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The Impact of Thin Capitalization and Profitability on Tax Avoidance

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ABSTRACT

This study examines the effect of thin capitalization and profitability on tax avoidance in basic materials companies listed on the Indonesia Stock Exchange (IDX) for the 2021–2024 period. The research was motivated by the ongoing issue of corporate tax avoidance in Indonesia, despite the implementation of anti–thin capitalization regulations. Using secondary data from audited financial statements, the study employed panel data regression analysis with the Common Effect Model (CEM) in EViews 12. The findings indicate that thin capitalization and profitability, both individually and simultaneously, have no significant effect on tax avoidance. The Adjusted R-squared value of –0.003957 shows that these variables explain only a minimal portion of tax avoidance behavior, implying that other factors such as firm size, capital intensity, or governance mechanisms may play a more dominant role. These results suggest that companies in the basic materials sector tend to prioritize operational stability and regulatory compliance rather than aggressive tax planning.

INTRODUCTION

Tax revenue serves as a primary source of national income and plays a vital role in financing development and sustaining economic stability (Aisyah Aulia et al., 2025; Kurniasih et al., 2022). However, corporate tax compliance in Indonesia remains a persistent challenge due to the widespread practice of tax avoidance, a legal strategy used by companies to minimize their tax burden through regulatory loopholes (Devereux & Vella, 2022; Hebous & Keen, 2022) . One of the most common mechanisms employed in tax avoidance is thin capitalization, in which companies finance their operations primarily through debt rather than equity (Bandiyono & Murwaningsari, 2020). This approach allows interest expenses to be treated as deductible items, thereby reducing taxable income. In response, the Indonesian government issued Minister of Finance Regulation No. 169/PMK.010/2015, which limits the maximum debt-to-equity ratio (DER) to 4:1 in order to mitigate base erosion and profit shifting (BEPS) practices.

Nevertheless, several studies suggest that this regulation has not been fully effective in curbing tax avoidance (Amni et al., 2023; Anindita et al., 2022). Firms with strong access to financing continue to utilize debt strategically to minimize their tax liabilities. Similarly, higher leverage ratio tends to increase the potential for tax avoidance, implying that debt financing remains a preferred tax-efficient strategy among corporations (Faruq Lasulita, 2025; Mahardika & Irawan, 2022).

Globally, corporate tax avoidance has attracted increasing attention as it undermines fiscal fairness and economic integrity. According to Bilicka et al. (2024) , multinational companies systematically exploit low-tax jurisdictions through intra-group transactions and complex capital structures to shift profits. Financial pressure and profitability are positively associated with tax avoidance, as profitable firms are more likely to engage in tax planning

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to sustain after-tax income levels (Dang & Nguyen, 2022; Etter-Phoya et al., 2025; Urrahmah & Mukti, 2021).

In Indonesia, several recent cases highlight the complexity and magnitude of corporate tax avoidance. For example, case involves PT Aneka Tambang Tbk (ANTAM), which allegedly avoided import duties and income taxes amounting to approximately IDR 2.9 trillion by altering the HS codes of imported gold worth IDR 47.1 trillion during 2021–2024 (Laily Rahmawaty, 2024) . Similarly, PT Toba Pulp Lestari Tbk was suspected of profit shifting to Macau, a low-tax jurisdiction, leading to potential tax losses of around IDR 1.9 trillion from Indonesia's dissolving pulp exports (Rengganis, 2020) . These cases collectively demonstrate how financial decisions and profitability levels may serve as strategic tools for minimizing corporate tax obligations.

Empirical studies further support this relationship. Anindita et al. (2022) and Amni et al. (2023) revealed that thin capitalization has a positive effect on tax avoidance, as greater debt utilization offers increased opportunities for tax savings through interest deductions. Likewise, Shubita (2024) and Kusumawati et al. (2024) found that firms with higher profitability tend to engage in more aggressive tax planning to enhance financial efficiency and maintain cash flow stability. However, other findings present a contrasting perspective. Nataherwin et al. (2023) and Oktiyanti & Nugraeni (2024) reported that profitability does not significantly influence tax avoidance, as highly profitable firms often prioritize maintaining a positive corporate image and complying with tax regulations. Conversely Fauzi et al. (2023) and Ekawati & Utami (2024) demonstrated that profitability positively affects tax avoidance because financially strong companies have greater resources to optimize tax management strategies to maximize firm value.

