DETERMINANTS OF CORPORATE TAX AVOIDANCE AMONG MALAYSIAN PUBLIC LISTED COMPANIES

BY

IBRAHIM ARAMIDE SALIHU

A dissertation submitted in fulfilment of the requirement for the degree of Doctor of Philosophy in Accounting

Kulliyyah of Economics and Management Sciences
International Islamic University Malaysia

MARCH 2015

ABSTRACT

Although the issue of tax avoidance practices is as old as tax itself, the manners and ways they are being perpetrated in recent times have transmuted so sophisticated among the corporate taxpayers. A report by the Global Financial Integrity in 2011 ascribes sixty to sixty-five percent of the global illicit flow of fund among developing economies to commercial tax non-compliance. Unfortunately the report ranks Malaysia fifth among the developing economies with the most illicit outflow of fund. This study, thus, investigates the determinants of corporate tax avoidance among Malaysian large companies. Specifically, the study investigates relationships of corporate tax avoidance with three forms of corporate ownership (family; foreign and government ownerships) and whether internal and external corporate governance mechanisms could mitigate such relationships. The study is among the very few studies on corporate tax avoidance both in Malaysia and internationally. The empirical data were obtained from the annual reports of the top 200 companies based on market capitalization of Bursa Malaysia over a period of five financial years. The collected data of 600 firm-year observations were analysed using the system Generalised Method of Moment (GMM) estimator. The findings showed that family oriented; foreign related firms and government-linked companies (GLCs) are tax avoidant in the main and interaction effect model estimations. However, the directors on the boards have little impact in mitigating firms' tax avoidance practices given their financial interests in the companies. However, despite this, board independence is found to have interactive negative effect with the forms of ownership in relations to corporate tax avoidance. The quality of external audit was equally documented to reduce the chances of tax avoidance practices. These findings were later subjected to qualitative investigation through face-to-face interview sessions with tax auditors in Inland Revenue Board Malaysia. The findings from the analysis of their responses provided further explanation to the quantitative results. It was concluded that tax avoidance practices are more of cost-benefit consideration rather than the issue of organizational legitimacy. The findings of this study are of relevant importance in the selection of cases for tax audit and investigation by the IRBM.

خلاصة البحث

تعد قضية منع الضريبة قديمة قدم تاريخ أخذ الضريبة نفسها، لكنها أخذت شكلاً رهيباً في هذه الآونة الراهنة بين أصحاب الشركات، وأثبت تقرير الصلاحية الدولية للشؤون المالية للعام 2011م بأن نسبة 60% - 65%، للتمويل العالمي الغير قانوني، بين الدول المتنامية اقتصادياً، يعزى إلى عدم الالتزام بدفع الضريبة المفروضة، وحسب هذا التقرير تعد ماليزيا الخامسة بين تلك الدول التي فشت فيها ظاهرة الفيض النقدي اللامشروع. يهدف هذا البحث إلى تقصي دوافع هذه الظاهرة بين أكبر عدد من شركات ماليزيا، ويعتمد المنهج الوصفي التحليلي للحصول على النتائج النهائية، ويسعى إلى معرفة مقدار هذه الظاهرة بين كل ثلاثة من مجموعة الشركات الماليزية، وسيكشف أيضاً عن مدى التأثيرات الداخلية والخارجية لترويج ظاهرة منع الضرائب بينها. ويتركز البحث على عددٍ معيّنٍ لمانعي الضرائب في ماليزيا وخارجها خلال ثلاث سنوات مضت، جرياً على مؤشرات مكتب الحسابات الماليزي **FTSE**، وتخضع نتائج البحث العلمية التحليلية للبحث المستمر بأسلوب **GMM**، عن طريق المقابلات الشخصية واللقاءات مع عشرة من أعضاء هيئة الموارد الداخلية الماليزية**IRMB**، وتعكس نتيجة البحث صورة تفشي منع الضرائب بين الشركات الأسرية، والفئة المرتبطة بالدعم الخارجي، لكن التي تحت الرعاية الحكومية **GLCs** ملتزمة بدفع الضريبة. ولاحظ الباحث الدور الذي يلعبه مديرو الشركات في ترويج منع الضريبة، كما يعد وجود المحاسبين الأكفاء في كشف ذلك مناسباً جداً. واستنتج الباحث أخيراً بأن مانعي الضريبة يهتمون بالكسب فقط دون اعتبار لقانونية العمل. وتفيد هذه الدراسة بعض القضايا العينية التي تتعلق بفحص دقيق للضريبة ومتابعتها من قِبَل**IRBM**.

