

## Impact of Debt-Equity-Ratio Regulation and Foreign Ownership on Tax Avoidance: The Moderating Role of Profitability in Indonesian Public Companies

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### ABSTRACT

This study examines the impact of debt-to-equity ratio (DER) regulation and foreign ownership on tax avoidance in Indonesian public companies, with profitability acting as a moderating variable. The sample includes companies listed on the Indonesia Stock Exchange that reported positive pre-tax and net income from 2011 to 2020. Using purposive sampling, the final dataset comprises 104 companies across six industrial sectors, averaged annually by sector, resulting in 60 data points. Data analysis was conducted using SPSS version 24. Findings reveal that DER regulation has a negative impact on tax avoidance, suggesting that higher DER values lead to greater creditor scrutiny, thus discouraging tax avoidance. This trend held consistent before and after the implementation of regulation PMK-169/2015. Conversely, foreign ownership positively influences tax avoidance, indicating that companies with higher foreign ownership levels tend to adopt tax avoidance strategies. Profitability, however, negatively moderates the foreign ownership-tax avoidance relationship, indicating that more profitable firms are less likely to engage in aggressive tax avoidance. This study underscores the importance of DER regulation in limiting tax avoidance and highlights profitability as a factor reducing tax avoidance in foreign-owned companies. Limitations include the study's focus on six industry sectors and annual data, which may overlook intra-year variations. Future research could expand the scope by including additional sectors and quarterly data to capture short-term tax strategies, and by examining other moderating factors, such as firm size and market competitiveness.

**Keywords:** *tax avoidance; DER Regulation; foreign ownership; profitability*

### INTRODUCTION

Tax avoidance practices have become a significant concern for regulators, stakeholders, and policymakers worldwide. This is primarily due to the substantial loss of potential tax revenues, essential for supporting economic growth and public services (Dom et al., 2022; OECD, 2017). The world loses \$169 billion each year due to offshore tax evasion associated with financial wealth. The UK and other countries account for 50 percent of this loss. Additionally, the tax avoidance network is responsible for 66 percent of the total loss (Tax Justice Network, 2023).

This issue is especially significant in developing countries such as Indonesia, where 82% of state revenue is derived from taxes (BPS, 2024). Indonesia's tax-to-GDP ratio stands at only 12.1%, which is relatively low compared to other ASEAN, and far below the Asia-Pacific average of 19.3% and the OECD of 34.0% (OECD, 2024). In 2020, the State of Tax Justice reported that tax losses in

Indonesia amounted to \$4.86 billion per year, equivalent to Rp68.7 trillion. Notably, 98% of this amount was corporate income tax (CNN Indonesia, 2020; Kompas.com, 2020). Besides, the Director General of Taxes of Indonesia revealed that over the past decade, tax avoidance by approximately 2,000 multinational companies (MNCs) has eroded the country's tax potential by Rp100 trillion through various strategies, such as utilizing investment incentives, transfer pricing, profit shifting, and most of them reporting of business losses. However, these companies still operating and expanding their activities (Ariyanti, 2021; mediaindonesia.com, 2016),

Tax avoidance is a complex strategy that exploits loopholes in tax law to minimize tax burdens and maximize shareholder wealth. Tax avoidance behavior plays a gray role and is risky because if proven to violate the law, it can be considered tax evasion and subject to criminal sanctions. (ProConsult, 2023). To combat tax avoidance, the Indonesian Ministry of Finance (MoF) issued Regulation No. 165/2015. This regulation limits the deduction of interest expenses for companies whose debt-to-equity ratio exceeds 4:1. The objective is to align fiscal goals with corporate financing practices and to curb excessive corporate debt (R. Chen, 2024; OECD, 2017; Riyanto, 2016). Foreign ownership in Indonesia is regulated based on the negative investment list. For public companies, foreign ownership can reach 100% of its shares. On the one hand, foreign companies create jobs, but on the other hand, foreign ownership has the potential to carry out tax avoidance, such as shifting profits or debt, which erodes the tax base in developing countries (OECD, 2017; Rahayu et al., 2024).