These inconsistent findings indicate a research gap in understanding how thin capitalization and profitability jointly influence tax avoidance, particularly in Indonesia's basic materials sector, which is characterized by high capital intensity and leverage ratios (Helmi, 2025). Therefore, this study aims to empirically examine the effect of thin capitalization and profitability on tax avoidance in basic materials companies listed on the Indonesia Stock Exchange (IDX) during 2021–2024. This research contributes to the advancement of accounting and taxation literature by providing empirical evidence on how corporate financing structures and financial performance drive tax behavior. Furthermore, it is expected to offer valuable insights for policymakers in strengthening debt-equity regulations and enhancing tax supervision mechanisms in Indonesia.

LITERATURE REVIEW AND HYPOTHESIS DEVELOPMENT

Agency theory

Agency theory describes the relationship between owners (principals) and managers (agents) who pursue different objectives. While shareholders focus on long-term firm value, managers are motivated by personal incentives such as bonuses or compensation According to Scott (2015) , information asymmetry allows managers to make opportunistic decisions, including tax avoidance strategies aimed at improving reported earnings. Armstrong et al. (2015) emphasized that tax avoidance is often used by managers to present higher after-tax profits, thereby enhancing their reputation and compensation (Yoshida, 2023) . However, excessive avoidance may increase agency costs and reputational risks. Therefore, agency theory supports the view that thin capitalization and profitability serve as managerial tools to pursue efficiency and self-interest (Bilicka et al., 2024).

Positive Accounting Theory (PAT)

Positive Accounting Theory (PAT) proposes that managers select accounting methods that maximize their economic benefits (Scott, 2015). Under this theory, tax avoidance is viewed as a rational and economically motivated decision to minimize costs and maximize firm value (Jamei, 2017). Prior research found that thin capitalization affects firms' capital structures and tax strategies (Anindita et al., 2022), while high profitability encourages firms to engage in more aggressive tax planning (Shubita, 2024). Consequently, PAT interprets tax avoidance as an outcome of rational managerial behavior within legal and economic boundaries (Scott, 2015).

H1: Thin capitalization positively affects tax avoidance

High leverage allows firms to deduct interest expenses from taxable income, reducing tax burdens (Shieh et al., 2014). Anindita et al. (2022) and Faisal & Rosid (2022) found that firms with higher debt ratios tend to exhibit greater tax avoidance, as debt financing provides tax advantages through deductible interest payments.

H2: Profitability positively affects tax avoidance

Highly profitable firms face higher tax obligations, motivating them to implement tax avoidance strategies to protect earnings (Darsani & Sukartha, 2021). Shubita (2024) and Milala & Darniaty (2024) demonstrated that profitability significantly drives firms' tax avoidance because it reflects both ability and incentive to engage in tax planning.

H3: Thin capitalization and profitability simultaneously affect tax avoidance

Capital structure and profitability jointly influence a firm's tax behavior, as both determine financial flexibility and tax-saving motivation (Faruq Lasulita, 2025). Darsani & Sukartha (2021) also confirmed that the combined effect of leverage and profitability significantly impacts tax avoidance levels, indicating that the interaction of financing decisions and firm performance is crucial in shaping tax behavior. Based on the theoretical framework and previous empirical studies discussed earlier, the conceptual framework of this research can be illustrated as follows.

METHODS

This research was conducted on companies in the basic materials sector listed on the Indonesia Stock Exchange (IDX) during the 2021–2024 period. The study aims to analyze the effect of thin capitalization and profitability on tax avoidance. The data used in this study are secondary data obtained from audited annual financial statements published on the official IDX website (www.idx.co.id) and other reliable sources. The research population includes all companies in the basic materials sector listed on the IDX, with a total of 268 observation samples that met the criteria through purposive sampling. Each research variable is operationalized as follows:

1. Cash Effective Tax Rate (CETR)
   CETR = Taxes Paid ÷ Profit Before Tax ……………………………………………… (1)

2. Debt to Equity Ratio (DER)
   DER = Total Debt ÷ Total Equity ………………………………………………………… (2)
3. Return on Assets (ROA)
   ROA = Net Income ÷ Total Assets ……………………………………………………… (3)

