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Financial Distress As a Mediator Between Capital Structure, Earnings Management, and Tax Aggressiveness

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Abstract: Purpose: This study explores how capital structure, earnings management, and financial distress influence tax aggressiveness among manufacturing firms on the Indonesia Stock Exchange. Amid increasing tax regulations and levies, this research provides critical insights. Methodology/Approach: Using a quantitative explanatory research approach, the study analyses secondary data from financial statements of 41 purposively sampled manufacturing firms. Findings: Capital structure significantly impacts financial distress and tax aggressiveness, whereas earnings management does not significantly impact either variable. Interestingly, financial distress mediates the relationship between capital structure and tax aggressiveness, but does not mediate the relationship between earnings management and tax aggressiveness. Lastly, financial distress has a significant positive effect on tax aggressiveness. Practical Implications: Findings help firms optimise financial strategies and assist regulators in curbing aggressive tax practices. Originality/Value: This study underscores financial distress as a crucial mediator in corporate tax strategies within the manufacturing sector.
Keywords: Capital Structure; Earnings Management; Financial Distress; Tax Aggressiveness.

Abstrak: Tujuan: Penelitian ini mengeksplorasi bagaimana struktur modal, manajemen laba, dan financial distress mempengaruhi agresivitas pajak pada perusahaan manufaktur di Bursa Efek Indonesia. Di tengah meningkatnya peraturan dan pungutan pajak, penelitian ini memberikan wawasan penting. Metodologi/Pendekatan: Dengan menggunakan pendekatan penelitian eksplanatori kuantitatif, penelitian ini menganalisis data sekunder dari laporan keuangan 41 perusahaan manufaktur yang diambil secara purposif. Temuan: Struktur modal ditemukan secara signifikan berdampak pada kesulitan keuangan dan agresivitas pajak, sedangkan manajemen laba tidak secara signifikan berdampak pada kedua variabel tersebut. Menariknya, financial distress memediasi hubungan antara struktur modal dan agresivitas pajak, tetapi tidak memediasi hubungan antara manajemen laba dan agresivitas pajak. Terakhir, financial distress berpengaruh positif signifikan terhadap agresivitas pajak. Implikasi Praktis: Temuan ini membantu perusahaan mengoptimalkan strategi keuangan dan membantu regulator dalam membatasi praktik pajak yang agresif. Keaslian/Nilai: Penelitian ini menggarisbawahi kesulitan keuangan sebagai mediator penting dalam strategi pajak perusahaan di sektor manufaktur.
Kata Kunci: Struktur Modal; Manajemen Laba; Kesulitan Keuangan; Agresivitas Pajak.

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INTRODUCTION

The primary goal of a company is to maximise shareholder value by increasing profits. This can be achieved through two main strategies: boosting revenue and reducing costs, including tax expenses. Taxes are a mandatory obligation directly affecting the company's profits, so effective tax management is crucial for achieving financial objectives without hindering profitability (Handayani & Mardiansyah, 2021). However, a high tax burden can reduce the company's net profit, encouraging companies to take aggressive actions in tax management. In this context, tax aggressiveness refers to a company's efforts to reduce the tax burden through legal means, such as tax avoidance, or even illegal means, such as tax evasion (Rachmawati & Fitriana, 2021). This phenomenon is still widespread in Indonesia, as evidenced by the high number of companies that report fiscal losses but continue to develop their operations, even in sectors with great potential such as mining (Handayani & Mardiansyah, 2021). The high participation in Indonesia's 2016 tax amnesty program reflects corporate awareness of tax reporting inconsistencies. Many companies, whether intentionally or not, engaged in tax avoidance and viewed the amnesty as a chance to correct past obligations without severe penalties. This indicates recognising the risks of aggressive tax strategies and a willingness to comply with regulations to avoid legal issues.

The mining industry, particularly, is prone to tax avoidance, despite government efforts to curb such practices through regulations like the Circular Letter of the Director General of Taxes Number 46 of 1995. Companies continue to exploit tax law loopholes, highlighting that tax aggressiveness involves legal and illegal tax planning strategies (González et al., 2019). Some companies utilise sophisticated methods such as transfer pricing, trade mispricing, and treaty shopping to manipulate tax payments, thereby reducing their tax burden while remaining within the boundaries of legal frameworks. Consequently, this creates a significant challenge for tax authorities in ensuring compliance and maintaining fair tax contributions from the sector.

On the other hand, earnings management is also an inseparable factor in corporate tax management. Earnings management is frequently implemented in response to agency issues between shareholders and managers. These parties have incentives to augment profits to accomplish specific performance objectives (Firmansyah et al., 2022). Earnings management can increase profits, but risks raising tax burdens since taxes are calculated on reported taxable income. Companies often exploit differences between financial reporting standards and tax calculations to manipulate taxable income. Both earnings management and capital structure influence tax aggressiveness, with earnings management—arising from agency conflicts between shareholders and managers—potentially increasing profits and resulting in higher taxes (Nogueira, 2019).

However, companies can use the differences between financial reporting standards and fiscal income calculations to lower taxable income, reducing the tax burden without affecting commercial profits. Dewey's 2018 (Leonardo et al., 2023) study found that earnings management had no significant effect on tax aggressiveness, while other studies by (Annisa et al., 2021) also agree that earnings management does not affect tax aggressiveness (ETR). However, studies by (Handayani & Mardiansyah, 2021) and (Pradhana & Nugrahanto, 2021) show that earnings management positively affects tax aggressiveness. In addition, a capital structure involving debt can also increase the potential for tax aggressiveness, because debt interest costs can reduce taxable income

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(Kurniasih et al., 2020). However, there are limitations on the burden of debt interest that have been regulated in tax regulations. However, companies can still take advantage of a high debt structure to reduce the taxes they have to pay.

The company's capital structure also plays a crucial role in tax aggressiveness. Using debt in the capital structure can significantly reduce taxable income, as interest expenses on debt are deductible from taxable profits (Law Number 36 of 2008).

This incentivises companies to finance their operations through debt rather than equity, as it provides tax benefits through lower tax liabilities. As a result, companies with a higher proportion of debt in their capital structure tend to exhibit greater tax aggressiveness, utilising debt as a strategic tool to minimise their tax obligations and enhance financial efficiency.