Despite the government's implementation of various regulations, tax avoidance remains widespread in Indonesia, raising concerns about the effectiveness of debt-to-equity ratio (DER) and foreign ownership regulations. Academic research on the impact of DER regulations on tax avoidance presents mixed results. For instance, Prabowo (2020) and Yully et al. (2022) have concluded that DER regulations significantly influence tax avoidance. In contrast, studies by Darsani & Sukartha (2021) and Faradisa & Fahlevi (2022) found no significant effect. Regarding the impact of foreign ownership on tax avoidance, Satyadini et al. (2019) indicates that foreign-owned companies are more likely to engage in tax avoidance. However, Deef et al. (2021) and Zarkasih & Maryati (2023) did not support this finding. Additionally, Muhajirin et al. (2021) and Pujiningsih & Salsabyala (2022) identified a negative relationship between foreign ownership and tax avoidance, while Susilawati & Tarmidi (2024) found a positive relationship.

Financial analysts view profitability as closely connected to investment risk and the long-term sustainability of a business. According to Brigham and Houston (2017) and Wahlen et al. (2023), high profitability indicates effective management of assets and debts in maximizing income. However, many previous studies have focused on profitability as an independent factor rather than recognizing it as a supportive element that can help reduce tax avoidance. Highly profitable companies typically prefer to use internally generated funds rather than relying on external debt. This is because they can effectively manage their tax liabilities and have less incentive to utilize debt for tax benefits. As a result, these firms often focus on reinvesting their earnings instead of attempting to minimize taxes. Consequently, they are less likely to engage in aggressive tax avoidance strategies (Chen et al., 2011). In contrast, companies with low profitability are more inclined to depend on debt and adopt various tax avoidance tactics (Rego and Wilson, 2012).

Most previous studies have treated profitability as an independent factor in tax avoidance, and the findings have been inconclusive. For instance, Putri et al. (2024) found no effect of Return on Assets (ROA) on tax avoidance. Darsani & Sukartha (2021) and Olanisebe et al. (2023) demonstrated a positive relationship. Conversely, Yully et al. (2022) and Shubita (2024) identified a strong negative correlation between ROA and tax avoidance. However, research the role of profitability as a moderating factor in reducing tax avoidance remains limited. Yustia & Khomsiyah (2024) found that ROA did not moderate the relationship between foreign ownership and tax avoidance. Mu'minah et al. (2023) revealed that profitability did moderate the effect of company size on tax avoidance, but not in relation to foreign ownership.

Given the strong association between foreign ownership and tax avoidance, the government has issued DER regulations to mitigate this issue (Riyanto, 2016). This study explores the role of

profitability as a moderating variable in the relationship between foreign ownership and tax avoidance.

## **LITERATURE REVIEW**

### **The Debt-to-Equity Ratio Regulation**

Capital structure theory suggests that companies often increase their debt levels to take advantage of tax benefits, as interest payments on debt are generally tax-deductible (Hargrave & Abapo, 2023). However, the reliance on debt financing rather than equity has raised significant concerns about tax avoidance worldwide. As a result, regulatory bodies have imposed limits on permissible Debt-to-Equity Ratios (DER), known as thin capitalization rules (OECD, 2017; Riyanto, 2016). In Indonesia, the DER limit is set at 4:1 through the Ministry of Finance Regulation number 169/PMK.010/2015, effective since the 2016 fiscal year (Menkeu RI, 2015).

### **Foreign Ownership**

Foreign ownership refers to the share of a company's equity held by investors or institutions outside its home country. This type of ownership can promote economic growth and introduce various governance standards and tax strategies influenced by global tax policies (Dom et al., 2022; Riyanto, 2016). According to agency theory, foreign shareholders are expected to exercise stronger oversight over management actions, which may inhibit aggressive tax planning and encourage higher tax compliance (Jensen & Meckling, 1976).

In Indonesia, the regulations for foreign ownership are based on the negative investment list. For instance, in the mining sector, Government Regulation 24/2012 mandates that foreign investors gradually reduce their ownership to at least 51% in favor of Indonesian participants (Nafisah, 2016). In the fintech sector, the OJK allows foreign ownership of up to 85% as stated by the Regulation Number 10/2022. However, for public companies, foreign ownership can be 100%. Foreign ownership may lead to increased tax avoidance due to access to cross-border tax planning opportunities and strategies that exploit tax differences across jurisdictions (R. Chen, 2024; Dom et al., 2022). In Indonesia, the risk of tax avoidance is higher among foreign-owned companies than all other taxpayers (Satyadini et al., 2019).