Data analysis in this research was carried out using EViews 12 Student Version Lite. The analytical procedures include descriptive statistical analysis to provide an overview of the data and classical assumption tests to ensure that the regression model meets the required criteria. The study applies panel data regression analysis to test the effect of thin capitalization and profitability on tax avoidance. Model selection was performed using the Chow, Hausman, and Lagrange Multiplier tests to determine the most suitable estimation model between the common effect, fixed effect, and random effect models. Furthermore, hypothesis testing was conducted using the t-test to determine the partial effect of each independent variable and the F-test to examine their simultaneous effect on tax avoidance. The regression model used in this study is expressed as:

$TA=\alpha+\beta 1 \quad DER+\beta 2 \quad ROA+\epsilon$…………………………………………………… (4)

RESULTS

Descriptive analysis aims to show statistical variables such as min, max, mean, sum, standard deviation.

Table 1. Descriptive Statistics

Variables	Indicators	Min	Max	Mean	Std. Dev
Thin Capitalization	X1_LEV	-7.732	5.651	0.93739552	1.38937963
Profitability	X2_ROA	-0.448	0.541	0.0395	0.09302359
Tax Avoidance	Y_CETR	-546.256	4.929	-2.2067276	33.4026010

Source: *Data were processed using Eviews 12*

Based on the descriptive statistics in Table 2, the Thin Capitalization (X1) variable, measured by the leverage ratio (LEV), has a minimum value of -7.732, a maximum value of 5.651, and a mean value of 0.9374 with a standard deviation of 1.3894. This indicates that the thin capitalization levels among the observed firms vary considerably.

The Profitability (X2) variable, represented by Return on Assets (ROA), ranges from -0.448 to 0.541, with an average of 0.0395 and a standard deviation of 0.0930, suggesting that profitability levels among firms tend to be relatively low but consistent.

Meanwhile, the Tax Avoidance (Y) variable, measured using the Cash Effective Tax Rate (CETR), has a wide distribution with a minimum of -546.256, a maximum of 4.929, a mean of -2.2067, and a standard deviation of 33.4026. This large standard deviation indicates significant variability in firms' tax avoidance behavior, implying that some companies experience extremely low or negative CETR values, which may result from losses or extraordinary financial events.

This study employed the Common Effect Model (CEM) as the estimation technique in the panel data regression analysis using EViews 12. The selection of this model was based on the results of the Chow and Hausman tests, which indicated that the CEM was the most appropriate model to describe the relationship between Thin Capitalization (X1), Profitability (X2), and Tax Avoidance (Y). The results of the regression estimation are presented in Table 2 below.

Table 2. Results of Regression Analysis (t-Test, F-Test, and R^2)

Variable	Coefficient	t-Statistic.	Prob.	Description
Thin Capitalization	-1.353615	-0.917591	0.3597	Not Significant
Profitability	6.428973	0.291789	0.7707	Not Significant
R-squared	0.003563			
Adjested R-squared	-0.003957			
F-statistic	0.473839			
Prob(F-statistic)	0.623134			

Source: *Data were processed using Eviews 12*

Based on the t-test results, Thin Capitalization (X1) has a calculated t-value of -0.917591, smaller than the t-table value of 1.997138, with a significance level of 0.3597 > 0.05. Therefore, H_a is rejected and H_0 is accepted, indicating that Thin Capitalization does not have a significant effect on Tax Avoidance (Y). Similarly, Profitability (X2) has a calculated t-value of 0.291789, which is smaller than 1.997138, and a significance level of 0.7707 > 0.05, meaning H_a is rejected and H_0 is accepted. Thus, Profitability also does not have a significant effect on Tax Avoidance.

The F-test results show that the calculated F-value (0.473839) is smaller than the F-table value (3.029985) and has a significance level of 0.623134 > 0.05. This means that H_0 is accepted and H_1 is rejected, indicating that Thin Capitalization and Profitability together have no significant simultaneous effect on Tax Avoidance.

The Adjusted R-Squared value obtained is -0.003957, indicating that Thin Capitalization (X1) and Profitability (X2) can only explain Tax Avoidance (Y) by -0.3957%. Practically, this shows that the model has almost no explanatory power, and more than 99% of the variation in Tax Avoidance is influenced by other factors outside the model. The negative Adjusted R-Squared also suggests that the model is less capable of explaining the relationship between the variables studied.

