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Aggressive tax planning: The impact of profitability and Environment Social Governance (ESG)

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Abstract

This study aims to determine whether ESG (Environmental, Social, and Governance) scores can reduce or weaken the influence of profitability on tax planning. The data used in this study are secondary data obtained from Bloomberg and the Indonesia Stock Exchange (IDX) as of December 31, 2023. The research population includes all companies listed on the IDX in 2023, while the research sample consists of companies that meet specific criteria. Moderation regression analysis was conducted to address the research questions. The results indicate that both profitability and ESG scores have a positive effect on aggressive tax planning. However, ESG scores do not moderate the relationship between profitability and aggressive tax planning. This suggests that companies with high ESG implementation do not necessarily avoid aggressive tax planning practices.

Keywords: Tax Planning, Profitability, ESG

INTRODUCTION

Tax planning is a crucial aspect of corporate financial management (Sun et al., 2023). Its primary objective is to legally minimize the tax burden in compliance with applicable tax regulations. This is achieved by leveraging available tax loopholes or incentives. However, aggressive tax planning strategies that push the boundaries of legality can lead to tax avoidance behavior. These practices are often employed to enhance operational efficiency and sustain corporate profitability (Tanko, 2023).

According to Blaufus et al. (2023) tax planning is an effort to minimize tax obligations by managing tax obligations in a legal and effective manner in accordance with applicable tax provisions. The purpose of tax planning is to achieve tax savings. This is done by optimizing tax reductions, utilizing tax credits and managing tax reporting times by utilizing provisions.

Corporate profitability is a key factor in various management decisions, including tax strategy (Rahmayani et al., 2023). In general, more profitable companies tend to have incentives to maximize net income by minimizing their tax liabilities. Although still carried out within the limits of the law, aggressive tax planning risks damaging the company's reputation and creating challenges in the field of good corporate governance.

Companies with high profitability often have more resources to implement complex tax planning strategies. As corporate profits increase, the incentive to engage in tax avoidance also tends to increase (Olanisebe et al., 2023). Tax savings can increase net cash flow, which can increase shareholder returns. However, aggressive tax planning strategies can carry additional risks, such as increased scrutiny from tax authorities and negative impacts on the company's reputation.

Several previous studies have shown that the level of profitability is positively related to aggressive tax planning (Fitriani & Indrati, 2023; Tanko, 2023). More profitable companies tend to use more tax avoidance mechanisms, as they have the incentive and ability to do so. In addition, companies seek to preserve profits? However, this relationship may change when external factors such as environmental, social, and governance (ESG) concerns are taken into account.

Environmental, Social, and Governance (ESG) scores describe how well a company fulfills its social responsibilities, safeguards its environmental impact, and practices good corporate governance. In recent years, attention to ESG has been growing, especially among investors concerned about business sustainability and corporate ethics. Good ESG performance typically enhances a company's reputation, attracts investors, and maintains positive relationships with the public and regulators. (Maaloul et al., 2023).

Legitimacy Theory states that companies should strive to operate within the norms, values, and social expectations of society (Martens & Bui, 2023). This legitimacy is obtained when the company is considered to operate ethically, transparently, and in accordance with social interests. If a company loses legitimacy, the trust of the public, government, and stakeholders can be lost. As a result, there can be reputational losses, stock price declines, or legal action.

In terms of taxation, companies are expected to contribute fairly to the state through tax payments, which are considered part of the social contract with society. Although legal, aggressive tax planning strategies can create negative perceptions in the eyes of the public because companies are considered not to be carrying out their social responsibilities. Under the legitimacy theory, companies must maintain a balance between conducting effective tax planning to maximize profits and meeting social expectations regarding transparency and fairness (Jallai, 2020).

ESG emphasizes good governance, including how companies manage their tax policies. Companies with high ESG scores are expected to be more transparent and ethical in their operations, including in terms of tax obligations (Chouaibi & Affes, 2021). The moderating role of ESG in the relationship between profitability and aggressive tax planning is still under-discussed. Whether companies with high profitability that have high ESG scores will try to avoid taxes is an interesting research question to analyze.