### **Profitability**

Investors and analysts rely on profitability information to evaluate the potential risks and future growth prospects of a firm (Wahlen et al., 2023). A practical explanation is that profitable firms typically require less debt financing, and high profitability enables them to primarily fund operations through internal resources. Consequently, profitability serves as a key indicator, measuring its ability to generate profits relative to its assets or equity (Brigham and Houston, 2017).

One of the most common measures of profitability is return on assets (ROA), which a high ROA indicates effective asset and debt management. In contrast, a low ROA may result from a deliberate choice to employ significant amounts of debt (Brigham and Houston, 2017; Wahlen, 2023). Previous studies that utilized ROA as a proxy for profitability for predicting tax avoidance include Olanisebe et al. (2023), Darsani & Sukartha (2021), Shubita (2024), and Yully et al. (2022).

### **Tax Avoidance**

Tax avoidance refers to legal strategies aimed at minimizing tax liabilities (Duhoon & Singh, 2023). However, these strategies can cross the line into tax evasion if they become excessive and are proven to be illegal, particularly when they involve concealing the true income of a company from tax authorities (Dom et al., 2022; ProConsult, 2023).

Tax avoidance methods often employ complex financial planning techniques. Hanlon & Heitzman (2011) suggested that tax avoidance can be evaluated using the effective tax rate (ETR) or Book-ETR derived from the GAAP income statement. The ETR is calculated by dividing the total income tax expense by the accounting profit before tax. A lower Book-ETR indicates a more aggressive approach to tax avoidance (R. Chen, 2024). Several studies have measured tax avoidance using

ETR, such as Olanisebe et al. (2023), Darsani & Sukartha (2021), Deef et al. (2021), Mantiri and Wikarya (2024), Prabowo (2020).

### **DER Regulation and Tax Avoidance**

Capital structure theory suggests that firms with higher levels of debt can benefit from tax shields on interest expenses. However, regulatory restrictions on debt-to-equity ratios (DER) may limit these benefits (Hargrave & Abapo, 2023). The World Bank reports that empirical studies have produced mixed results regarding the effectiveness of DER limits in reducing tax avoidance (Dom et al., 2022). Previous research reseluts were inconclusive. Indriyanti et al. (2023), Mantiri nad Wikarya (2024), Prabowo (2020), and Yully et al. (2022) found that DER regulation affects tax avoidance. In contrast, Darsani & Sukartha (2021)and Faradisa & Fahlevi (2022) did not identify such an effect. Therefore, examining the impact of DER regulation on tax avoidance will contributes to the practical effectiveness of these measures (Dom et al., 2022). Thus, we hypothesize:

**H1:** Debt-to-Equity Ratio regulation impact on tax avoidance.

### **Foreign Ownership and Tax Avoidance**

Foreign ownership refers to the percentage of shares held by foreign investors to the total shares outstanding (Deef et al., 2021). Traditionally, agency theory suggests that foreign ownership can lead to reduced tax avoidance behavior due to the adoption of global tax strategies or compliance with higher governance standards associated with international investment practices (Dom et al., 2022). However, various cases have shown that foreign ownership can also lead to increased tax avoidance (OECD, 2017; Tax Justice Network, 2023). Duhoon & Singh (2023) argue that when shareholders have high expectations of increasing risk-free post-tax income, managers may feel pressured to adopt tax avoidance strategies. This pressure may drive managers' decisions to meet shareholders' expectations, and possibly their interests. Supporting this perspective, Satyadini et al., (2019) found that foreign-owned firms are more likely to engage in tax avoidance. This finding has been corroborated by research conducted by Muhajirin et al. (2021) and Pujiningsih & Salsabyala (2022). Based on these considerations, we propose the following hypothesis:

**H2:** Foreign ownership has a significant impact on tax avoidance.

### **Profitability as a Moderator**

Highly profitable firms are generally less likely to rely on debt as a tax shield, as they can easily handle their tax liabilities. This action usually leads to a reduced propensity to engage in aggressive tax avoidance strategies (Chen et al., 2011). Profitable firms focus more on reinvesting their earnings rather than minimizing taxes. This effect of reducing tax avoidance is because they believe that continued success is more important than the immediate benefits of tax avoidance (Desai & Dharmapala, 2009). In contrast, firms with low profitability that do not meet owners' expectations are more likely to employ tax avoidance tactics (Rego and Wilson, 2012). This behavior is crucial to address, particularly for foreign owners who often exploit various facilities in the host country. The issuance of DER regulations is closely linked to the issue of tax avoidance by foreign investors (Riyanto, 2016; Tax Justice Network, 2023). It is anticipated that profitability will moderate the relationship between foreign ownership and tax avoidance. Given that previous research on this topic is relatively limited, we propose the following hypothesis:

**H3:** Profitability moderates the relationship between foreign ownership and tax avoidance.

Based on the literature review, the conceptual framework of the research is as follows:

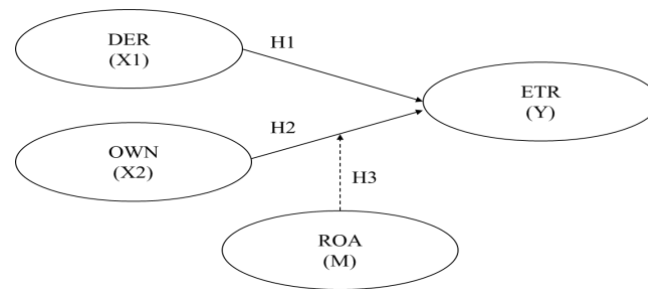


Figure 1. The Conceptual Framework

## RESEARCH METHODS

### Data Collection Method

This quantitative study uses secondary data from financial reports and annual reports of public companies listed on the Indonesia Stock Exchange (IDX). Financial data were obtained from the IDX and company websites, while foreign ownership data was from the Indonesian Central Securities Depository (KSEI) website <https://www.ksei.co.id>. The target population consists of reported positive pre-tax and net income from 2011 to 2020, the pre- and post-DER regulation PMK-169/2015. A purposive sampling method was employed, resulting in a dataset of 104 companies across six industrial sectors, namely 38 non-cyclical consumer companies, 23 energy companies, seven health companies, 20 industrial companies, 11 infrastructure companies, and five technology companies, then averaged annually per sector, yielding 60 data points for analysis.

The use of secondary data from reliable sources ensures the accuracy and relevance of the data, which supports the robustness of the research findings (Sekaran & Bougie, 2016). The diversity of these sectors is collected to provide a comprehensive picture of the impact of profitability (ROA) in strengthening the influence of DER and foreign ownership (OWN) regulations on tax avoidance (ETR).

### Data Analysis Method

This study utilized data analysis conducted with the Statistical Package for the Social Sciences (SPSS) version 24. This version is capable of managing large datasets and offers powerful statistical tools, making it suitable for quantitative analysis (Rahman & Mukhtadir, 2021). The SPSS output includes descriptive statistics that provide insights into the fundamental characteristics of the data, as well as the results of hypothesis testing based on multiple regression models.

### Variables and Measurement

The dependent variable for tax avoidance (Y) is measured by the Effective Tax Rate (ETR), which indicates the level of tax avoidance behavior based on data from the company's financial statements (R. Chen, 2024; Hanlon & Heitzman, 2011). The formula for calculating ETR is as follows:

$$\text{ETR} = \text{Tax Expense} / \text{Profit Before Tax}$$

The first independent variable (X1) is the Debt-to-Equity Ratio (DER), which reflects the degree of leverage utilized by the company (Brigham and Houston, 2017). The DER is calculated using the following formula:

$$\text{DER} = \text{Total Liabilities} / \text{Total Equity}$$

The second independent variable (X2) is Foreign Ownership (OWN), which represents the proportion of foreign ownership in the company (Deef et al., 2021; Yustia & Khomsiyah, 2024). This is measured using the formula:

$$\text{OWN} = \text{Foreign Ownership} / \text{Number of Shares Outstanding}$$

Profitability as a moderating variable (M) with a proxy of Return on Assets (ROA), indicating the company's net profit after tax relative to its total assets (Brigham and Houston, 2017; Wahlen et al., 2023) which is calculated using the formula:

$$\text{ROA} = \text{Net Profit} / \text{Total Assets}$$

The multiple regression model is as follows:

$$\text{ETR} = a + b_1.\text{DER} + b_2.\text{OWN} + b_3.\text{OWN}.\text{ROA} + e$$

