Tax Risk

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The Effect of Tax Risk on Tax Avoidance

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Abstract

This research intent to investigate whether tax risk is associated with tax avoidance, which proxied by CETR. Tax risk is measured by six tax risk components, such as transactional risk, compliance risk, operational risk, financial accounting risk, managerial risk, and reputational risk. The samples in this research are manufacturing companies which listed in Indonesian Stock Exchange (IDX) from 2014 until 2019. With purposive sampling method, there are 168 firm-years which we analyzed with OLS regression. The result in this study showed that tax risk is positively associated with CETR. This implied that choices of tax strategies and activities are involved in high tax risk but firms still choose to comply with tax regulations, which can be seen in high CETR values. This research found that firms need tax risk management to ensure that tax strategies do not have impact on the firms' future losses from additional tax payments and fines. Other than that, this research gives new option for future researcher to measure tax risk using scoring method and indicators that are engaged in each of tax risk components, such as transactional risk, operational risk, compliance risk, financial accounting risk, managerial risk, and reputational risk.

Keywords: CETR, Taxation, Tax Avoidance, Tax Risk, Uncertainty

JELClassification:

Introduction

Generally, prior studies about tax avoidance have been more focused on how the choice of company's strategies could provide tax benefits through lower Effective Tax

Rate (ETR) value. For example, investigations between tax avoidance and cost of debt (Kovermann, 2018; Hutchens & Rego, 2013), CSR (Zeng, 2019), tunneling strategy for tax benefit (Tang, 2016), and transfer pricing strategies (Amidu et al., 2019). However, these choices of activities could lead to failure because of uncertainties in which company is.

Tax risk occurs when there are variability in taxation law, inconsistencies in the implementation of taxation, poor authorities enforcement, possible audits in the future, and changes in tax provision and tax rates which formed uncertainties or tax risk in the future. (Guenther et al., 2013; Sreesing, 2018; Chen, 2020a, 2020b). Drake et al., (2019) defined tax risk as all tax-related uncertainties which is inherent in firm's transactions, whether related to the operational, financial reporting decisions, and reputation. According to Lin et al (2019), tax risk is differ from tax aggressiveness which only has short-term objectives to reduce tax payments. High tax risks can be imposed because of aggressive tax planning (Kovermann, 2018). According to Kovermann (2018), there is a negative association between cost of debt and tax avoidance and a positive association between tax risk and tax avoidance. In summary, creditors on the one hand give a positive assessment to tax avoidance. But when tax avoidance level is too high, creditors could assess a company's tax strategies as risky and therefore give high cost of debt.

Example of tax risk components is transactional risk. One of inherent risks in firms' transactions is tax risk. Tax risk has negative impacts because uncertainties could lead into unexpected financial losses. For example, investment decisions are important for managers because these activities are risky and may impose high economic costs, such as unwanted payment of tax and fines in the future (Lin et al., 2019). Another example is transfer pricing transactions which can be complex and cause significant increase in tax risk because those also increase overall future cash flow (Goh et al., 2016).

Besides transactional risk, tax risk can be in the form of reputational risk, which is the extent of which tax planning activities have impacts on a company's brand image. Companies with low debt to equity ratio intend to consider reputational risk more carefully and sometimes also minimize risky investment decisions, rather than companies with high debt to equity ratio (Sreesing, 2018). Low debt to equity ratio companies will increase the debt level only if they need to give appropriate protection to creditors

through tax avoidance. Therefore, benefits from good reputation are being compared with benefits of tax avoidance, which on the one hand give guarantee related to availability of future cash flows to pay leverages, while on the other hand also increase tax risk in the future. This study is in line with Guenther et al. (2013), which investigated that high level of tax avoidance could cause high tax risk.