Studies that simultaneously combine profitability, ESG and tax planning are still limited, so it is necessary to understand the direct influence of ESG on tax planning and how ESG affects the relationship between profitability and tax planning. This study aims to reveal whether ESG scores can reduce or weaken the influence of profitability on tax planning, and how companies that have good financial performance but are also committed to ESG, balance financial interests with their ethical and social responsibilities. The results of this study are expected to be a guide for policymakers and investors who want to assess the integrity and sustainability of a company's business, as well as the impact of tax practices on reputation and long-term performance.

LITERATURE REVIEW AND HYPHOTESIS DEVELOPMENT

Literature Review

Legitimacy theory is a concept in accounting and management that states that organizations or companies will strive to ensure that their activities and goals are in accordance with the values, norms, and social expectations of the society in which they operate (Hoque, 2006). This theory is often used to explain corporate behavior in disclosing environmental information, social practices, and tax policies. Legitimacy theory emphasizes the importance of alignment between corporate activities and social values.

Tax planning is a strategic effort by a company to minimize its tax burden within the existing legal corridor. In the context of legitimacy theory, tax planning can affect public perception of the company. By following ethical tax practices, companies can increase their legitimacy in the eyes of the public. When companies are seen to comply with tax obligations, negative attention or sanctions from tax authorities can be avoided. Companies that engage in aggressive tax planning strategies may face legitimacy risks (Brühne & Schanz, 2022). If the public perceives the company as avoiding taxes unethically, this can trigger distrust from the public or other stakeholders, which can harm the company's reputation.

Profitability and Environmental, Social, Governance (ESG) are two important elements that can influence corporate tax planning practices. According to agency theory, corporate managers are responsible for maximizing shareholder wealth, one of which is through tax efficiency strategies (Jensen & Meckling, 1976). As a result, high profitability often goes hand in hand with more aggressive tax planning to minimize tax (Ftouhi & Ghardallou, 2020). On the other hand, the implementation of ESG according to legitimacy theory can be one strategy to gain legitimacy from society and stakeholders, allowing companies to limit tax avoidance practices and demonstrate greater contributions to society through taxes.

Profitability is a measure to assess a company's ability to generate profits from its operational activities. Profitability is expressed in various ratios that help measure how efficiently a company manages resources to generate profits. Profitability is a key indicator in assessing a company's financial performance, showing how well the company generates profits from sales or investments made (Arbelo et al., 2021). Profitability provides an overview of the company's operational efficiency, competitiveness, and potential to grow and provide benefits to shareholders or investors.

ROA (Return on Assets) is a crucial profitability ratio as it measures a company's efficiency in utilizing its assets to generate profits. ROA is calculated by dividing net income after tax by the company’s total assets (Salvatori et al., 2020). It reflects the extent to which management effectively uses the company's assets to generate profits. Investors and creditors rely on ROA to evaluate operational effectiveness, resource management efficiency, and financial stability.

The concept of Environmental, Social, and Governance or ESG first emerged in 2004 when the UN together with several global financial institutions proposed the principles of sustainable investment (Dmuchowski et al., 2023). The principle emphasizes an approach that takes into account environmental, social, and governance impacts in business will generate long-term benefits for stakeholders, including investors and the wider community. As the name implies, ESG consists of 3 (three) main dimensions, namely environmental, social and governance. The environmental dimension assesses how companies minimize negative impacts on the environment, such as pollution, greenhouse gas emissions, and energy and natural resource consumption. The focus of the social dimension is the company's relationship with the community, employees, and customers. Governance involves transparency, ethics, and a strong management structure within the company. Aspects in the governance dimension include diversity and corporate leadership, as well as board structure.

ESG measurement is important because it can help investors and stakeholders assess the risks and sustainability impacts of a company's business activities. Various ESG research institutions have developed methods to evaluate company performance, one of which is Morningstar Sustainalytics, which is known for its comprehensive approach to assessing ESG risk (Sorrosal-Forradellas et al., 2023). Sustainalytics assesses companies based on their exposure to material ESG risks, as well as the company's ability to manage those risks effectively (Vezeteu & Stănciulescu, 2024). Sustainalytics approach produces ESG Risk Ratings that classify companies into five risk categories, ranging from negligible to severe, which aim to provide an overview of the company's vulnerability to ESG challenges. The details of these risk categories can be seen in table 1.