However, excessive reliance on debt also comes with risks, particularly financial distress, in which a company experiences financial difficulties that could threaten its stability. When faced with financial distress, companies may resort to extreme measures, including aggressive tax avoidance strategies, to alleviate their financial burden. This could involve excessive interest deductions, profit shifting, or even the use of tax havens to reduce taxable income further. While these strategies may provide short-term relief, they can also attract scrutiny from tax authorities and regulatory bodies, potentially leading to penalties and reputational damage.

Therefore, companies must balance optimising their capital structure for tax efficiency and maintaining financial stability to avoid long-term negative consequences (Junaidi et al., 2023). Previous studies have shown that capital structure affects tax aggressiveness, although the results vary. Several studies have shown that a higher capital structure is associated with higher tax aggressiveness (Kurniasih et al., 2020), while other studies have found no significant relationship (Johanna Leonardo et al., 2023).

Earnings management can be defined as the actions employed by firm managers to influence or change the data presented in financial reports. 'Earnings management' refers to manipulating financial data and transactions to mislead stakeholders regarding a company's financial performance (Junaidi et al., 2023). "Earnings management" refers to when upper-level management skews financial report profit figures to suit their agenda. The earnings management strategy aims to achieve several objectives, such as maintaining the company's credibility and incentivising managers to enhance their welfare and pursuits (Imaniah & Kurnia, 2023). The results of (Sayidah et al., 2020) corroborate this conclusion, showing that earnings management does not worsen financial difficulty. The corporation could be saved from financial ruin if it lied to its stakeholders to pique their interest in investing. High debt in a company's capital structure increases financial burden due to interest and principal repayments, raising the risk of financial distress. Trade-off theory emphasises finding an optimal balance between debt benefits and drawbacks. Strategic borrowing can enhance operations, leading to increased profits. When earnings exceed interest expenses, companies can avoid financial distress, suggesting that capital structure positively affects financial condition. Thus, a high debt-to-equity ratio could mitigate financial crisis issues. Signal theory indicates that debt levels serve as indicators of financial health for creditors and investors—well-managed debt creates value, while poorly managed debt generates unsustainable liabilities. Potential backers might think about this data before putting their money down. Capital structure significantly and positively affects the likelihood of financial difficulties, according to studies conducted by (Fitri & Dillak, 2020), (Panjaitan & Dillak, 2021) and (Rahma & Dillak, 2021).

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To address the existing research gap, it is crucial to test intervening variables that clarify the indirect relationship between independent and dependent variables. Tax aggressiveness, which involves exploiting loopholes in tax regulations, may be driven by financial distress, compelling companies to seek ways to alleviate their financial challenges (Muttaqin, 2020). Often employed during financial difficulties, earnings management can exacerbate this distress (Sayidah et al., 2020). Research by Muttaqin (2020) also found that financial distress significantly influences tax aggressiveness, suggesting it may mediate the relationship between earnings management and tax aggressiveness. Furthermore, a high capital structure, particularly through debt, increases the risk of financial distress due to higher interest expenses (Fitri & Dillak, 2020; Panjaitan & Dillak, 2021; Rahma & Dillak, 2021). According to trade-off theory, efficient debt use can enhance profits and mitigate financial distress (Ari & Sudjawoto, 2021). Thus, financial distress mediates the relationship between capital structure and tax aggressiveness.

THEORETICAL REVIEW

Agency Theory. As stated by (Jensen et al., 1976), agency theory explains that a firm is a collection of contracts (nexus of contracts) between the principal, who is the owner of economic resources, and the manager, who is the agent, who oversees the use and control of these resources. According to (Jensen et al., 1976), an agency problem is a business issue that arises when there is a conflict of interest between the owner (the shareholder) and management in general. According to (Drake et al., 2019), this issue may arise because the two sides do not have a unified goal, meaning each party does their best to maximise profits. The company considers a transfer of wealth from the corporation to the government as the result of making tax payments. The corporation is facing a significant financial hardship due to this tax burden. Consequently, businesses tend to reduce the tax burden they are responsible for by employing various tax avoidance or savings strategies (Drake et al., 2019). Agency theory provides a basic framework for understanding why managers may engage in earnings management and tax aggressiveness. Conflicts of interest between shareholders and managers may motivate managers to manipulate earnings while simultaneously attempting to reduce tax burdens, which benefits shareholders by increasing after-tax profits.

Trade Off Theory. (García & Herrero, 2021) Explains the trade-off hypothesis, which states that the corporation will be in debt up to a particular amount. Within the framework of trade-off theory, it is explained that decisions regarding a firm's capital structure are connected to the risk of bankruptcy and the utilisation of debt. As (D'Amato, 2020) stated, this theory aims to balance the advantages and downsides of using debt. If there are higher advantages, then further debt may be added. On the other hand, debt is not permitted if it results in a sacrifice being made to pay for anything. This study applies trade-off theory to understand how firms balance their capital structure decisions with tax considerations, whereby firms optimise their debt levels to take advantage of tax shields while managing the risk of financial distress. Trade-off theory helps explain why firms with different financial characteristics may exhibit varying levels of tax aggressiveness based on their capital structure choices."

Signal Theory. The Theory of Signalling According to (Muslimin & Bahri, 2022), signalling theory refers to the information a firm sends, such as financial reports. It serves

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as a signal for external parties, particularly investors, when making investment decisions. The actual status of the firm may be determined with substantial proof from financial reports. (Dewi & Efendi, 2023) If a firm's reported income continues to improve and creates profit, then this implies that the company has strong performance and is categorised as a positive signal. In other words, this suggests that the company is being successful. If, on the other hand, a firm's financial report reveals a decline in either profit or loss, then the company can be categorised as suffering financial difficulty, and there is a negative signal. In relation to this study, signalling theory helps explain how earnings management and financial reporting decisions send signals to market participants about a firm's financial health. This study investigates how these signals may relate to tax aggressiveness and financial distress among Indonesian public firms.

Hypothesis Development. Agency issues frequently arise between shareholders and managers, leading to earnings management incidents. Agency theory often explains earnings management, which describes a conflict of interest between managers and shareholders (Aldona & Listari, 2020). Managers may engage in earnings management to meet financial targets, which can lead to higher reported earnings and increased tax liabilities. Managers may be encouraged to engage in earnings management in order to boost reported earnings on the occasion that the performance objectives that were established are not attained. This may increase the taxes that need to be paid. Companies can take advantage of the differences between financial reporting standards and fiscal income calculations to manage their taxable income, as stated by (Handayani & Mardiansyah, 2021) in their study on the trade-off between financial reporting and tax decisions. For instance, companies can report high commercial profits while maintaining low fiscal profits. Earnings management has been proven to have a favourable influence on tax aggression, according to studies conducted by (Handayani & Mardiansyah, 2021) and (Pradhana & Nugrahanto, 2021). However, the results differ from those of (Aldona & Listari, 2020), who showed the opposite. Consequently, the theory that was developed is as follows:

H1: Earnings management has a positive effect on tax aggressiveness.

