new credit access, or equity financing access. A corporate having internal cash flow will consider internal budgeting for investment if it is more beneficial from the aspect of expense compared to the budgeting from new credit or equity financing. On the contrary, the corporate will deploy external budgeting if the internal budgeting is fluctuating. The financial impact towards investment due to the information problem of capital market is dominantly happened among companies with high retention rates. Budgeting retention arises in a corporate when there is a limitation in capital market in which could affect the investment and average tax burdens on companies (Farzzari *et al.*, 1988).

The investment done by most of the companies generally deploys several financial sources, such as shareholders, debt holders, and state through tax avoidance (Tronsoco & Vergara, 2010). When there is financial limitation in capital market, a corporate can deploy internal budgeting from cash flow, retained earnings, or debt financing. The debt financing affects the increase of marginal cost of new debt resulting in financial and agency cost problems. A higher debt-to-equity ratio leads a manager to conduct actions that are not in accordance with the owner's interest, since it puts more concern on creditors (Farzzari *et al.,* 1988). On the other hand, high debt-to-equity ratio indicates the existence of agency problem between manager and owner that caused creditors to limit the debt contract.

A corporate facing financial constraints will consider the funding source from state by demonstrating tax avoidance. The more serious the constraints appear to be, the bigger motivation the corporate has to evade the tax due to its needs for investment and profit (Tronsoco & Vergara, 2010).

Financial constraints are shown by the external funding (debt) ratio used by the corporate. The ratio of debt financing induces consequence of loan's principal payment and additional interest expense on the next period. This leads to the decrease of cash flow and investment opportunity allowing a corporate to conduct tax avoidance and to increase the cash flow (Almeida, Campello, Weisbach., & Finance, 2004) and also to alleviate investment problems (C. Chen & Lai, 2010). The research by Chen dan Lai (2010) using the samples of public companies in America year 1986-2011 shows that 1) the companies facing financial constraints are involved in tax avoidance, and 2) the Environmental Tax Reform (ETR) of the companies with financial constraints is 3-8 % lower than those which do not have any. It is supported by Amstrong, et al., (2011) who figure out that the aggression of the tax avoidance perpetrator affects the increase of corporate's investment.

1.2. Corporate Governance and Tax Avoidance

According to Forum for Corporate Governance in Indonesia (FCGI, 2004), Corporate Governance is: A set of rules stipulating the relationship between shareholders, manager, creditors, government, employee, and the other internal and external stakeholders concerning on their rights and liabilities, or in other words, the system that directs and controls the corporate.

Corporate governance is a medium, mechanism, and structure functioned as monitor on self-serving behavior of the manager or agent (Short et al., 1999). A transparent and accountable management of a corporate can prevent the emergence of self-serving behavior. According to Keasey and Wright (1997, p.2), the key elements of corporate governance are the supervision on manager's performance and the assurance of management accountability towards the shareholders and stakeholders. Therefore, good corporate governance can also be interpreted as interaction between structure and mechanism ensuring the availability of supervision and accountability to reduce the manager's self-serving behavior.

Good Corporate Governance (GCG) is a system in which the corporate business is directed and controlled (FCGI, 2004). Corporate governance system determines the distribution of rights and liabilities between parties in a corporate such as board of directors and/or commissionaires, shareholders, the other internal parties, and external stakeholders (employees, creditors, government); and the making of procedures and rules in decision making. Thereby, the stipulation of goals and performance can be determined.

Corporate Governance (CG) is a system regulating and controlling a corporate which creates additional values through the supervision of management performance and the availability of management accountability towards stakeholders based on the regulation. In general, CG is a set of mechanisms influencing the decision made by the manager through the function control on board of directors, the audit committee, institutional shareholders, and market mechanism. (Jiang, Lee, & Anandarajan, 2008). CG is correlated with fraud. A weak CG reflects a poor supervision on corporate's activity including financial statements. Poor control over financial statements is caused by its poor quality. Low quality of finance indicates the existence of fraud in financial statements preparation. Thus, poor CG and financial control will foment fraud in financial statements. (Beasley, 1996; Dechow, Sloan, & Sweeney, 1995). Conversely, a good CG reflects transparency and accountability in a corporate, thus it is expected that the activity of financial statements is well-conducted and the reliability of the financial statements is assured.