Table 1: ESG risk score categories

Risk Score	Category	Description
0-10	Negligible	Considered to have negligible ESG risk
10-20	Low	Considered to have low ESG risk
20-30	Medium	Considered to have moderate ESG risk
30-40	High	Considered to have high ESG risk
>40	Severe	Considered to have severe ESG risks

Source: (Sustainalytics, 2023)

Hypothesis Development

Effect of profitability on tax planning

Profitability is the company's ability to generate profits. Companies with high profitability tend to have large profits and therefore have higher tax burdens. Agency theory explains that company managers are responsible for maximizing shareholder wealth, one of which is through tax efficiency strategies. Thus, companies with high profits will be more motivated to carry out aggressive tax planning to maximize after-tax profits. Christensen et al. (2022) revealed that companies with high profitability are

more motivated to make tax savings through aggressive tax planning. So the first hypothesis in this study is as follows.
H_1 : Profitability has a positive effect on aggressive tax planning.

The impact of ESG on tax planning
ESG measures the extent to which a company meets sustainability and ethical standards in the areas of environment, social, and governance. In general, companies that pay attention to ESG criteria focus more on transparent, ethical, and responsible business practices regarding social and environmental impacts. Legitimacy theory explains that companies with good ESG practices will strive to meet societal expectations and maintain their social legitimacy. Thus, companies with high ESG commitments are more likely to avoid aggressive tax planning practices to maintain their reputation and legitimacy in the eyes of the public. Research by Jiang et al. (2024) shows that companies committed to ESG tend to avoid aggressive tax planning practices. So the second hypothesis in this study is as follows.
H_2 : ESG negatively impacts aggressive tax planning.

ESG's influence on the relationship between profitability and tax planning
Legitimacy theory states that companies seek to gain, maintain, and enhance their legitimacy by adjusting business activities to conform to the norms, values, and expectations of society or stakeholders. Companies with higher levels of profitability face higher pressure to pay a fair amount of tax, as a form of their social contribution to society. Aggressive tax planning will pose reputational risks and reduce the company's legitimacy in the eyes of the public. High profitability provides an incentive for companies to conduct tax planning in order to minimize the tax burden that must be paid. However, companies that are highly committed to ESG will be more careful in conducting tax planning, so that ESG can function as a moderating variable that influences the relationship between profitability and aggressive tax planning. Elamer & Boulhaga (2024) stated that well-defined corporate governance and internal ESG strategies improve corporate performance and reputation. So the third hypothesis in this study is as follows.
H_3 : ESG moderates the effect of profitability on aggressive tax planning.

METHODS

This study was conducted with the aim of studying and analyzing the influence of profitability and ESG on corporate tax planning. Profitability is measured using ROA, namely by dividing net profit after tax by the company's total assets. The higher the ROA value, the better the company's profitability. ESG is measured using the ESG Rating published by Sustainalytic. The higher the ESG Rating, the more severe the company faces ESG risks. Tax planning uses the Effective Tax Rate (ETR) measurement. A lower ETR value indicates aggressive tax planning by the company (Shamil et al., 2024).

The data used in this study are secondary data, namely data published in Bloomberg and the Indonesia Stock Exchange. ESG score data was obtained from the list published by the IDX via idx.co.id as of December 31, 2023. The research population is all companies listed on the Indonesia Stock Exchange (IDX) in 2023. The research sample is companies that meet certain criteria, namely (1) The company must have been listed on the stock exchange at the beginning of the observation period and not exit the stock exchange until the end of the observation period, namely 2023, (2) The company did not experience losses in 2023, and (3) All company data needed for the study is available.

To obtain information about the description of the data owned without testing the hypothesis, descriptive statistical analysis is used. This technique is needed to clarify the condition or characteristics of research data through presentation and analysis accompanied by calculations.