Different results are shown by Firmansyah & Muliana (2018). This study explained that tax avoidance doesn't increase firm's risk and tax risk doesn't affect firm's risks. Tax avoidance activities succeeded in maintaining availability of future cash flow in which at the same time didn't increase the firm's tax risk. Based on the background, it is important to investigate how tax risk affects firm's tax avoidance activities. Prior studies have proxied tax risk by volatility of ETR and cash ETR. Meanwhile in this research, we would like to measure tax risk by its relevant business activities. Therefore, tax risk is proxied by transactional risk, operational risk, compliance risk, financial accounting risk, managerial risk, and reputational risk. This research also used varied control variables, such as leverage, profit margin, inventory intensity, selling, general, and administrative expense, and book-to-market ratio.

1. **Hypothesis Development**

Tax avoidance has been explained in prior studies as "the reduction of explicit taxes" (Hanlon & Heitzman, 2010) and "activities that generate cash tax savings and provide financial reporting benefits" (Hutchens et al., 2020). In this study, we would like to investigate the relationship between tax avoidance and tax risk, adapted from the research model of Neuman et al. (2013) that are developing and validating the tax risk score and then investigating the association between the tax risk score and tax avoidance. Measuring tax risk based on scoring is rarely used, especially for research in Indonesia. Tax risk is different from business risks because there are influences of tax law and revenue authority oversight on future tax outcomes uncertainty (Neuman et al., 2020). According to Elgood et al. (2004), tax risk is classified into six tax risk components.

Transactional risk is risk and exposure associated with a firm's specific transactions because of uncertainties (Elgood et al., 2004). The more unusual and uncommon the

transactions are, the bigger the tax risk's possibilities related to those transactions (Neuman et al., 2013). Operational risk is the risk of loss resulting from inadequate or failed internal processes, people, and systems or external events, which also includes the uncertainty in applying tax laws to routine operations (Cozmei & Şerban, 2014). With the increase in trade globalization, there will be an increase in operational risk because of the country's taxable presence in which they are operating.

Compliance risk is risk associated with meeting an organization's tax compliance obligations (OECD, 2004). Complexity is also becoming one of many factors that increases a firm's compliance risk because it affects information quality, especially related to tax payments (Bushman et al., 2004). Financial accounting risk is risk in financial statement reporting, such as a material error caused in a not faithfully represented financial statement (Elgood et al., 2004). We measured it by the delay in submitting financial reports. Prior research consistently found a positive association between late accounting reports and low-quality earnings (Cao et al., 2016).

Reputational risk occurred in return for management's effort to reduce tax payments using tax avoidance activities (Gallemore et al., 2014). Therefore, reputational risk is valued as necessary by the executives in decision-making processes related to tax avoidance (Graham et al., 2013). Ineffective management in allocating a firm's resources, such as skills, time, and expenses, can lead to unintended managerial risk (Cozmei & Şerban, 2014). Therefore, firms with high managerial risk have a low quality of resources and lack management skills. Agency theory in tax avoidance can be seen as an opportunist act conducted by taxpayers to gain maximum tax benefits. In the practice of agency theory, managers will look for ways to minimize tax expenses through tax planning which mostly aren't consistent with government regulation related to taxation and result in more considerable earnings after tax (Putra et al., 2018). These actions are contrary to tax authorities' beliefs that tax is a significant income for the country. Engaging in tax planning could increase managers' rewards who can deal with more tax risk (Neuman et al., 2013). In line with Neuman et al. (2013), there is a negative association between tax risk and CETR, which means that firms are inclined more in risky tax planning because they can lower the tax expense in the form of lower CETR.

H1: Tax risk is negatively associated with CETR

2. Method, Data, and Analysis

Sample Selection

We use a purposive sampling method for the sample selection shown in Table 1.