Fraud cases due to weak CG is reported in the consultant research conducted by McKinsey & Co (Kaihatu, 2006). This study showed that most of public companies are indicated overvalued. As much as 90% of market value is determined by growth expectation and the other 10% are determined by current earning system. For comparison, in developed countries the determiner of healthy companies is 30% of growth expectation and 70% of current earning system. Another fraud cases due to weak GC occurred in large companies, such as Enron, Wordrlcom, Tycco, London & Common Wealth, Poly Peck and Maxwell (Kaihatu, 2006).

The studies linking GCG and tax avoidance have been conducted by (1996), Xie, Wallace and Dadalt (2003), Wawo (2010). The result of Xie, Wallace and Dadalt (2003) study is that the percentage of independent board of director from outside corporate has significant negative effect toward discretionary accrual. On the other hand, Beasley (1996; Wawo, 2010) and Wawo (2010) concluded that the composition of board of director from outside is more likely to reduce the number of fraudulent financial report instead of audit committee implementation.

According to Beasley (1996) and Uzun, Szewcyk and Varma (2004), companies with high percentage of independent director tend to experience less fraud cases. Independent directors have relatively less intention to commit fraud and the higher number of such position is able to prevent or avoid the fraudulent behavior of executive director.

Good Corporate Governance is an important element in the improvement of economic efficiency and economic growth, whereas it is also able to improve investor's trust (Owens, tt). Corporate Governance covers the relationship between corporate's management, the board, shareholders and other stakeholders (Owens, tt). Corporate Governance structure somehow affects the way a corporate to meet

tax obligation, although on the other side tax planning significanty depend on the corporate governance dynamics of a corporate (Friese, Link and Mayer, 2006 in Annisa and Kurniasih (2012) and Desai and Dharmapala (2007).

There are four main components in the concept of good corporate governance; fairness, transparency, accountability and responsibility (Annisa & Kurniasih, 2012). Those four components are highly essential in the implementation of good corporate governance due to its consistency in improving the quality of financial statement (Beasley, 1996; Kaihatu, 2006), in suppressing the aggressive profit management of a corporate (Siregar, 2005) and in inhibiting or reducing the activities of performance cheating which does not describe the actual financial condition of a corporate (Kaihatu, 2006).

Institutional ownership in the last decade appears to be more prominent as GCG mechanism as evidenced by percentage improvement of publicly traded equities held by institutions, from 10% in 1970 to 60% in 2006 ((Aghion, Van Reenen & Zingales, 2010). Theoretically, institutional ownership has relatively strong encouragement and ability to actively and to effectively monitor the managers, which somehow could improve overall corporate governance (Gilan & Stark, 2003; Scheilfer & Vishny 1997). Other study (Cornett, Marcus, & Tehranian, 2008); Chung, Firth & Kim, 2002) found a consistent result with institutional investor monitoring in the area of financial statement, which documenting negative correlation between institutional ownership level and profit management. The study of Moore (2012) examined the external monitoring of institutional ownership toward Book-Tax Difference in the broader context of reporting with potential implication due to the information environment and/or capital markets. The result is that institutional ownership negatively associated with total, permanent, and temporary BTD. It is in contrast with Annisa and Kurniasih (2012) study, which found no effect between institutional ownersip and tax avoidance.

However, other studies showed the existence of information potential effect of BTD, including the negative effect on the informative rate of financial statement (Hanlon, 2005). Previous study also found that market participant (including analysis) do not completely connect BTD and stock-prices forecast (Weber, 2009; Hanlon. 2005; Lev and Nissin, 2004). Besides, BTD also contribute to the different opinion in the market (Comprix, Graham and Moore, 2011). Other studies linking the level and variation of BTD found the negative effect toward quality and precision of information reported in financial statement (Hanlon, Krishnan and Mills, 2012; Ayers, Laplante and McGuire, 2010; Dhaliwal, Huber, Lee and Pincus, 2008).

BTD to some extent contributed to the information and/or economic outcome in which both of them support or otherwise toward shareholders interest. It shows that an effective GC will affect BTD in several cases. Moore (2012) predicted there was a negative correlation between BTD and institutional ownership level. The

result was that temporary BTD is not as strong as permanent BTD, and it happened due to the encouragement by sample period portion of post-SOX. The relationship between institutional ownership and temporary BTD is more feflective toward the financial statement aggressivity than permanent BTD (Badertscher, Philips, Pincus and Rego, 2009, Frank and Rego, 2006; Hanlon, 2005; Philips, Pincus , Rego and Wan, 2004; Philips, Pincus and Rego, 2003).