Descriptive statistics provide an explanation of various data characteristics such as average (mean), standard deviation, variance, maximum value and minimum value of data.

Regression analysis tools are used to test the effect of profitability and ESG on tax planning. Regression analysis is a series of statistical processes to estimate the relationship between variables. To see the effect of ESG on the relationship between profitability and tax planning, moderated regression analysis is used. The research equation can be formulated in 3 models as follows:

$ETR= \alpha+ \beta1\ ROA+e$………………………………………. (model 1)
$ETR= \alpha+ \beta1\ ROA+\beta2\ ESG+e$…………………………….. (model 2)
$ETR= \alpha+ \beta1\ ROA+\beta2\ ESG+ \beta3\ ROA*ESG + e$………….. (model 3)

RESULTS AND DISCUSSIONS

Results

Testing was conducted on 65 companies listed on the Indonesia Stock Exchange in 2023 that met the criteria. The results of the descriptive test showed that the average ETR was at 26.53%. This effective tax rate is not below the corporate tax rate which is generally 22%. The lowest ETR score was 0.15% and the highest ETR score was 72.31%. A lower ETR score indicates aggressive tax planning efforts, while a high ETR score indicates high tax payments by the company, meaning the company has not succeeded in making tax savings.

Descriptive results show that the average ROA of sample companies is 7.60%. The lowest ROA is at 0.07%, while the highest ROA is at 36.08%. The higher the ROA value, the company is perceived as healthier and more efficient in managing assets. A high ROA value indicates that the company can maximize the use of assets to generate greater profits. In the regression test, the LGROA value is used so that the data can meet the normality assumption in the regression test.

Descriptive testing shows the lowest ESG score is 12.67 and the highest is 46.23. The higher the ESG score, the higher the ESG risk faced by the company, which means the company has not taken sufficient mitigation measures. The average ESG score in the sample companies is 28.16. Based on table 1, this average is in the medium category for the ESG risk faced by the company. In detail, the results of descriptive testing can be seen in Table 2.

Table 2. Descriptive Statistics

Item	ROA	ESG	ETR
Min	0,07	12,67	0.15
Max	36,08	46,23	72,31
Mean	7,60	28,16	26,53
Std. Deviation	7,48	8,68	13,71

Sumber : data processed, 2024

The results of the regression test of model 1 provide an adjusted R2 value of 0.144. This means that the variability of ETR that can be explained by the variability of ROA is 14.4%. The remaining 85.6% is explained by other variables not included in the regression model. Table 3 shows that the calculated F value is 11.765 with a significance of 0.001. The test shows significant results at a 5% confidence level. This means that the regression model can be used to predict tax planning.

LGROA based on the test results in model 1 has a regression coefficient of -10.281 and is significant at the 0.05 level. This means that the higher the ROA value, the smaller the ETR value will be. A smaller ETR value indicates aggressive tax avoidance because it is further away from the normal tax rate. Based on this, the first hypothesis stating that profitability has a positive effect on aggressive tax planning is accepted.

Table 3. Results of The Regression

Variables	ETR		
	Model 1	Model 2	Model 3
LGROA	-10,281*	-11,450*	5,424
ESG	-	0,486*	0,975*
LGROA*ESG	-	-	-0,653
N	65	65	65
R^2	0,157	0,250	0,275
Adj. R^2	0,144	0,226	0,240
F	11,765	10,345	7,725
Sig.	0,001	0,00	0,00

Note : * significant at the level o,o5

The results of the regression test of model 2 provide an adjusted R2 value of 0.226. This means that the variability of ETR that can be explained by the variability of ROA and ESG is 22.6%. The remaining 77.4% is explained by other variables not included in the regression model. Table 3 shows that the calculated F value is 10.345 with a significance of 0.001. The test shows significant results at a 5% confidence level. This means that the regression model can be used to predict tax planning.