The capital structure trade-off theory states that firms balance debt's tax benefits with bankruptcy costs, as Modigliani and Miller did in 1963. Interest payments on debt are tax-deductible, making high leverage an attractive strategy for firms seeking to minimise taxable income. A company's combination of debt and equity to finance its operations is called its capital structure. According to Revenue Tax Law No. 36 of 2008, using debt in a corporation's capital structure can affect the firm's tax aggressiveness. This is because the interest expenses associated with debt can limit the amount of revenue that is taxable; however, even though the Circular of the Director General of Taxes No. 46 of 1995 places limitations on interest charges, businesses that have substantial capital structures still have the opportunity to enhance their tax aggressiveness. According to (Kenourgios et al., 2020), debt may be beneficial to the success of a corporation, particularly in situations when taxes are involved. One more thing that (Kurniasih et al., 2020) discovered was that the capital structure of a company has a considerable impact on the tax aggressiveness of the company. In their study, (Annisa et al., 2021) discovered that a company's capital structure impacts the equity tax rate. Capital structure has a considerable beneficial influence on tax aggressiveness, according to (Handayani & Mardiansyah, 2021) and

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(Pradhana & Nugrahanto, 2021), who both express agreement with this statement. However, the results differ from those of research by (Saif-Alyousfi et al., 2020), where the results showed the opposite. Following is the formulation of the hypothesis, which is based on the description of the impact of leverage on tax aggressiveness in part:

H2: Capital structure has a positive effect on tax aggressiveness.

Signalling theory states that firms manage earnings to project financial stability to stakeholders. However, excessive earnings manipulation can lead to misleading financial statements, which increases the risk of financial distress when the firm's actual performance is revealed—the Relationship Between Earnings Management and Financial Struggle Management. Earnings management is one of the elements that influences the conditions associated with financial hardship. According to Sayidah et al. (2020), businesses tend to manage earnings when confronted with financial difficulty. Earnings management is a strategy implemented by management to enhance profits within the organisation and provide improved financial reports that conform to the provisions of the firm (Dewi & Efendi, 2023). According to (Sayidah et al., 2020), the high degree of earnings management that the firm engages in impacts the amount of financial distress that is also increasing for the company. These findings are consistent with the findings of a study conducted by (Sayidah et al., 2020), which shows that earnings management has a beneficial impact on the financial distress of the organisation. However, the results differ from those of research by (Dewi & Efendi, 2023). Earnings management does not affect Financial Distress. As a result, the hypothetical situation that follows can be stated:

H3: Earnings management has a positive effect on financial distress.

The trade-off theory states that firms prefer internal financing over debt to minimise the risk of financial distress. High debt levels can increase financial distress due to increased interest costs, while a balanced capital structure can reduce such risks by ensuring financial stability. According to trade-off theory, a company's capital structure should strike a balance between the pros and cons of employing debt. Borrowing money allows businesses to grow by investing in themselves and their operations. Revenue and earnings will rise due to the company's enhanced operational performance. A capital structure with a high DER can help a company avoid financial distress because, as profits rise, they surpass interest expenses. Therefore, capital structure positively affects financial distress. According to signal theory, credit and investors may gauge a company's health by looking at its debt levels. Optimal use of debt can lead to profit, whereas poor debt management typically results in substantial liabilities that must be paid. Before making any judgments, investors might evaluate this information. Capital structure significantly mitigates financial distress, according to studies conducted by (Fitri & Dillak, 2020), (Panjaitan & Dillak, 2021) and (Rahma & Dillak, 2021). However, the results differ from those of the research. (D'Amato, 2020) Capital structure does not affect Financial Distress.

H4: Capital structure hurts financial distress.

According to legitimacy theory, firms experiencing financial distress can adopt aggressive tax strategies to conserve cash and maintain operations. Some people believe

that tax aggressiveness is lawful since it does not violate any tax regulations; instead, it takes advantage of loopholes already included in the tax provisions. In this study, financial difficulty is included as a variable since it is a factor that triggers corporations to employ tax aggression and is beneficial in this study. A corporation is said to be in a state of financial distress when it is experiencing financial difficulties and is working to find a means to move out of this state of affairs. By employing tax aggressiveness, the firm can minimise the tax burden and contribute to reducing the tax burden that the company is subject to. According to (Muttaqin, 2020), financial distress has a considerable and favourable impact on tax aggressiveness.

H5: Financial Distress has a positive effect on Tax Aggressiveness.

Agency theory explains that firms experiencing financial distress often use earnings management and tax aggressiveness as survival strategies. Managers attempt to exert control over financial reports to accomplish specific objectives, such as maximising their interests and preserving the firm's reputation (Imaniah & Kurnia, 2023). Earnings management is called earnings management. The practice of earnings management is common among businesses that are experiencing financial difficulties (Sayidah et al., 2020). This practice might exacerbate the financial hardship that the company is experiencing (Handayani & Mardiansyah, 2021).

Furthermore, research conducted by (Muttaqin, 2020) demonstrates that financial difficulty has a favourable and substantial impact on tax aggressiveness. This tax aggressiveness is legally permissible since it takes advantage of gaps in tax legislation. As a result, financial distress can mediate the link between earnings management and tax aggressiveness. This lends credence to the contention that earnings management indirectly impacts tax aggressiveness through the medium of financial difficulty.

H6: Earnings management affects Tax Aggressiveness with Financial Distress as a mediator.

Trade-off theory highlights the role of debt in tax planning, suggesting that firms use debt to maximise tax shields while avoiding excessive financial distress. A large capital structure can increase the danger of experiencing financial hardship, particularly in debt (Fitri & Dillak, 2020; Panjaitan & Dillak, 2021) and (Rahma & Dillak, 2021). High interest expenditures and debt obligations can lead to excessive debt. According to trade-off theory, businesses must balance the advantages and hazards of debt. Making effective use of debt may lead to increased earnings while lowering the likelihood of experiencing financial difficulty (Ferawati & Bimantoro, 2022). However, when significant amounts of debt are not adequately handled, they can lead to a rise in financial hardship, which encourages businesses to engage in tax aggression to reduce their tax responsibilities (Muttaqin, 2020). As a result, financial difficulty has the potential to act as a mediator in the connection between capital structure and tax aggressiveness.