Overall, the finding of Moore (2012) is consistent with high level of institutional ownership, which is able to monitor the management effectively in producing lower BTD. Such effect is mainly encouraged by the permanent component of BTD during pra-SOX period, whereas in post-SOX period it is consistently showed that both permanent and temporary BTD are influenced by institutional ownership.

2. CONCLUSION

The study on tax avoidance contributes to a wider theory .in agency-level relation between the owner and management in responding tax avoidance It is expected that the contribution of the policy can be realized by understanding various characteristics of the corporate which demonstrating tax avoidance. Furthermore, it is also expected that the state's tax ratio can be raised through policies that can reduce the chance of tax avoidance.

3. FURTHER STUDY

There are weakness and inadequacy in previous studies, such as in Gallemore, Maydew, & Thornock, 2012, which states that the enigma of tax protection could not be explained by reputation cost, even in companies that are presumed to aggressively commit tax avoidance. Therefore, it leaves question of why companies forgo tax avoidance whereas other do not.

This idea is supported by Hasseldine, Holand and Rijt (2012) who stated that research on tax avoidance is perceived to be very comprehensive and closely related to financial statement, economic consequences, and society in general. Furthermore, a review conducted by Hanlon and Heitzman (2010) on tax avoidance recommends a particular problem of study for further research, which is the reason on why a certain corporate tends to avoid tax more than others are.

In the perspective of agency theory, a separate ownership and management has created imperfect work contract (Sari & Martini, 2010). This situation creates an opportunity for managers not to act fully for the benefit of the owners. Thus, it emerges the need for Corporate Governance as a means of monitoring performance. Tax avoidance is a profitable investment which provides profit in economic sector by initiating a raise in cash flow and profit. Nevertheless, the owners do not expect their managers to initiate tax avoidance if the loss due to the act is greater than the profit.

The research result that associates the ownership with inconsistent and inconclusive tax avoidance has provided further research opportunity. This research offers several development options to complete an existing research gap. The previous research result has not tested the ownership structure toward tax avoidance employing concentrated ownership parameter (Badertscher *et al.,* 2013; Desai, 2008), family ownership (S. Chen *et al.,* 2010; Sari & Martani, 2010), institutional ownership (Moore, 2012), but there is only few that employs the dispersed-ownership parameter.

A dispersed ownership reduces the authority of shareholders to control the corporate; thus, it creates more agency issues. Therefore, to reduce agency issues between manager, shareholders and among the shareholders themselves, it requires delivery of information to reduce the asymmetric information. Information deliberated by the corporate will enhance the corporate transparency and accountability. Therefore, the dispersed ownership requires corporate's transparency and accountability. This will reduce the occurrence of tax avoidance as well as agency issues between the corporate as taxpayers and the government.

Corporate Governance is a system and mechanism that can change manager decision in choosing tax avoidance. A Go Public Corporate is obliged to inform its CG implementation. The CG implementation in every corporate is still varying. Different implementation of CG in certain companies depends on the influence of culture, industrial type and strategy. Thus, it affects certain decision taken in the corporate including tax avoidance.

Several previous studies have proven the effect of various governance dimension toward specific managerial accounting decision that reflects the BTD. For instant, there are several studies that documented the negative relation between governance power and management profit (Cornett et al 2008; Chung et al, 2002; (Klein & 2006); Beasley, Carcello, Hermanson dan Lapides, 2000; (M.dechow, Sloan, & Sweeney, 1996); Beasley, 1996) and other studies provided mixed evidence toward governance influence on tax planning or aggressive report (Lanis dan Richardson, 2011, Minick dan Noga, 2010, Khurana dan Moser, 2009).

Corporate Governance is a structure and mechanism that employ institutional ownership and transparency. It enables the corporate to direct its activity in order to reduce or change the possibility of fraudulence within the corporate by employing the tax avoidance. Implementation CG in every states is differ depends on prevailing regulation and corporate's internal factor in term of business type, business risk, capital structure, management and corporate's history (Irawan & Farahmita, tt). The result of the study on CG and inconsistent tax avoidance as well as the various CG implementations among companies enables the CG test to be taken as moderation variable in relation among various corporate characteristic with tax avoidance.

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