ESG based on the test results in model 2 has a regression coefficient of 0.486 and is significant at the 0.05 level. This means that the higher the ESG value, the greater the ETR value. A high ESG value according to Sustanailtyc means that the company is considered to face a heavier ESG risk. Meanwhile, a higher ETR value indicates lower tax avoidance. Based on this, the second hypothesis stating that ESG has a negative effect on aggressive tax planning is rejected.

The results of the regression test of model 3 provide an adjusted R2 value of 0.240. This means that the variability of ETR that can be explained by the variability of ROA, ESG and the interaction of both is 24%. The remaining 76% is explained by other variables not included in the regression model. Table 3 shows that the calculated F value is 7.725 with a significance of 0.001. The test shows significant results at a 5% confidence level. This means that the regression model can be used to predict tax planning.

The interaction variable (ROA*ESG) and ROA based on the test results in model 3 have a regression coefficient of 0.486 and are not significant. This means that the higher the ESG value, the greater the ETR value. A high ESG value according to Sustanailtc means that the company is considered to face a heavier ESG risk. Meanwhile, a higher ETR value indicates lower tax avoidance. Based on this, the third hypothesis stating that ESG moderates the effect of profitability on aggressive tax planning is rejected.

Discussions

The results of testing model 1 show that profitability has a positive effect on aggressive tax planning. The greater the profit earned, the more companies tend to try to minimize their tax burden. In the context of agency theory, managers have incentives to carry out aggressive tax planning in order to achieve profitability targets or maintain a certain level of profit. High profitability raises the potential for a large tax burden for the company so that company management tends to be more aggressive in maintaining a higher level of net profit. Research by Rufus Akintoye et al., (2020) shows that companies with higher profits more often carry out tax planning to reduce their tax burden and increase cash flow. Research by Hashfi (2024) found that highly profitable companies are more likely to use tax avoidance strategies to maintain their profit performance, especially in competitive industries.

The results of model 2 testing show that the higher the ESG value, the less likely the company is to engage in aggressive tax planning. Conversely, the lower the ESG value, the more likely the company is to engage in aggressive tax planning. This means that companies with low ESG risk tend to be more aggressive in tax planning. Based on legitimacy theory, companies seek to gain social legitimacy from stakeholders by demonstrating a commitment to social and environmental issues. However, companies that prioritize ESG may also face expectations to maintain profitability. This can trigger a contradiction where companies seek to project a positive image related to ESG but still use aggressive tax strategies to maintain profits. Research by Widuri (2023) found that companies that are actively involved in CSR (Corporate Social Responsibility) are more motivated to reduce taxes through aggressive tax planning to offset the CSR costs incurred. Yoon et al. (2021) found that companies with low ESG risk use tax avoidance strategies to allocate more resources to sustainable programs, assuming that stakeholders may not view this negatively because of their positive ESG scores.

The results of model 3 testing show that ESG does not moderate the effect of profitability on aggressive tax planning. This indicates that the level of company profitability performance (ROA) independently affects aggressive tax planning without being influenced by ESG commitment. In legitimacy theory, companies that prioritize environmental, social, and governance (ESG) aspects are expected to pay attention to their contributions to society, including tax compliance. However, if ESG is not a moderating variable, companies with high profitability still tend to carry out aggressive tax planning regardless of how high or low the ESG score is. A study by Elamer & Boulhaga (2024) shows that although ESG and sustainable business practices often have a positive impact on a company's reputation, this is not strong enough to change a company's tax strategy, especially in companies with high profitability. Research by Kovermann & Velte (2021) also suggests that financial factors are often more dominant than ESG commitment when companies have to make decisions related to tax management.

CONCLUSIONS

Based on the results of the test and analysis, it can be concluded that profitability and ESG have a positive effect on aggressive tax planning. ESG cannot moderate the effect of profitability on aggressive tax planning. This means that companies with high ESG implementation do not always avoid aggressive tax planning practices. The implications of this finding suggest that regulators and stakeholders cannot assume companies focusing on ESG will reduce aggressive tax planning practices, particularly when they have high profitability. For investors or stakeholders who value tax transparency, it is important to evaluate a company's tax structure independently of its ESG commitments.

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