Where: ETR is the effective tax rate, as a proxy for the dependent variable tax avoidance; a is a constant; b<sub>1</sub>, b<sub>2</sub>, b<sub>3</sub> are regression coefficients; DER is the debt-to-equity ratio, as a proxy for the independent variable DER regulation; OWN is the percentage of foreign ownership, as a proxy for the independent variable foreign ownership; and ROA is the return-on-assets, as a moderating variable for foreign ownership.

## RESEARCH RESULTS AND DISCUSSION

### Results

The classical assumption tests indicate that the assumptions of normality, heteroscedasticity, and multicollinearity are satisfied after removing 14 outliers from a total of 60 data points. Based on the remaining 46 data points, the VIF values are as follows: for the Debt-to-Equity Ratio (DER) variable, the VIF is 1.436; for Ownership (OWN), it is 2.829; and for the interaction of OWN and Return on Assets (ROA), it is 3.018, all of which are below the threshold of 10.

The descriptive analysis reveals that the mean Effective Tax Rate (ETR) is 0.374057, indicating an average tax burden of 37%. The mean value of the Debt-to-Equity Ratio (DER) is 1.230709, much lower than the maximum limit of 4:1 set by PMK-169/2015. Furthermore, the mean ownership (OWN) percentage is 0.346476, showing that foreign ownership averages 34.6%. This level of foreign ownership is categorized as significantly influencing the company's operational and financial policies (Christensen et al., 2016).

#### Descriptive Statistics

	N	Range	Minimum	Maximum	Mean	Std. Deviation
ETR	46	.2943	.2422	.5365	.374057	.0794642
DER	46	2.5095	.3360	2.8455	1.230709	.5056688
OWN	46	.1449	.2591	.4039	.346476	.0575304
OWN_ROA	46	.05	.01	.06	.0306	.01266
Valid N (listwise)	46					

Source: Data processed SPSS v24

The table of summary model result shows that the coefficient of determination ( $R^2$ ) is 0.229. This means that the independent variables—Debt-to-Equity Ratio (DER), Ownership (OWN), and Return on Assets (ROA)—simultaneously explain 22.9% of the variation in the dependent variable, the Effective Tax Rate (ETR). An  $R^2$  value between 10% and 50% is generally considered acceptable in social science research (Ozili, 2023).

#### Model Summary<sup>b</sup>

Model	R	R Square	Adjusted R Square	Std. Error of the Estimate	Durbin-Watson
1	.478 <sup>a</sup>	.229	.154	.0731051	1.928

a. Predictors: (Constant), Before\_After, OWN-F, DER, OWN\_ROA

b. Dependent Variable: ETR

Source: Data processed SPSS v24



The results of the F-test seen in the ANOVA table show a sig. 0.028 ( $p < 0.5$ ) means that the data in the regression model meets the requirements of the goodness of fit or the independent variables DER, OWN, and ROA simultaneously affect ETR. This result allows us to continue with the hypothesis test (t-test).

ANOVA <sup>a</sup>					
Model		Sum of Squares	df	Mean Square	F Sig.
1	Regression	.065	4	.016	3.042 .028 <sup>b</sup>
	Residual	.219	41	.005	
	Total	.284	45		

a. Dependent Variable: ETR

b. Predictors: (Constant), Before\_After, OWN-F, DER, OWN\_ROA

Source: Data processed SPSS v24

The results of the hypothesis test (t-test), as presented in the Coefficients table, indicate that the DER variable is not significant ( $p$ -value = 0.496), leading to the rejection of H1, which means that DER does not affect ETR. On the other hand, the OWN variable is significant ( $p$ -value = 0.029) with a regression coefficient of 0.719. Therefore, H2 is accepted that OWN has a significant positive effect on ETR, indicating that the greater the percentage of foreign ownership, the higher the tax avoidance behavior. Additionally, the interaction between the OWN and ROA variables is significant ( $p$ -value = 0.024) with a coefficient of -3.501, leading to the acceptance of H3. This finding suggests that ROA acts as a moderator variable influencing the effect of OWN on ETR in a negative direction, meaning that the higher the probability, the greater the possibility of foreign ownership reducing tax avoidance behavior.

