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(Research/ Review) Article

Profitability and Tax Avoidance: Exploring the Role of Financial Distress as a Driver of Tax Strategies

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Abstract: This study investigates the effect of profitability, measured by Return on Assets (ROA), on tax avoidance, represented by the Effective Tax Rate (ETR), while considering financial distress (Z-Score) as a moderating variable. The research focuses on consumer goods manufacturing companies listed on the Indonesia Stock Exchange (IDX) during the 2018–2022 period, involving a sample of 35 firms. The study is motivated by the challenges faced by companies under financial pressure, where profitability and tax strategies often intersect. By employing multiple linear regression and Moderated Regression Analysis (MRA), this research provides empirical evidence on how financial distress influences the relationship between profitability and tax avoidance. The findings reveal that profitability has a significant negative effect on tax avoidance, indicating that more profitable companies tend to engage less in tax avoidance. However, when financial distress is present, this relationship intensifies—companies experiencing financial pressure are more likely to adopt aggressive tax avoidance strategies, even if they are profitable. This suggests that financial distress acts as a catalyst, amplifying the tendency to minimize tax obligations. The study contributes to the literature by offering insights into the moderating role of financial distress in corporate tax behavior, particularly in the Indonesian context. These findings have practical implications for policymakers and regulators in designing more effective tax compliance frameworks and understanding corporate financial risk during economic downturns.

Keywords: Financial Distress; Profitability; Return Assets; Tax Avoidance; Tax Rate

1. Introduction

The current state of the consumer goods sector shows significant economic pressure, which is affecting corporate strategies regarding tax management and financial operations. In 2024, despite a moderation compared to previous years, global inflation remains high, making it difficult for companies in this sector to maintain profit margins without further price increases. According to Deloitte, consumer goods price inflation reached extremely high levels in 2023, and many companies are adjusting their strategies to avoid relying solely on price hikes, as consumers are beginning to limit their spending(Deloitte, 2024).

The financial pressure on companies in this sector has driven them to seek cost-saving alternatives, one of which is tax avoidance strategies. Given that consumers are becoming increasingly price-sensitive, companies must find other ways to maintain profitability without sacrificing sales volume. A study by Bain & Company reveals that in 2023, 95% of retail sales growth in the US and Europe was driven by price increases rather than volume growth. However, with the inability to continue raising prices in 2024, tax avoidance strategies become even more relevant as a way to reduce expenses and maintain healthy cash flow (Bain & Company, 2024).

Moreover, data from AlphaSense reveals that global economic uncertainty and declining consumer purchasing power have forced consumer goods companies to use tax avoidance strategies as a means to maintain liquidity amid high production costs and supply chain fluctuations. The use of digital technology and data analytics to optimize operational efficiency has also become a trend, but it has not been fully able to mitigate margin pressures without

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reducing tax burdens. As a result, companies in this sector continue to explore various avenues, including tax avoidance, to survive in unstable economic conditions.

Manufacturing companies in the consumer goods sector play an important role in Indonesia's economy, particularly in terms of employment absorption and contributions to Gross Domestic Product (GDP). However, this sector is also vulnerable to global and domestic economic fluctuations, especially in situations of increased economic uncertainty since the COVID-19 pandemic. The impact of the pandemic has caused many companies to experience demand downturns and supply chain disruptions, which could potentially increase the risk of financial distress (Fadhilah & Kusumawati, 2024). In this context, it is important to understand how companies' financial conditions, especially profitability, interact with the tax avoidance strategies they employ in response to financial pressure.

Profitability, often measured through financial ratios such as Return on Assets (ROA) or Return on Equity (ROE), is a key indicator of a company's financial performance. High profitability generally reflects a company's ability to generate profit from its assets. However, in situations of financial distress, companies may be more inclined to seek ways to minimize their tax burden as part of efforts to maintain liquidity (Lanis & Richardson, 2012). Therefore, the relationship between profitability and tax avoidance becomes relevant for further study, especially in terms of how financial distress may moderate this relationship.