H7: Capital Structure affects Tax Aggressiveness with Financial Distress as a mediator.

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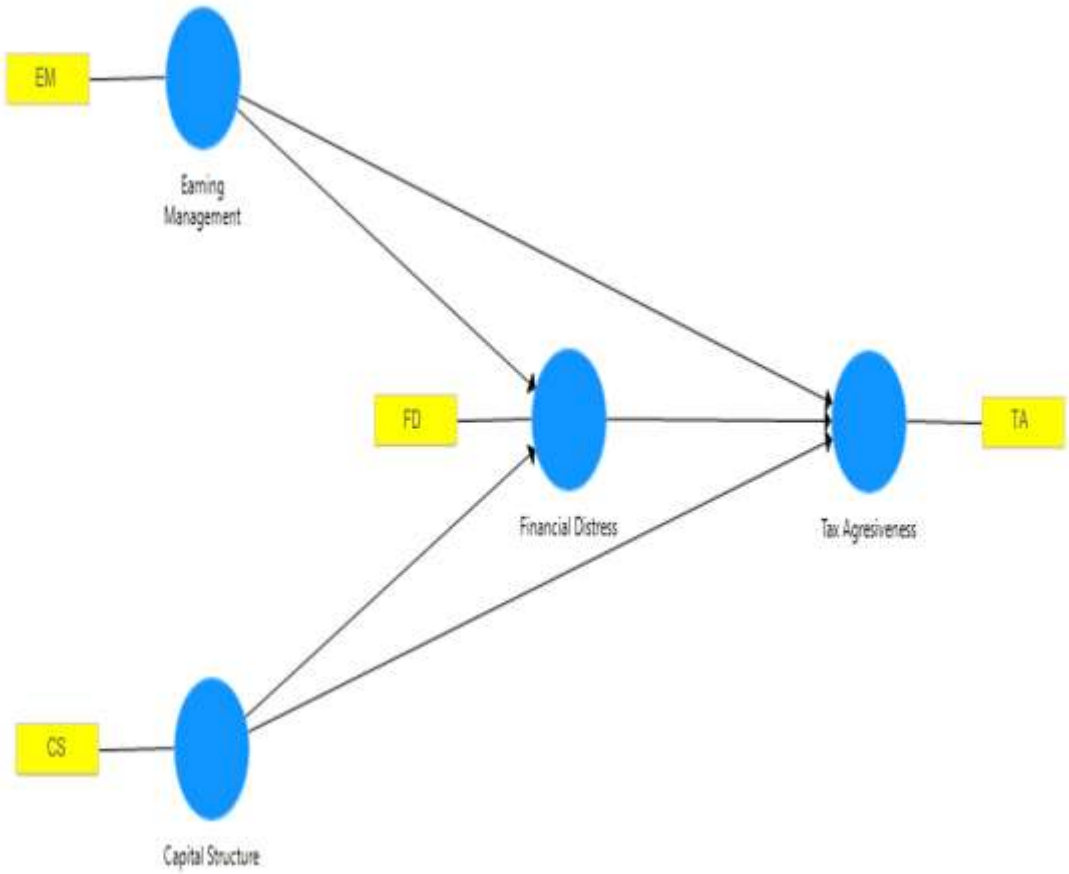

Figure 1. Research model
Source: SEM Processing, 2025

METHODS

Quantitative research is the study discussed here since it uses data in numbers. The objective of this form of study, which is quantitative descriptive, is to ascertain the value of a particular variable (Sugiyono, 2022). The research population comprises all the manufacturing businesses in the consumer products sector listed on the IDX. The sample is decided through the use of a technique known as purposive sampling, which involves picking samples based on specified criteria. As a result, 41 companies are collected as samples. Information for the study was gathered via yearly financial reports, which included income statements, balance sheets, and notes to financial statements, among other types of financial documents (Sugiyono, 2022).

Operational definition of variables. The operational definition of variables refers to how each variable in the study is measured, observed, and quantified within the research framework. Clearly defining these variables ensures they can be empirically tested and consistently interpreted. This study's key variables include capital structure, financial distress, tax aggressiveness, and earnings management. Each variable is operationalised based on relevant financial indicators, theories, and previous empirical research.

Earning management. According to (Rahma & Dillak, 2021), allude to earnings management, that is, efforts made by company managers to organise financial statements

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to meet particular goals—such as lowering taxes or increasing net income—which they hope to achieve. This paper evaluates income management efficiency using the modified Jones Model to predict discretionary accruals. Several steps are going through, which include the proxy for assessing income management (Joe & Ginting, 2022).
Measuring total accruals with the formula:

$$TA_{it} = NI_{it} - CFO_{it} \quad (1)$$

Conduct an estimate using the Modified Jones Model with the formula:

$$\frac{TA_{it}}{A_{it-1}} = \beta 1 \left(\frac{1}{A_{it-1}}\right) + \beta 2 \left(\frac{\Delta Rev_{it}}{A_{it-1}}\right) + \beta 3 \left(\frac{PPE_{it}}{A_{it-1}}\right) + \varepsilon \quad (2)$$

Calculating the value of non-discretionary accruals:

$$\frac{NDA_{it}}{A_{it-1}} = \beta 1 \left(\frac{1}{A_{it-1}}\right) + \beta 2 \left(\frac{\Delta Rev_{it} - \Delta Rev_{it}}{A_{it-1}}\right) + \beta 3 \left(\frac{PPE_{it}}{A_{it-1}}\right) + \varepsilon \quad (3)$$

Determine discretionary accruals using the formula:

$$DA_{it} = TA_{it} - NDA_{it} \quad (4)$$

Capital Structure. According to (Ikpesu & Eboiyehi, 2018), owners should use the tunnelling incentive to manage business resources to further collective or personal goals. The debt-to-equity Ratio (DER) is the substitute used in this study for this variable. This is because their greater DER majority owners have more opportunity to deploy debt and capital management wealth transfer strategies (Naely et al., 2024).

$$DER = \frac{Total\ Liabilities}{Total\ Equity} \quad (5)$$

Tax Aggressiveness. According to (Ivanda et al., 2024), tax avoidance is the legal process by which businesses aim to reduce their required tax payments by using legal gaps in the laws governing taxes. Comparing the income tax burden to the profit before tax helps one show tax evasion for the objective of this study using the Effective Tax Rate (ETR). A lower ETR score implies that the business has avoided more tax payments.