Furthermore, the researcher investigated whether there was a significant difference in the impact of DER regulations before (2011-2015) and after (2016-2020) the implementation of PMK-169/2016. The statistical test results of the dummy variable before-and-after showed not significant ( $p$ -value = 0.236), implying that there was no difference in influence from DER regulations on tax avoidance between the two periods.

Coefficients <sup>a</sup>							
Model		Unstandardized Coefficients		Standardized Coefficients		Collinearity Statistics	
		B	Std. Error	Beta	t	Sig.	Tolerance VIF
1	(Constant)	.241	.101		2.393	.021	
	DER	-.018	.026	-.113	-.687	.496	.696 <b>1.436</b>
	OWN-F	<b>.719</b>	.319	.520	2.256	<b>.029</b>	.353 <b>2.829</b>
	OWN_ROA	<b>-3.501</b>	1.495	-.558	-2.341	<b>.024</b>	.331 <b>3.018</b>
	Before_After	.029	.024	.181	1.202	.236	.826 <b>1.211</b>

a. Dependent Variable: ETR

Source: Data processed SPSS v24

## Discussion

The impact of Debt-to-Equity Ratio (DER) regulation on tax avoidance is insignificant, indicating no correlation between the level of DER and tax avoidance behavior. As shown in the descriptive statistics, the average Debt-to-Equity Ratio is considerably lower than the regulatory limits, and the average level of tax avoidance is also relatively low during the observed periods. This finding supports previous studies by Darsani and Sukartha (2021) and Faradisa and Fahlevi (2022), which concluded that DER has no significant effect on tax avoidance.

In contrast, foreign ownership affects significantly positively on tax avoidance, suggesting that a higher percentage of foreign ownership is associated with increased tax avoidance behavior. The descriptive statistics reveal that the average foreign ownership stands at 34.6%, which is considerable enough to influence a company's operational and financial policies, as noted by Christensen et al. (2016). This could be attributed to multinational stakeholders' familiarity with international tax planning strategies or the pressure on companies to maximize post-tax returns for foreign shareholders. Such dynamics may lead to the shifting of profits or debts, potentially eroding the tax base in developing countries, as argued by the OECD (2017) and Rahayu et al. (2024). These findings align with the research of Satyadini et al. (2019), who found that foreign-owned companies are more likely to engage in tax avoidance, and Susilawati and Tarmidi (2024), who reported a positive relationship.

The moderating variable of profitability negatively impacts the relationship between foreign ownership and tax avoidance, implying that as profitability increases, companies with foreign ownership are less likely to engage in tax avoidance behaviors. Chen et al. (2011) argued that more profitable firms may be less inclined to pursue aggressive tax strategies due to concerns about their reputation or the regulatory pressures that often accompany high performance. Instead, these companies tend to prioritize reinvesting their earnings over trying to minimize their tax obligations. This finding contrasts with the conclusions of Yustia and Khomsiyah (2024), who determined that profitability (ROA) did not moderate the relationship between foreign ownership and tax avoidance. Furthermore, the analysis showed no significant difference in the impact of Debt-to-Equity Ratio (DER) regulations before (2011-2015) and after (2016-2020) the implementation of PMK-169/2016. This suggests that tax avoidance behavior was not directly influenced by the DER regulations..

## CONCLUSIONS AND SUGGESTIONS

The findings of this study highlight the importance of regulating the Debt-to-Equity Ratio (DER) in reducing tax avoidance, particularly when considering profitability factors. This regulation is especially vital for decreasing tax avoidance among foreign-owned companies. However, a limitation of this study is its focus on only six industrial sectors using annual data, which may miss important fluctuations that occur within the year. Future research should expand to include more industrial sectors and use quarterly data to better capture short-term tax strategies. Additionally, it would be beneficial to examine other moderating variables, such as firm size and market competitiveness.

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