Tax avoidance is a common practice among companies to legally reduce their tax obligations. On one hand, this strategy can improve a company's cash flow, but on the other hand, it can trigger reputational risks and increased scrutiny from tax authorities (R. Chen et al., 2022). For companies facing financial distress, the motivation to engage in tax avoidance may increase, but its effects may vary depending on the company's level of profitability. Companies with low profitability may be more aggressive in seeking tax avoidance opportunities, while highly profitable companies may be more cautious, as they have the capacity to weather a crisis without taking legal risks (Sari et al., 2021).

This study is also supported by recent research showing an increasing trend of tax avoidance in companies experiencing financial pressure. For instance, (Fadhilah & Kusumawati, 2024)) found that financial distress plays a significant role in driving companies to adopt tax avoidance strategies. These findings are relevant to this study, particularly in understanding the dynamics between profitability, financial distress, and tax avoidance in the consumer goods manufacturing sector.

This research is important in light of increasingly stringent government tax oversight policies and the implementation of tax amnesty programs aimed at improving tax compliance (Directorate General of Taxes, 2021). In uncertain economic conditions, this study will provide deeper insights into how companies react to financial pressure and applicable tax regulations. Additionally, the consumer goods sector is chosen as the focus of this research due to its sensitivity to market demand fluctuations. This makes companies in this sector more vulnerable to financial distress risks, especially if there is insufficient product diversification (Rosadani & Wulandari, 2023). Therefore, understanding the interaction between profitability, financial distress, and tax strategies in this context will help companies and policymakers formulate more effective strategies for managing risks and ensuring business sustainability.

In its analysis, this study will examine data from manufacturing companies listed on the Indonesia Stock Exchange (IDX) over the 2018-2022 period to ensure the validity of the results obtained. It will also explore how profitability and financial distress interact in influencing tax avoidance behavior.

2. Literature Review

Agency Theory

Agency theory explains the relationship between shareholders (principals) and management (agents) within a company. It highlights potential conflicts of interest that arise when managers (agents) prioritize their personal interests, such as increasing compensation or bonuses, over the shareholders' goal of maximizing company value (Jensen & Meckling, 1976). In this context, managers may take steps such as tax avoidance to reduce the company's tax obligations, which can increase cash flow and improve the company's short-term performance (Hadiwibowo et al., 2024; Mukunoki & Okoshi, 2021).

Recent studies show that in times of financial pressure, managers are increasingly likely to engage in tax avoidance practices as a strategy to maintain liquidity and ensure the company's operational continuity (Hadiwibowo et al., 2024). This aligns with the agency theory's

view that managers act based on short-term incentives, even if it may conflict with the long-term interests of shareholders (S. Chen et al., 2010). In times of financial distress, the conflict between agents and principals becomes more pronounced as managers focus more on their own survival rather than full compliance with tax regulations (Edwards et al., 2016; Lanis & Richardson, 2012).

Tax Avoidance

Tax avoidance is a corporate strategy to minimize tax liabilities legally through various techniques such as manipulating profit reports or shifting costs to reduce taxable income. This practice is intended to improve the company's cash flow but can also carry reputational risks and attract attention from tax authorities (Alstadsæter et al., 2022; Desai & Dharmapala, 2006) One common indicator used in measuring tax avoidance is the Effective Tax Rate (ETR), which is the ratio of tax expenses to pre-tax profit. A lower ETR indicates higher efforts in tax avoidance (R. Chen et al., 2022). Recent studies reveal that highly profitable companies sometimes still engage in tax avoidance to maintain competitiveness and maximize net profits (Liu et al., 2019). Although tax avoidance is not illegal, it may pose risks if companies are perceived as avoiding fair social and tax responsibilities (Gavious et al., 2022). Thus, tax avoidance not only affects the company's financial statements but also public perceptions of the company's integrity.

Profitability / Return on Assets (ROA)

Profitability, measured by Return on Assets (ROA), shows how efficiently a company generates profit from its assets. ROA is calculated by dividing net income by total assets, with a higher ratio indicating better performance and operational efficiency. ROA reflects not only how well a company manages its assets but also how effectively it executes strategies to maximize profits (Prasetya & Muid, 2022). However, some studies reveal that ROA has a varied relationship with tax avoidance. Some companies, despite having high profitability, still engage in tax avoidance to optimize cash flow and maintain market competitiveness (Arianandini & Ramantha, 2018). On the other hand, companies with low profitability may be more driven to avoid taxes as a way to reduce operational burdens and survive financial pressure (Zarkasih & Maryati, 2023).