$$ETR = \frac{Income\ Tax\ Expense}{Profit\ Before\ Tax} \quad (6)$$

Financial distress. According to (Ari & Sudjawoto, 2021), "financial distress" summarises the state of affairs in the business sector where a firm is very vulnerable to insolvency and shows indications of financial problems. Considering liquidity, profitability, leverage, solvency, and productivity, the Altman Z-Score is a bankruptcy prediction tool. Using the Altman Z-Score, this research estimates the financial difficulties a company is experiencing. The re-estimated Z-score produced from the Z-score used in 1968 will help us gauge the degree of financial difficulties in this study. This looks to be the Z'-score formula, which was obtained from Altman's 1968 research in (Sari & Hermi, 2023):

$$Altman\ Z'score = 0.717.LR + 0.847.AP + 3.107.OP + 0.420.ML + 0.998.AE \quad (7)$$

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Liquidity Ratio is calculated by dividing Working Capital by Total Assets, which shows the company's ability to meet its short-term obligations. Accumulative profitability is measured by comparing retained earnings to total assets, reflecting the accumulation of retained earnings and the total assets owned by the company. Operational profitability is obtained by dividing EBIT by Total Assets, indicating operational efficiency in generating earnings before interest and taxes. Market Leverage is calculated as Market Value of Equity divided by Total Liabilities, which describes how much market equity is compared to the company's total liabilities. Meanwhile, Asset Efficiency is measured by the ratio of Sales to Total Assets, which shows the company's effectiveness in using its assets to generate revenue.

Analysis Techniques. Structural Equation Modelling (SEM) analyses complicated latent-manifest correlations concurrently. SEM was chosen for this study for several important reasons. First, our research conceptual framework involves multiple latent variables that cannot be directly measured and require manifest indicators, which SEM handles effectively. Second, our research examines complex relationships with potential mediating and moderating effects between variables that would require multiple separate regression analyses but can be tested simultaneously in SEM. Third, SEM allows us to concurrently test measurement models (relationships between latent variables and their indicators) and structural models (relationships between latent constructs), providing more robust results than separate regression analyses. Finally, SEM offers superior capabilities for assessing measurement errors and examining model fit indices, providing a more comprehensive analysis of the theoretical framework. This approach allows us to understand better the complex interrelationships among financial variables in the IDX data that would be difficult to capture using standard regression techniques.

The SEM process comprises creating a conceptual model, measurement model, structural model, data collection and analysis, validity and reliability testing, hypotheses testing, and model evaluation (Ghozali, 2021). Because it can estimate variance-based models and handle small to medium samples, SmartPLS software was used to analyse data. The loading factor value, Average Variance Extracted (AVE), Composite Reliability, and Cronbach's Alpha assessed validity and reliability. The hypothesis was tested using T-statistics and P-values, with acceptance based on T-statistics less than 1.967 and P-values more than 0.050. Goodness of Fit (GoF) was used to evaluate the model's fit to the study data (Ghozali, 2021).

RESULTS

Table 1 shows the earnings management variable, which shows a range of values between -0.460 and 2.830, with an average of 0.230 and a standard deviation of 0.493. The distribution of this data tends to be skewed to the right, with a skewness of 2.666, indicating that most companies have low earnings management. For capital structure, the range of values recorded is between 0.100 and 7.640, with an average of 1.430 and a standard deviation of 1.240. A skewness of 1.866 indicates a tendency for the distribution to be skewed to the right, reflecting that most companies have a low capital structure. The tax aggressiveness variable has an extensive range of values, between -4.250 and 19.680, with an average of 1.060 and a standard deviation of 3.149, and a skewness of 4.559, indicating a distribution that is skewed to the right, with most companies having low tax aggressiveness values.

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The recorded value for the financial distress variable ranges from 0.410 to 9.64, with an average of 2.450 and a standard deviation of 1.289. Skewness of 1.417 indicates a right-skewed distribution, with most companies experiencing relatively low financial distress. Overall, there is significant variation in the level of earnings management, capital structure, tax aggressiveness, and financial distress between companies. Several companies show extreme conditions on each variable, which may reflect differences in corporate policies and strategies related to tax management, capital structure, and financial resilience.

Table 1. Descriptive Statistical Test

Variables	Min	Max	Mean	Standard Deviation	Excess Kurtosis	Skewness
Earning Management	-0.460	2.830	0.230	0.493	7,706	2,666
Capital Structure	0.100	7.640	1.430	1.240	4.465	1,866
Tax Aggressiveness	-4.250	19.680	1.060	3.149	26,704	4,559
Financial Distress	0.410	9.640	2.450	1.289	4.280	1,417
N	164					

Source: SEM Data Processing, 2025

The Outer Model Test is a crucial step in evaluating the reliability and validity of constructs in structural equation modelling (SEM) using SmartPLS. This assessment ensures that the measurement model accurately represents the underlying theoretical framework. Three primary criteria evaluate the outer model: convergent validity, composite reliability, and discriminant validity. Convergent validity is assessed using Average Variance Extracted (AVE), while composite reliability and Cronbach's alpha measure the internal consistency of the constructs. Additionally, rho_A is an alternative reliability measure, reinforcing the indicators' consistency. According to (Ghozali, 2021), these indicators collectively establish the robustness of the measurement model, ensuring that the constructs used in the study are statistically sound and theoretically meaningful.

Table 2 shows the results of the PLS algorithm for the outer model, demonstrating that all measurement criteria meet the required thresholds. The composite reliability values exceed 0.900, indicating a high level of reliability for each construct. Similarly, the Cronbach's alpha values are also above 0.900, confirming strong internal consistency, meaning that all indicators within each construct are highly correlated. The AVE values surpass 0.500, which indicates that the constructs explain a sufficient proportion of variance in their indicators, satisfying the conditions for convergent validity. With these results, the constructs in the model are well-defined and suitable for further analysis. Since convergent validity has been confirmed, the next step involves testing discriminant validity to ensure that each construct is distinct from others, strengthening the overall credibility of the research model.