Table 1. Purposive Sampling

Criteria	Total
Indonesian manufacturing companies listed on IDX for period 2014-2019	194
(-) Operating Loss	(63)
(-) Incomplete Annual Report Data	(58)
(-) CETR is less than 0 or more than 1	(30)
Total sample (number of firms)	43
Total Observation (number of firm-years)	172

Research Model

This type of research is a quantitative research method using Ordinary Least Square (OLS) regression analysis. To test the hypothesis, the research model is as follows:

$$CETR_{it} = \beta_0 + \beta_1 \, TRISK_{it} + \beta_2 \, LVG_{it} + \beta_3 \, PM_{it} + \beta_4 \, INV_{it} + \beta_5 \, SGA_{it} + \beta_6 \, BM_{it} + \varepsilon$$

Variables

We use Cash Effective Tax Rates (CETR) as our dependent variable, measured by cash tax paid divided by pretax income. According to Hanlon & Heitzman (2010), CETR has the closest meaning to tax avoidance as reducing direct taxes. CETR is often used as a proxy for tax avoidance (Drake et al., 2019; Hutchens et al., 2020). To measure tax risk, we identify whether a firm engages in transactions or exhibits characteristics associated with categories of tax risk and then assign a score for each of the risks. Higher values of the tax risk score indicate higher levels of tax risk. We follow Elgood et al. (2004) and Neuman et al. (2013) in examining the transactions associated with each of the six categories of tax risk, which is explained below.

The variation payments of merger/acquisition may increase transactional risk (Dube & Glascock, 2006). Apart from payment procedures, mergers/acquisitions signal weak internal controls within firms (Gleason et al., 2017). Discontinued operations are defined as a disposal of significant business lines or segments and are often used by

earning management as a tool for classification shifting (Skousen et al., 2019). These two are unusual transactions in which accounting processes are less equipped to handle such transactions and could lead to financial reporting misstatement. Lastly, financing transactions create tax risk because of their infrequent occurrence and extensive documentation requirements (Neuman et al., 2013). Capital structure decisions could lead to uncertainties because of different taxation treatments between debt and equity capital structures (Voeller & Overesch, 2010).

Companies that have foreign operations, called multinational companies, have bigger opportunities to tax avoidance since they can exploit lower foreign tax rates by shifting income to other foreign subsidiaries (Taylor & Richardson, 2012; Guenther et al., 2013). They also have a more complex decision making related to different environments, culture, and policies (Bushman et al., 2004), resulting in increased firms' operational risk. In line with multinational companies, tax haven countries have lower and even zero tax rates which lower tax expenses. Operating a subsidiary in a tax haven country leads to an operating tax risk due to increased government scrutiny of possible reallocation of income from tax haven operations (Gravelle, 2009). Another proxy used is operational volatility that is directly related to uncertainty in measuring firm's annual taxable income and tax payment.

Large firms that have a lot geographic and business segments which are not well concentrated are more complex and can result in bigger risk, such as an input error in their tax return (Demerjian et al., 2011). Another possible reason are a difference in taxation, currency, etc (Bushman et al., 2004). Large firms also have more resources for it to be invested in their internal tax department, and this may cause an increase in tax risk (Guenther et al., 2013). Next is tax deferral, which is usually used by tax departments to reduce their ETR, by delaying the recognition of taxable income and accelerating tax deductions or tax savings (Ayers et al., 2011; Mulatsih et al., 2019). Deferred tax liability causes a negative fiscal correction. It is difficult to keep two sets of books, thus resulting in not complying with all tax regulations (Neuman et al., 2020). Deferred taxes lead to additional regulatory scrutiny (Hanlon, 2005).

Firms that are late in their annual and quarterly report submission can raise its financial accounting risks. This late submission indicates a low financial report's quality that results in shareholders' negative perception, auditors' skepticism, and bad publicity (C. Wang et al., 2013; Cao et al., 2016). Prior research (Impink et al., 2012; Chiu et al., 2018) found that annual and quarterly reports' late submission is associated with material weakness in firms' internal control, thus auditors might assess higher risks of material misstatement.