Financial Distress

Financial distress refers to the condition when a company struggles to meet its financial obligations, often measured using the Z-Score. The Z-Score estimates the likelihood of bankruptcy based on several financial ratios, such as profitability, leverage, and liquidity (Suryani et al., 2023). The higher the Z-Score, the lower the risk of financial distress, and vice versa. In times of financial distress, companies are often motivated to engage in tax avoidance to maintain sufficient cash flow and prevent bankruptcy (Fadhilah & Kusumawati, 2024). In many cases, financially pressured companies seek to optimize all possible means, including tax strategies, to maintain stability and liquidity. Studies by (Fadhilah & Kusumawati, 2024; Xu et al., 2018) also show that financial distress plays a significant role in pushing companies toward tax avoidance.

Relationship Between Profitability and Tax Avoidance

The relationship between profitability (ROA) and tax avoidance remains a topic of debate in the literature. Some studies suggest that highly profitable companies tend to avoid taxes to maximize net profits (R. Chen et al., 2022) However, other studies reveal that companies with high profitability may prefer to comply with tax regulations to maintain their reputation and reduce the risk of audits by tax authorities (Lanis & Richardson, 2012). On the other hand, companies with low profitability often adopt a more aggressive approach to tax avoidance as a strategy to maintain cash flow and ensure operational continuity (Indah Iwanty & Asih Surjandari, 2022; Prasetya & Muid, 2022;Niandari & Novelia, 2022). Therefore, this study focuses on the role of financial distress in moderating the relationship between profitability and tax avoidance, considering the uncertainty in previous research findings.

Hypothesis Development

The hypotheses developed for this study are as follows:

H1: Profitability negatively affects tax avoidance, indicating that higher profitability leads to lower tax avoidance efforts.

H2: Financial distress moderates the relationship between profitability and tax avoidance, where financial distress increases the likelihood of tax avoidance, even in highly profitable companies.

3. Proposed Method

Research Methodology

This study adopts a quantitative approach using descriptive and causal methods to analyze the relationship between profitability, financial distress, and tax avoidance. The descriptive method is used to describe the characteristics and phenomena present in consumer goods manufacturing companies listed on the Indonesia Stock Exchange (IDX). The causal approach is applied to explore and test the cause-and-effect relationship between the independent variable (profitability) and the dependent variable (tax avoidance), with financial distress as the moderating variable. The analysis technique employed is multiple linear regression and Moderated Regression Analysis (MRA) to assess the moderating effect of financial distress.

This method aims to test the proposed hypotheses based on theory and previous research. With regression analysis, the researcher can identify the extent of the influence of profitability on tax avoidance and how financial distress moderates this relationship. This method also allows the researcher to control for other variables that may affect the relationship, ensuring more accurate and relevant research results. Data processing is conducted using statistical software such as SPSS to ensure the validity and reliability of the analysis.

Population and Sample

The population in this study consists of 78 companies operating in the consumer goods sector and listed on the Indonesia Stock Exchange (IDX). These companies are divided into six sub-sectors: (1) food and beverages, (2) tobacco factories, (3) pharmaceuticals, (4) cosmetics and household goods, (5) household appliances, and (6) other sub-sectors.

The sample for this study is selected using purposive sampling. The criteria for selecting the research sample are as follows: Manufacturing companies in the consumer goods sector listed on the Indonesia Stock Exchange (IDX) during the period 2018 to 2022. Manufacturing companies in the consumer goods sector that have published and distributed complete annual financial reports for the years 2018 to 2022. Manufacturing companies in the consumer goods sector that recorded profits during the period 2018 to 2022.

With these criteria, the study focuses on companies that are not only active but also demonstrate stable and profitable financial performance over the past five years. Based on the criteria set by the researcher, 35 companies were selected as the research sample from a total population of 78 companies.