DISCUSSION

Thin Capitalization has a positive effect on Tax Avoidance

The first hypothesis is rejected, indicating that an increase in leverage or the proportion of debt in the capital structure does not significantly affect tax avoidance. This finding implies that firms tend to use debt for operational and investment purposes rather than for tax efficiency. According to Agency Theory (Scott, 2015), managers consider both the benefits of tax savings and the potential risks of financial distress when determining debt levels.

This result is consistent with the research of Asmedi & Adjie (2023) and Alamsyah et al. (2024), who found that thin capitalization did not significantly affect tax avoidance due to the implementation of ant thin capitalization rules and prudent corporate financial management. Similarly, Anindita et al. (2022) observed that thin capitalization rules shape corporate financing structures but do not necessarily lead to more aggressive tax planning. Conversely, Faruq Lasulita (2025) and Faisal & Rosid (2022) showed that in some cases, the influence of thin capitalization on tax avoidance depends on regulatory enforcement and the firm's ability to exploit cross-border financing. Hence, the absence of significant results in this study suggests that the observed companies prioritize stability over tax minimization through debt strategies.

Profitability has a positive effect on Tax Avoidance

The second hypothesis is rejected, meaning that profitability does not significantly influence the level of tax avoidance. Firms with higher profitability tend to comply with tax regulations to maintain their credibility and avoid reputational damage. Based on Positive Accounting Theory (PAT), managers act rationally to maximize firm value, but high-profit firms may avoid aggressive tax behavior due to political cost and public scrutiny.

This result is consistent with Darsani & Sukartha (2021),Oktiyanti & Nugraeni (2024), and Milala & Darniaty (2024) who also found that profitability had no significant effect on tax avoidance. Similarly, Fadhila & Andayani (2022) showed that even profitable firms often engage in conservative tax management to reduce audit risks. In contrast, studies by Shubita (2024) and Fauzi et al. (2023) found a positive association between profitability and tax avoidance, particularly in industries with flexible tax planning opportunities. Therefore, the lack of significance in this study indicates that profitability alone is insufficient to drive tax avoidance behavior, likely due to stronger enforcement and corporate governance mechanisms in the sample firms (Ekawati & Wiwik, 2024; Zhang et al., 2022).

Thin Capitalization and Profitability simultaneously affect Tax Avoidance

The third hypothesis is rejected, showing that thin capitalization and profitability together do not significantly influence tax avoidance. This result indicates that the combined financial structure and profitability performance are not key determinants of corporate tax avoidance in the observed sample. Other factors such as firm size, capital intensity, sales growth, or governance quality may play a more dominant role, as noted by Fasita & Firmansyah (2022) and Kusumawati et al. (2024)

This finding is consistent with Rahman et al. (2023) and Mahardika & Irawan (2022), who reported that simultaneous effects of leverage and profitability on tax avoidance were insignificant due to the moderating influence of financial distress and institutional ownership. Overall, this study reinforces prior evidence suggesting that financial indicators alone do not fully explain corporate tax avoidance behavior, emphasizing the importance of broader institutional and policy contexts.

CONCLUSION

This study examined the effect of Thin Capitalization (DER) and Profitability (ROA) on Tax Avoidance (CETR) in companies during the 2021–2024 period using panel data regression with the Common Effect Model (CEM) in EViews 12. The empirical results show that both variables, individually and simultaneously, do not significantly affect tax avoidance. The low and negative Adjusted R-Squared value indicates that the model has a weak explanatory ability, meaning that thin capitalization and profitability are not the main determinants of tax avoidance in the observed firms.

These findings suggest that companies' tax behavior is influenced more by other internal and external factors, such as firm size, capital intensity, sales growth, corporate

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governance, and fiscal regulations. The results align with several prior studies (Asmedi & Adjie, 2023; Darsani & Sukartha, 2021; Mahardika & Irawan, 2022) which also found that leverage and profitability alone are insufficient to explain variations in tax avoidance practices.

From a theoretical perspective, while Agency Theory and Positive Accounting Theory predict that managerial financing and profitability decisions could influence tax management, this relationship was not empirically supported in this study. Future research is recommended to include additional moderating or control variables such as institutional ownership, firm size, or corporate governance mechanisms to better understand the complexity of tax avoidance behavior

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