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Table 2. Construct Reliability and Validity

	Cronbach's Alpha	rho_A	Composite Reliability	Average Variance Extracted (AVE)
Capital Structure	1.000	1.000	1.000	1.000
Earning Management	1.000	1.000	1.000	1.000
Financial Distress	1.000	1.000	1.000	1.000
Tax Aggressiveness	1.000	1.000	1.000	1.000

Source: SEM Data Processing, 2025

Discriminant validity is an essential criterion in assessing the quality of a measurement model, ensuring that each construct is distinct and not excessively correlated with others. One of the most widely used methods for discriminant validity is the Fornell-Larcker Criterion, as shown in **Table 3**. This approach compares the Average Variance Extracted (AVE) square root for each construct with its correlations with other constructs. A model is considered to have good discriminant validity when the square root of AVE for each construct is greater than its highest correlation with any other construct. **Table 3 shows** that the diagonal values represent the square root of AVE, while the off-diagonal values indicate the correlation between constructs. The results demonstrate that each construct meets the Fornell-Larcker criterion, confirming that the variables in the study maintain their conceptual distinction.

The findings in **Table 3** show that Capital Structure, Earnings Management, Financial Distress, and Tax Aggressiveness exhibit appropriate levels of discriminant validity. For example, the correlation between Financial Distress and Capital Structure is -0.528, indicating a moderate negative relationship, yet it does not exceed the diagonal value of 1.000. Similarly, the correlation between Earnings Management and Capital Structure is -0.244, remaining within acceptable limits. This suggests that while there are relationships between constructs, they are not so high as to indicate redundancy or lack of distinctiveness. By meeting the Fornell-Larcker criterion, the model demonstrates that the constructs used in the study are adequately defined and separate, enhancing the validity and reliability of subsequent hypothesis testing. This strong discriminant validity ensures that the study results can be interpreted confidently, reinforcing the theoretical framework's robustness and implications for financial decision-making.

Table 3. Fornell-Larcker Criterion

	Capital Structure	Earning Management	Financial Distress	Tax Aggressiveness
Capital Structure	1.000			
Earning Management	-0.244	1.000		
Financial Distress	-0.528	0.185	1.000	
Tax Aggressiveness	0.105	0.044	0.277	1.000

Source: SEM Data Processing, 2025

I understand that the structural or inner model is tested to find the R-Square value for each endogenous latent variable. This number represents the structural model's ability to anticipate outcomes. If I am correct, the R-Square value may be used to determine the impact of specific exogenous latent factors on the substantive effect of endogenous

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variables (Ghozali, 2021). It is important to note that an estimate is required to either determine the degree of the effect on the chosen independent latent variable or to provide a complete explanation for the latent variable that is dependent on the independent latent variable. According to (Ghozali, 2021), the Smart PLS approach may be categorised into three unique criteria: A value of R-Square greater than 0.670 is considered very important. R-Square values greater than 0.330 are considered moderate. An R-Square score of less than 0.190 is deemed unsatisfactory and is presented in **Table 4.**

Table 4. R Square

	R Square	R Square Adjusted
Financial Distress	0.282	0.273
Tax Aggressiveness	0.166	0.151

Source: SEM Data Processing, 2025

R-Square criteria according to (Ghozali, 2021), the R-Square value of Financial Distress of 0.282 falls into the range of 2 (moderate) because it is between 0.190 and 0.330. This shows that the independent variables in the model can explain 28.200 per cent of the variability of Financial Distress, while other factors outside the model influence the rest. Meanwhile, the R-Square for Tax Aggressiveness of 0.166 falls into the range of 3 (unsatisfactory) because it is below 0.190, which means that the independent variables can only explain 16.600 per cent of the variability of Tax Aggressiveness. Hence, the model has weak predictive power for this variable. The Adjusted R-Square value, which is slightly lower than the R-Square, indicates an adjustment to the number of variables in the model. The model can be improved by including more relevant variables to increase its predictive power.

After confirming the validity and reliability of the measurement model through the Outer Model Test, the next step is to evaluate the structural model using the bootstrapping technique in SmartPLS. Bootstrapping is a resampling method that assesses the stability and significance of path coefficients in the model by generating multiple subsamples from the original dataset. This technique helps determine whether the relationships between constructs are statistically significant, providing confidence in the hypothesised relationships. The results of the bootstrapping model, as illustrated in **Figure 2**, include key statistical outputs such as T-statistics and P-values, which indicate whether the relationships between variables are meaningful in the given research context.

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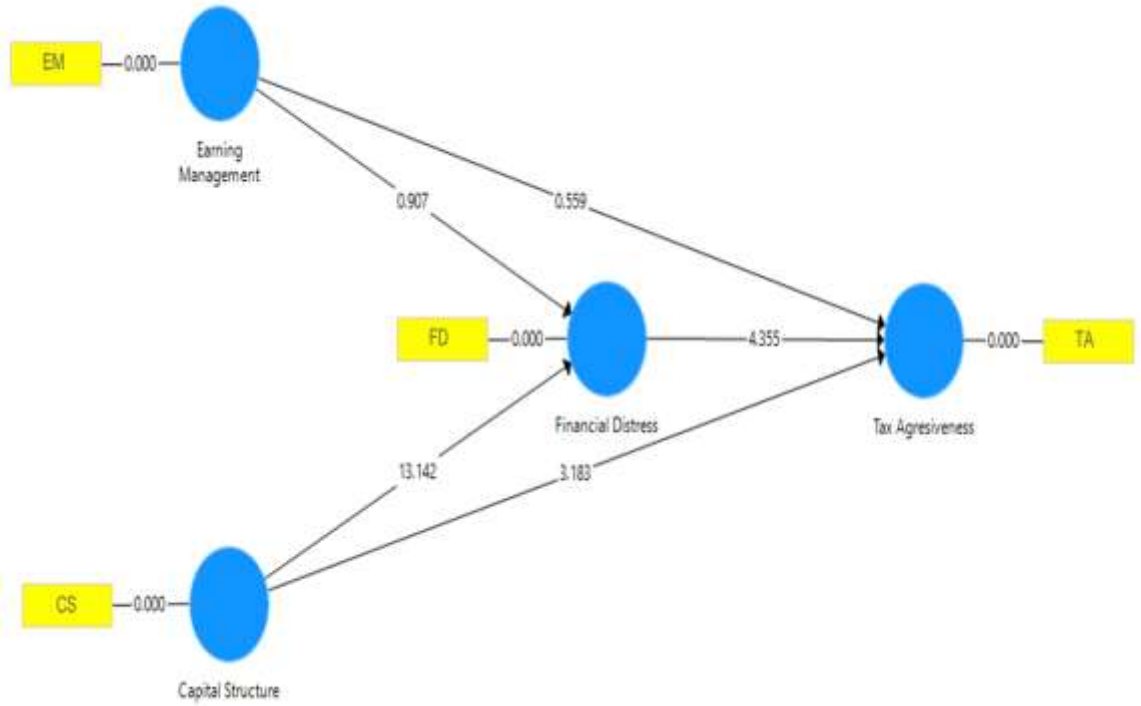