Ineffective management in managing firms' activities is managerial risk, that can be seen from inability to reserve competent employees or inadequate competencies in current employees which lead to the dismissal (Johansen, 2013; Cozmei & Șerban, 2014). High employment volatility indicated that most employees aren't familiar with the process and business practices, therefore increasing managerial risks (Neuman et al., 2020). Sometimes firms also hire outside tax experts if there are no skills available for tax avoidance planning, especially if there are unusual transactions and employees have inadequate knowledge to administer them (McGuire et al., 2012; Hutchens et al., 2019). Hiring external tax experts could reflect high tax avoidance in hirer companies.

More media exposure on a firm causes bigger pressure and attention from the public, that may result in risks for the firm (Kanagaretnam et al., 2018). A highly visible firm to the public can get a negative press when they disclose tax issues (Neuman et al., 2020). Reputational risk occurred in return of management's effort to reduce tax payments using tax avoidance activities, which caused uncertainties about fines and interest payments, engagement in litigation, and damaged brand name in the future (Gallemore et al., 2014). Lastly, institutional shareholders are defined as the ownership by the government, insurance companies, foreign investors, and banks (Oktaviyani & Munandar, 2017). According to F. Wang et al. (2020), institutional shareholders and tax avoidance are positively associated. These institutional shareholders made a bigger risk for firms because they have big influences and credibility's on the marketplace and resulted in more reputational risk for firms.

Table 2. Tax Risk Indicators

TAX RISK	DEFINITION	SCORE

INDICATORS		MIN	MAX
TR_ACQ	TR_ACQ is 1 for firms that have M&A activity in the period	0	1
TR_DOP	TR_DOP is 1 for firms that have discontinued operations in the period	0	1
TR_FTR	TR_FRT is 1 for firms either issuing bonds or shares, 2 if issuing both	0	2
OR_FOP	OR_FOP is the tertile rank of the firm's foreign income	0	3
OR_SV3	OR_SV3 is the quartile rank of sales volatility, measured from the standard deviation of annual sales from t-2 to t	1	4
OR_TXH	OR_TXH is the tertile rank of the number of subsidiaries that are in tax haven countries (Gravelle, 2009)	0	3
CR_BSG	CR_BSG is the tertile rank of the number of business segments	1	3
CR_GSG	CR_GSG is the tertile rank of the number of geographic segments	1	3
CR_SIZ	CR_SIZ is the quartile rank of natural log of assets	1	4
CR_DTL	CR_DTL is the tertile rank of deferred tax liabilities divided by lagged assets	0	3
CR_FEE	MR_FEE is 1 for firm's with tax department	0	1
FR_IEA	FR_IEA is the quartile rank of late reporting of quarterly earnings	0	4
FR_AEA	FR_AEA is the quartile rank of late reporting of annual earnings (Q4), 0 if otherwise.	0	4
FR_TKL	FR_TKL is the quartile rank of late reporting of annual reports	0	4
MR_EMP	MR_EMP is the quartile rank of the standard deviation of total employees from years t–2 to t.	1	4
MR_EXP	MR_EXP is 1 if the firm hires an outside tax expert	0	1
RR_ADM	RR_ADM is 1 for firms that receive awards in the period	0	1
RR_SET	RR_SET is 1 for firms that have litigation or legal cases in the period	0	1
RR_IST	RR_IST tertile rank of the number of institutional shareholders	0	3
TOTAL		5	50

Notes: TR = Transactional Risk, OR = Operational Risk, CR = Compliance Risk, FR = Financial Risk, MR = Managerial Risk, RR = Reputational Risk. Source: Indicators for TRISK components are adapted from prior study (Neuman et al., 2013, 2014, 2020).