Moderated Regression Analysis (MRA)

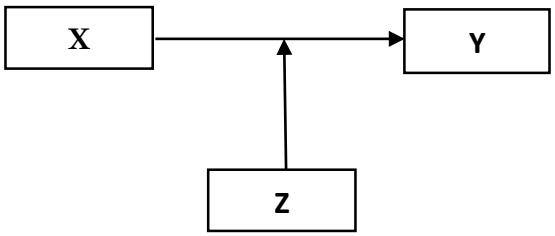

Figure 1. Regression Model Relationship with Moderating Variable.

In this study, the researcher uses the Moderated Regression Analysis (MRA) technique to test the influence of the moderating variable. The formula used in the MRA calculation is as follows:

$$Y = \alpha + \beta X + \beta M + \beta X*M + \varepsilon \quad (1)$$

Explanation:
Y = Tax avoidance
α = Constant
β = Regression coefficient
X = Return On Assets
M = Financial distress
ε = Residual value

4. Results and Discussion

Results

Descriptive Statistics

The factual analysis in this study includes quantitative testing, mean values, standard deviations, and the highest and lowest profits for the variables ROA, financial distress, and ETR (Effective Tax Rate). The research sample consists of consumer goods manufacturing companies listed on the Indonesia Stock Exchange during the fiscal period of 2018 to 2022. From the sample selection process, 165 companies were chosen using the purposive sampling method. The researcher then used SPSS-26 to process the financial data from these 165 companies. Below are the results of the descriptive statistical tests for consumer goods manufacturing companies listed on the Indonesia Stock Exchange for the 2018-2022 period.

Table 1. Descriptive Statistical Analysis

N		Minimum	Maximum	Mean	Std. Deviation
X_ROA	165	,01	44,68	10,9001	8,39364
Y_ETR	165	3,20	86,38	25,1112	8,60044
Z_ZSCORE	165	,33	33,92	8,1452	5,19503
Valid N (listwise)	165				

Source: SPSS Output, 2024

The descriptive statistical test results for consumer goods manufacturing companies during the 2018-2022 period show that the lowest ROA (Return on Assets) value of 0.01 was recorded by PT Buyung Poetra Sembada Tbk in 2022, indicating a significant decline in the company's ability to manage its assets to generate profit. Meanwhile, the highest ROA of 44.68 was achieved by PT Unilever Indonesia Tbk in 2018, reflecting strong demand for the company's products. The average ROA in this sector was 10.90, with a standard deviation of 8.39. For the ETR (Effective Tax Rate), the lowest value of 3.20 was achieved by PT Budi Starch Sweetener Tbk in 2020, while the highest value of 86.38 was recorded by PT Buyung Poetra Sembada Tbk in 2022. A lower ETR indicates that the company may be engaging in tax avoidance. The average ETR in this sector was 25.11, with a standard deviation of 8.60. The Z-Score, which measures a company's financial health, had a minimum value of 0.33 (PT Wahana Interfood Nusantara Tbk in 2018), indicating a risk of bankruptcy, and a maximum value of 33.92 (PT Darya Varian Indonesia Tbk in 2018), indicating a healthy financial condition. The average Z-Score was recorded at 8.14 with a standard deviation of 5.19, reflecting significant differences in the financial conditions of companies in this sector.

Normality Test

One of the important assumptions in linear regression analysis is that the residuals of the regression model must follow a normal distribution. To test this assumption, a normality test of residuals was conducted using a Normal P-P Plot (Probability-Probability Plot) of the standardized residuals.