Figure 2. Bootstrapping model
Source: SEM Processing, 2025

The bootstrapping model in **Figure 2** visually represents the estimated path coefficients and their significance levels. A commonly used threshold for statistical significance is a T-statistic greater than 1.967 (at a 5 per cent significance level), indicating that a given relationship is statistically significant. Additionally, P-values less than 0.050 further support the significance of the path coefficients. This step is crucial in structural equation modelling, as it helps validate the research hypotheses and provides insights into the strength and direction of the relationships among constructs. By analysing the bootstrapping results, researchers can assess the overall model fit and determine whether the theoretical framework effectively explains the observed data. If the structural relationships are significant, it further strengthens the study's conclusions and implications for financial decision-making and corporate strategy. Next, a structural test was carried out, which produced the following bootstrapping model:

Table 5. Hypothesis Results

	Original Sample (O)	Sample Mean (M)	T Statistics (|O/STDEV|)	P Values	Sig
Capital Structure -> Financial Distress	-0.513	-0.517	13.142	0.000	yes
Capital Structure -> Tax Aggressiveness	0.358	0.361	3.183	0.002	yes
Earnings Management -> Financial Distress	0.060	0.061	0.907	0.365	No
Earning management -> Tax Aggressiveness	0.046	0.043	0.559	0.577	No
Financial distress -> Tax Aggressiveness	0.457	0.457	4.355	0.000	Yes

Source: SEM Processing, 2025

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Table 5 shows the analysis results. Capital Structure significantly affects both Financial Distress (β is -0.513, p is 0.000) and Tax Aggressiveness (β is 0.358, p is 0.002), indicating that a higher capital structure tends to reduce financial distress while increasing tax aggressiveness. In contrast, Earnings Management does not significantly influence either Financial Distress (p is 0.365) or Tax Aggressiveness (p is 0.577), suggesting that earnings management practices do not directly affect these variables. Meanwhile, Financial Distress positively and significantly affects Tax Aggressiveness (β is 0.457, p is 0.000), implying that companies facing financial pressure are more likely to engage in aggressive tax strategies.

Table 6. Results of the Mediation Hypothesis

	Original Sample (O)	Sample Mean (M)	T Statistics (|O/STDEV|)	P Values	Sig
Capital Structure -> Financial Distress -> Tax Aggressiveness	-0.235	-0.237	3,711	0.000	Yes
Earning Management -> Financial Distress -> Tax Aggressiveness	0.027	0.028	0.855	0.393	No

Source: SEM Processing, 2025

Table 6 shows the mediation analysis. Capital Structure has a significant indirect effect on Tax Aggressiveness through Financial Distress (β is -0.235, p is 0.000), indicating that the firm's financial condition mediates part of the impact of capital structure on tax aggressiveness. In contrast, Earnings Management does not significantly affect Tax Aggressiveness via Financial Distress (p is 0.393), suggesting that financial distress is not a meaningful mediating variable in the relationship between earnings management and tax aggressiveness.

DISSCUCION

The hypothesis testing findings are as follows: Rejecting Earning Management on Tax Aggressiveness. This hypothesis is rejected since the p-value is larger than the earnings management does not affect tax aggressiveness. These findings support the Trade-Off argument that profit management does not affect tax aggression (Handayani & Mardiansyah, 2021). According to this theory, companies will choose the optimal tax policy by considering the tax costs and benefits obtained, including financial costs and other costs arising from tax aggressiveness practices. In this case, earnings management has not been proven to affect more aggressive tax policies, possibly because companies consider other factors such as financial stability and corporate social responsibility rather than carrying out tax aggression for short-term profits. In addition, these results can also be explained by the Signalling theory (Octaviani & Sofie, 2019). Companies may choose not to be too aggressive in earnings management or tax policies because they want to give a more positive signal to investors and regulators that they have transparent and low-risk policies. Although there are potential benefits from more aggressive tax management, companies may avoid such behaviour to maintain their reputation and long-term relationships with stakeholders, who value good tax compliance more (Meryana & Erna Setiany, 2021; Nugroho et al., 2020). In 2018, research (Leonardo et al., 2023) found that

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earnings management had no significant effect on tax aggressiveness, while other studies by (Annisa et al., 2021) also agree that earnings management does not affect tax aggressiveness.

Capital Structure on Tax Aggressiveness is approved. This hypothesis shows that tax aggressiveness increases with capital structure, with a p-value. The Trade-Off hypothesis explains these findings that a stronger capital structure increases tax aggression. This hypothesis states that corporations with a large capital structure use debt tax shields to reduce taxes, leading to more aggressive tax strategies (Jacoby et al., 2019). By using debt as a source of financing, companies can obtain greater tax benefits, but this must be paid for by increasing financial risk and costs (Saif-Alyousfi et al., 2020). Companies with a high capital structure and debt obligations may be encouraged to engage in tax aggressiveness to reduce tax burdens and maximise company value.

On the other hand, these results also support the Signalling theory (Octaviani & Sofie, 2019), where companies with a higher capital structure can signal to the market and investors that they can manage risk and increase company value by being aggressive in tax policy. Tax aggressiveness practices related to using debt in the capital structure indicate that companies dare to make riskier decisions to achieve greater profits. This is an effort to improve the company's reputation in the eyes of investors by signalling that the company has capable management in managing financial and tax policies. (Kurniasih et al., 2020) also found that capital structure significantly affects tax aggressiveness. (Annisa et al., 2021) found that capital structure affects tax aggressiveness. (Octaviani & Sofie, 2019) and (Pradhana & Nugrahanto, 2021) agree that capital structure significantly affects tax aggressiveness.