We include LVG_{it} as our control variable because firms with high leverage will pay more interest and engage in tax planning due to the tax shield benefit (Hasan et al., 2014). LVG_{it} is the ratio of Long Term Debt and Total Assets. PM_{it} is the ratio of pretax income and total sales. Prior studies have found that lower profit margins drive the firm's future tax avoidance lowers, which indicates that profit margin has a positive association with tax avoidance (Katz et al., 2013). INV_{it} is the ratio of total inventories and prior period total asset. Inventory intensity is the opposite of capital intensity (Taylor & Richardson, 2012). Therefore, it can be inferred that INV_{it} is positively associated with CETR. SGA_{it} is the ratio of SGA expenses divided by prior total asset. SGA expenses can be tools for

managers' discretion for income shifting to decrease income tax payments (Badertscher et al., 2018). It can be said that SGAit is negatively associated with CETR. Lastly, BMit is the natural log of the ratio of common book equity divided by market value of equity which is used as a risk control measure. BMit controls the extent to which growth opportunities companies (Guenther et al., 2013).

Results

Table 3. Descriptive Statistics

Variables	N	Mean	St. Dev.	Minimum	Maximum
TRISKit	168	22.738	7.034	8	41
CETRit		0.253	0.106	0.002	0.711
LVGit		0.083	0.121	0.000	0.490
PMit		0.117	0.083	0.010	0.530
INVit		0.214	0.121	0.010	0.620
SGAit		0.197	0.167	0.248	0.850
BMit		-0.671	1.061	-4.412	1.497

Source: Author's Processed Results Based on SPSS Output

The number of selected samples is 43 companies within 4 years from 2016 to 2019, or 172 firm-years observations. The summary of the results of descriptive statistics in this study presented in Table 3. When we conducted regression analysis, we found that there was an outlier from one of firm-samples which affected the validity of our results. As a consequence, we removed this outlier and the remaining observations are 168 firm-years.

Table 4. Classic Assumption Test

MODEL	Normality	Multicollinearity		Autocorrelation	Heteroscedasticity	
	Kolmgrorov-Smirnov	Tolerance	VIF	Durbin-Watson	t	Sig.
TRISKit		0.631	1.584		1.799	0.074
LVGit		0.686	1.457		-1.231	0.220
PMit	Asymp. Sig. (2-tailed) 0.200	0.452	2.213	1.920	-1.482	0.140
INVit		1.159	1.159		1.606	0.110
SGAit		0.744	1.344		-0.792	0.430
BMit		0.373	2.684		0.357	0.721

Source: Author's Processed Results Based on SPSS Output

Table 4 shows that the Kolmogrorov-Smirnov Asymp. Sig. (2-tailed) value in our data is 0.200 which is greater than 5%, so it can be said that our data is normally distributed. Multicollinearity test can be seen from VIF value, which is less than 10, means that independent variables are free from multicollinearity. Autocorrelation test is seen from Durbin-Watson value. DW table shows dL = 1.2022 and dU = 1.8451, which means that our DW value is in the middle of dU and 4-dU and there is no positive autocorrelation in the model. Lastly, we conduct a heteroscedasticity test that can be seen from sig. Values that are greater than 5% which means there is no heteroscedasticity problem. Therefore, all of the classic assumptions are satisfied.

4. Discussion

Table 5. Hypothesis Test

$CETR_{it} = 0.184 + 0.003\,TRISK_{it} - 0.272\,LVG_{it} - 0.059\,PM_{it} + 0.137\,INV_{it} + 0.021\,SGA_{it} + 0.013\,BM_{it} + \varepsilon$			
Dependent Variable : CETRit			
Variable	**Expectation Sign**	**Coefficient**	**Probability**
Independent Variables			
TRISKit	-	0.003	0.021**
LVGit	-	-0.272	<0.001***
PMit	-	-0.059	0.673
INVit	+	0.137	0.049**
SGAit	-	0.021	0.698
BMit	?	0.013	0.281
R square		**0.127**	
Adjusted R Square		**0.095**	
Sig. F		**0.001***	