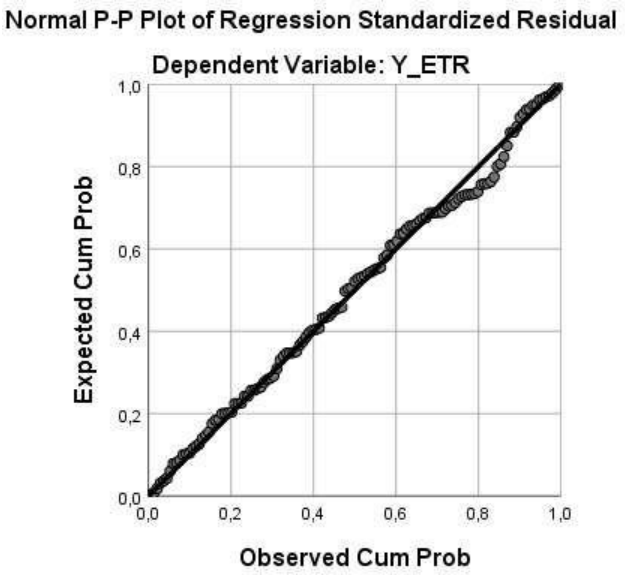

Figure 2. Normal Probability Plot Test Results.

The figure above displays the Normal P-P Plot of Regression Standardized Residuals for the dependent variable Y_ETR (Effective Tax Rate). In this plot, the horizontal axis represents the cumulative probability of the observed residuals, while the vertical axis represents the expected cumulative probability if the residuals follow a normal distribution. The diagonal line on the plot represents the perfect normality line, where points that align with a normal distribution are expected to lie along this line.

Based on the results of the Normal P-P Plot, it can be concluded that the residuals from the regression model for the Y_ETR variable have a distribution that closely approximates normality. Deviations from normality are observed only in a few points at the ends of the distribution; however, this is considered acceptable and does not significantly affect the validity of the regression model. Therefore, the assumption of normality for the residuals in this regression analysis can be considered fulfilled, making the regression model suitable for further interpretation. The fulfillment of the normality assumption is important to ensure that the regression parameter estimates are unbiased and efficient, and to support the validity of the hypothesis testing conducted in this study.

Heteroscedasticity Test

Table 2. Heteroscedasticity Test Results.

UnstandardizedCoefficients			Standardized Coefficients	t	Sig.	Collinearity Statistics	
ModelB		Std. Error	Beta			Tolerance	VIF
(Constant)	24,936	1,294		19,268	,000		
X_ROA	-,400	,035	-,804	-11,523	,000	,772	1,295
Z_ZSCORE	,254	,068	,403	3,742	,000	,325	3,081

In the heteroscedasticity test results above, the ROA variable has a significance value of 0.477 > 0.05, and the Z-Score has a significance value of 0.279 > 0.05. These results indicate that this study is free from the issue of heteroscedasticity.

Autocorrelation Test

Table 3. Autocorrelation Test Results.

Model	R	R Square	Adjusted RSquare	Std. Error ofthe Estimate	Durbin-Watson
1	,733[a]	,538	,526	1,90842	1,776

The Durbin-Watson value of 1.776 indicates that this model does not have a significant autocorrelation issue. This value is close to 2, meaning that the residuals in this model are not correlated or have very low autocorrelation. It can be concluded that there is no strong indication of autocorrelation in this regression model. Therefore, the regression results are reliable, and the assumption that the residuals are not correlated with each other is fulfilled.

Hypothesis Testing

Table 4. Partial Test Results (T-Test).

Model	Unstandardized Coefficients		Standardized Coefficients Beta	t	Sig.
	B	Std. Error			
(Constant)	24,936	1,294		19,268	,000
X_ROA	-,400	,035	-,804	-11,523	,000
Z_ZSCORE	,254	,068	,403	3,742	,000

The first hypothesis in this study concerns the effect of profitability on tax avoidance. Profitability is represented by the ROA ratio, while tax avoidance is measured using the Effective Tax Rate (ETR). The partial analysis results show that ROA has a regression coefficient of -0.40 (negative), with a t-value of -11.523 and a significance level of 0.000 < 0.05. Based on these results, it can be concluded that profitability, as measured by ROA, has a negative and significant effect on tax avoidance, as represented by ETR. Therefore, the first hypothesis (H1), which stated that profitability positively affects tax avoidance, is rejected. The higher the level of profitability, the lower the company's ETR. A lower ETR indicates a higher likelihood that the company is engaged in tax avoidance.

This finding is consistent with stakeholder theory, which suggests a misalignment of interests between internal parties (the company) and external parties, such as the government as the tax collector. Companies with high profitability levels tend to seek ways to minimize their tax burdens.