Rejecting Earning Management on Financial Distress, the p-value is larger than. Showing that earnings management does not affect financial hardship in the sample. The Trade-Off theory can explain results indicating no substantial association between earnings management and financial hardship (Sanjayyana & Urumsah, 2021). Companies involved in earnings management do not always experience financial difficulties, because they may carry out the practice to maintain financial stability and avoid financial distress. Within the framework of the Trade-Off theory (Dewi & Efendi, 2023), companies try to balance earnings management and financial risk, where their main goal is to minimise losses and avoid financial crises. Therefore, although earnings management is carried out, it is not enough to significantly affect financial distress. In addition, these results are also related to the signalling theory (Handayani & Mardiansyah, 2021). Earnings management practices aim to signal to the market and investors that the company has stable performance, even though the company may face financial problems. In this case, the company may choose not to display symptoms of financial distress through manipulated financial reports, which shows an effort to maintain the company's image in the eyes of stakeholders despite financial pressure. In line with (Dewi & Efendi, 2023), Earnings management does not affect Financial Distress.

Capital Structure on Financial Distress is approved. A greater capital structure increases the company's financial difficulty. This supports the Trade-Off argument that greater capital structures cause financial turmoil (D'Amato, 2020). According to this theory, the higher the use of debt in the capital structure, the greater the company's financial risk. Excessive use of debt increases interest expenses and payment obligations, which can cause liquidity pressures and potential bankruptcy, leading to financial distress. In this context, companies with a high capital structure are more vulnerable to financial

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distress, especially when they face declining revenues or sharp market fluctuations. In signalling theory (Sutomo et al., 2020), companies with a higher capital structure can signal to the market that they may face higher financial risks. Although using debt can provide tax benefits, companies that rely on debt to finance their operations may be viewed by investors and other stakeholders as riskier entities, potentially leading to financial distress if not managed properly. Therefore, a higher capital structure can indicate the potential for financial distress in the future. The results of research by (Fitri & Dillak, 2020), (Panjaitan & Dillak, 2021), and (Rahma & Dillak, 2021) show that capital structure has a significant positive effect on financial distress.

Financial Distress on Tax Aggressiveness: Financial difficulties positively and significantly affect the company's tax aggressiveness. According to the Trade-Off hypothesis, financial difficulty increases tax aggressiveness positively and significantly (Ari & Sudjawoto, 2021). When companies face financial distress, they may reduce their tax burden in order to increase liquidity and financial stability. Tax aggressiveness practices, such as exploiting loopholes in tax regulations, can be one strategy to obtain additional funds and reduce financial pressure. In this context, companies experiencing financial difficulties may be more motivated to find ways to minimise the taxes paid, even though this carries further risks (Nugroho et al., 2020).

Signalling Theory is also relevant in this context, because companies experiencing financial distress may choose to carry out tax aggressiveness as a signal to the market and investors that they still have a strategy to survive and improve financial performance. Although more aggressive tax practices can increase legal and reputational risks, financially distressed companies may feel that such steps are necessary to improve their financial situation and signal to stakeholders that they have control over their problems, in line with (Muttaqin, 2020). Financial Distress has a positive and significant effect on Tax Aggressiveness.

Mediation of Earning Management by Financial Distress on Tax Aggressiveness. This hypothesis is rejected because financial strain does not mediate earnings management and tax aggression. The Trade-Off hypothesis explains these findings that financial difficulty does not mediate earnings management and tax aggressiveness. In 2018, research conducted by Dewey was packaged in (Leonardo et al., 2023) study, which found that earnings management had no significant effect on tax aggressiveness, while other studies by (Annisa et al., 2021) also agree that earnings management does not affect tax aggressiveness. Although companies manage earnings to regulate market perceptions and avoid financial distress, this is not enough to affect their tax policy (Ari & Sudjawoto, 2021). In this case, companies may focus more on managing capital structure and debt to reduce the risk of financial distress rather than manipulating earnings for tax purposes. Thus, financial distress does not strongly mediate this relationship (Nugroho et al., 2020). From the Signalling theory perspective (Annisa et al., 2021), companies may choose not to rely on financial distress as a mediator in the relationship between earnings management and tax aggressiveness. On the other hand, they may prefer to show good earnings performance despite facing financial difficulties, to maintain the company's image and avoid negative impressions in the eyes of the market. In this case, companies prefer to give a positive signal through earnings reports rather than link financial distress to more aggressive tax policies.

Financial Distress Mediates Capital Structure on Tax Aggressiveness. The p-value demonstrates that financial distress mediates the negative link between capital structure

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and tax aggressiveness. Financial distress mediates the capital structure-tax aggressiveness link, amplifying its adverse effect. According to the Trade-Off hypothesis, high-capital-structured enterprises confront more risks, which can cause financial distress (Muttaqin, 2020). Companies may be driven to increase tax aggressiveness to overcome financial difficulties, such as utilising tax loopholes to reduce tax burdens. However, excessive use of debt also carries the risk of financial distress, a condition where a company faces financial difficulties that can trigger the company to take extreme measures, including tax avoidance to reduce the financial burden (Junaidi et al., 2023). Previous studies have shown that capital structure affects tax aggressiveness, although the results vary. Several studies have shown that a higher capital structure is associated with higher tax aggressiveness (Kurniasih et al., 2020). Financial distress here acts as a factor that worsens the impact of high capital structure on more aggressive tax practices. In signalling theory, companies in financial distress and with high capital structures can signal that they are struggling to survive and need extreme methods such as tax aggressiveness to improve their financial condition (Muttaqin, 2020). This signal can influence market and investor perceptions of the risks involved, with companies trying to convey that they are still in control despite the difficult situation.

CONCLUSION

Both tax aggressiveness and financial distress were shown to be significantly influenced by capital structure, with financial hardship also affecting tax aggressiveness, according to the findings of this study. It has not been demonstrated that earnings management affects financial distress or tax aggressiveness directly or indirectly through the entity that mediates financial difficulty. Financial difficulty is a substantial mediator in the association between capital structure and tax aggressiveness. This suggests that businesses with high capital structures and experiencing financial crises are likelier to engage in tax aggressiveness. Both the Trade-Off and Signalling theories are supported by these findings when applied to the context of tax policy and the capital structure of corporations.

Companies should consider balancing capital structure and financial risk to avoid financial distress that can trigger more aggressive tax practices. Companies with high capital structures should carefully manage debt to reduce potential financial distress. In addition, although earnings management does not directly affect tax aggressiveness, companies should still prioritise transparency and appropriate tax management to maintain a good reputation for investors and regulators. For financial practitioners, these findings provide insight into the importance of careful capital structure management to avoid financial distress and improve more efficient tax management. From a regulatory perspective, these results remind us that companies facing financial distress tend to use more aggressive tax policies, which may add challenges for tax authorities in ensuring compliance. This study also reinforces the importance of companies in maintaining a positive signal to investors despite facing financial distress.

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