***) Significance level at 1%; **) Significant level at 5%. Source: Author's Processed Results on SPSS Output

The result in Table 5 shows that total tax risk is positively associated with CETR, which can be seen that the coefficient is 0.003 and the sig value is 0.021 or less than 5%, which is significant. The R Square value is 12.7%, which explains that our independent and control variables can only explain 12.7% of the relationship with the dependent variable. In contrast, the remaining is explained by other variables which are not included

in this model. Some of our control variables (LVGit and INVit) are significantly associated with our dependent variable–CETR, while the other variables (PMit, SGAit, and BMit) are not significantly associated with CETR.

Based on the analysis result, H1 is not accepted. This result is in line with Guenther et al. (2017) because there are several ways to increase tax avoidance without an associated increase in tax risk. Only after firms exhaust these no risky tax avoidance opportunities would we expect a risk-return trade-off. Another study also found that higher tax risk is associated with higher CETR if managers cannot manage the risk effectively (Neuman et al., 2013). Another point of view in this result is explaining that revenue authorities have effectively implemented law enforcement in which firms used high risk tax activities while maintaining to keep comply with the law requirements. This result is in line with Wang (2015) which investigated the higher the taxation law enforcement is, the higher the risk which firms tried to anticipate the potential loss from future additional tax payment and fines.

The samples that we observed in this study are big manufacturing companies which have bigger capacity to manage resources efficiently. According to Sreesing (2018), large-sized companies that run their business in high tax rates countries take more risky investment decisions. These considerations are based on the effort to utilize tax shields inherent in each of firms' activities. High risk activities, such as merger and acquisitions, transfer pricing, discontinued operations, and many more, give tax benefits to firms although at the same time also put firms in high tax risk positions. It means that high tax avoidance is positively valued by shareholders, in turn to the high tax risk.

In Indonesia, external factors such as variability in taxation laws, law enforcements, inconsistencies in implementation of tax, tax audits, high tax rates, and frequent changes in tax requirements are forming the uncertainty in the firm's taxation (Firmansyah & Muliana, 2018). On the other hand, firms are responding to uncertainty by complying with tax regulations and requirements. In summary, although firms could get tax benefits in Indonesia as a developing country, tax risk in a firm's environment is highly influenced by external factors rather than internal factors that formed the tax risks itself.

Meanwhile, (Chen et al., 2010) found that tax aggressiveness level is based on the extent of marginal benefits and marginal costs. If the marginal cost is greater than the benefits, firms will be less involved in aggressive tax avoidance. The significance of taxation as a source for Indonesia also increases scrutiny of the company's tax strategies. Recent studies (Guenther et al., 2013, 2017; Hamilton & Stekelberg, 2016; Lin et al., 2019) also indicated that paying lower taxes does not necessarily lead to increases in tax risk.

5. Conclusion, Limitations, and Suggestions

Conclusion

The purpose of this study was to investigate the effect of tax risk on tax avoidance. We use six components of risk as our proxies for tax risk and CETR as our proxy for tax avoidance. Results from prior study (Neuman et al., 2013) found that tax risk has a negative effect on CETR. Tax risk affects tax avoidance because it is about the uncertainty of future tax outcomes. Tax risk can be handled by conducting tax planning in the firm in which higher tax risk can produce lower CETR. Contrary to our prediction, we found a positive association between tax risk and CETR. This finding could possibly happen because of bad tax planning that is conducted within the firms or there is an increase in control by the Directorate General of Tax to escalate Indonesia's source of income.

Limitation and suggestions

The limitation on this study is that there are a lot of firms with incomplete data and also have operating losses so we can not use them for our study. The other limitation is the measurement we use for tax avoidance is using only CETR. Suggestions for future researchers, in order to expand the reach of this study, another independent variable that can affect tax avoidance, like ETR, and also use another industrial sector as the sample. Another suggestion is to use tax planning as a mediator variable in the future study.

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