MRA Test

Table 5. Coefficient of Determination (MRA) Results.

Model		Unstandardized Coefficients		Standardized Coefficients	t	Sig.
		B	Std. Error	Beta		
1	(Constant)	23,900	,242		98,646	,000
	X_ROA	-2,248	,191	-,811	-11,790	,000
	Z_ZSCORE	1,237	,315	,446	3,927	,000
	X_Z	,501	,239	,156	2,094	,038

Based on the moderation test results in the table above, it is evident that financial distress has a significant effect on tax avoidance, with a significance value of 0.000, which is smaller than 0.05. Additionally, the interaction between the moderating variable, financial distress, and the effect of profitability on tax avoidance shows a significance value of 0.038, which is

also less than 0.05. These results indicate that the financial distress variable (Z-Score) can moderate the effect of profitability (ROA) on tax avoidance (ETR).

Financial distress, which significantly moderates, also functions as an independent variable influencing the dependent variable, thus referred to as a quasi-moderator. Based on these findings, the second hypothesis (H2), which states that financial distress can moderate the effect of profitability on tax avoidance, is accepted.

5. Discussion

The Effect of Profitability on Tax Avoidance

Based on the analysis, profitability as measured by Return on Assets (ROA) has a negative and significant effect on tax avoidance, as measured by the Effective Tax Rate (ETR), in consumer goods sector companies listed on the Indonesia Stock Exchange (IDX). This result indicates that the higher the company's profitability, the lower the resulting ETR, suggesting a tendency for the company to engage in tax avoidance strategies. These findings align with research conducted by (Arianandini & Ramantha, 2018) which states that high profitability encourages companies to minimize their tax burden in order to increase net profits. Furthermore, (Nugrahitha & Suprasto, 2018) support this finding, showing that more profitable companies tend to have greater resources and capabilities to design tax avoidance strategies to optimize after-tax profits.

However, some studies present conflicting results. For example, (Prasetya & Muid, 2022; Pratiwi & Budyastuti, 2024)) found that companies with high profitability are more likely to comply with tax regulations to maintain their reputation in the eyes of the public and stakeholders. This is linked to Stakeholder Theory, which asserts that highly profitable companies have greater responsibilities toward external parties, such as the government, and therefore tend to be more cautious in their tax avoidance strategies. On the other hand, this study also relates to Agency Theory, which suggests that company management, as agents, often have incentives to minimize tax payments to increase shareholder returns, even though this may sometimes involve legal risks if done aggressively.

The Effect of Profitability on Tax Avoidance Moderated by Financial Distress

The study results show that financial distress (Z-Score) significantly moderates the effect of profitability (ROA) on tax avoidance (ETR). When companies experience financial pressure, they tend to use tax avoidance strategies to ensure business continuity. (Edwards et al., 2016) indicated that companies under financial distress are more likely to employ tax strategies to improve liquidity. This result is consistent with the findings of Fadhilah & Kusumawati (2024)), who found that companies in distress tend to be more aggressive in avoiding taxes, as financial pressure motivates them to reduce tax burdens and improve cash flow.

However, some studies present the opposite view. Lanis & Richardson (2012) revealed that although companies in poor financial conditions have incentives to avoid taxes, they often face higher risks due to increased government scrutiny and stakeholder pressure, which may limit their ability to engage in tax avoidance. According to Agency Theory, company managers may take riskier tax avoidance measures when the company is under financial distress, but this also increases the reputational risk if the company is involved in practices perceived as unethical.

6. Conclusions

The study concludes that profitability (ROA) exerts a significant negative influence on tax avoidance (measured by ETR) among consumer goods companies listed on the IDX. In other words, as profitability increases, firms tend to report lower effective tax rates, reflecting greater engagement in tax avoidance practices. Furthermore, financial distress, as proxied by the Z-Score, is found to significantly moderate this relationship. Companies experiencing higher levels of financial distress are more inclined to adopt tax avoidance strategies. These results are consistent with prior research, although contextual differences suggest that while financial constraints heighten the incentives for tax avoidance, they may simultaneously restrict a firm's capacity to implement such strategies.

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