APPROVAL PAGE

The dissertation of Ibrahim Aramide Salihu has been approved by the following:

Siti Normala Shiekh Obid
Supervisor

Hairul Azlan Annuar
Supervisor

Shamsul Nahar Abdullah
Internal Examiner

Norman Mohd Salleh
External Examiner

El-Fatih Abdullah Abdelsalam
Chairman

DECLARATION

I hereby declare that this dissertation is the result of my own investigations, except where otherwise stated. I also declare that it has not been previously or concurrently submitted as a whole for any other degrees at IIUM or other institutions.

Ibrahim Aramide Salihu

Signature ……………………………… Date ……………………

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ACKNOWLEDGEMENTS

All praises and adorations are due to Almighty Allah (SAW). The Uncreated Creator of the Universe, Unsustained Sustainer of Mankind and Unchanged Changer of the affairs of Man. May His peace and ceaseless blessings be showered continuously on the noble soul of the seal of the prophet, his household, his companions and all the Muslim Ummah until the day of recompense.

First, I would like to express my gratitude to my supervisors, Associate Professor Dr Siti Normala binti Sheikh Obid and Associate Professor Dr. Hairul Azlan Annuar, for their attention, time and efforts in supporting and guiding me through the enormous journey of writing this thesis. The thesis has benefited greatly from their objective contributions, suggestions and constructive criticisms. All of these made the thesis to see the light of the day.

My appreciations further go to all the staff (both academics and administrative) of the Department of Accounting and the Kulliyyah of Economics and Management Sciences of International Islamic University Malaysia. Special thanks go to the administrative staff in the Postgraduate Unit of KENMS. Their attentions, assistances and supports during the PhD programme cannot be overemphasized.

My appreciations also go to the management and staff of the Inland Revenue Board of Malaysia (IRBM) for granting me the permission to conduct personal interviews with the tax auditors of the Board. Special thanks further go the interview respondents for sparing their time for the conducts of the interviews.

My gratitude also goes to all postgraduate students of International Islamic University Malaysia during my period of study, especially the Nigerian students. Worthy of mentioning are colleagues and senior colleagues, whose names could not listed due to lack of space, in the Kulliyyah of Economics and Management Sciences. I say jazakum Allah khayran to all of you.

Finally, I would like to express my appreciations to my beloved parents, whose love; care; prayers and guidance have taken me to this height of my career. May you live long to witness more advancements in my life, insha Allah. My heartfelt gratitude goes to my wife for her endurance, perseverance and sacrifices during the period of writing this thesis. Dear, you are special gift to me. My loving children ‘Aisha (my angel); ‘Abdullah (my heart); ‘Abdurrahman (my pleasure); ‘Abdurraheem (my love); and ‘Abdurrazaaq (my soul), may Allah bless you all with abundant and ceaseless blessings, amin.

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LIST OF ABBREVIATIONS

ANOVA	Analysis of Variance
BM	Bursa Malaysia
BTG/BTD	Book-Tax Gap/Difference
CTA	Corporate Tax Avoidance
ETR	Effective Tax Rate
FDIs	Foreign Direct Investments
GMM	Generalized Method of Moment
GST	Goods & Services Tax
IRBM	Inland Revenue Board Malaysia
ITA	Income Tax Act
ITO	Income Tax Ordinance
LOBATA	Laubuan Business Activity Tax Act
MCCG	Malaysian Code of Corporate Governance
MIDA	Malaysian Investments Development Authority
NOL	Net Operating Loss
OAS	Official Assessment System
OECD	Organization for Economic Co-operations and Development
OFCs	Offshore Finance Centres
OLS	Ordinary Least Square
RM	Ringgits Malaysia
RMC	Royal Malaysian Custom
RPC	Real Property companies
S&P	Standard & Poor
SAS	Self-Assessment System
SPSS	Statistical Package for Social Sciences
UTB	Unrecognized Tax Benefits
VIF	Variance Inflation Factor

CHAPTER ONE

INTRODUCTION

1.1 BACKGROUND TO THE STUDY

The roles of taxes in the development of any economy cannot be overemphasized. It helps in funding the governmental activities, assists in resources' redistribution, streamlines consumptions (of certain goods and services), mitigates inflation and creates opportunities for employment. According to Musgrave and Musgrave (1989) tax systems are used by governments all over the world to achieve a variety of objectives. These objectives, in a broad term, may include maximization of governmental revenue yields, attainment of equity (both vertical and horizontal) and the promotion of economic development (Akanle, 1991).

However, in spite of these tremendous benefits of taxes, the study of tax non-compliance has become more increasingly important in the recent past (Verboon & Dijke, 2007). This is because of the prevalence of the phenomenon in all societies using taxes to finance governmental expenditures (Uadiale, Fagbemi & Ogunleye, 2010). Although tax imposition and legislation have never been much of problems (Bradley, 1994); taxpayers' non-compliance has been a serious problem in all societies where taxes exist, and it is "as old as taxes themselves" (Andreoni, Erard & Feinstein, 1998: 818). Because tax evasion and avoidance are social phenomena, there have been increasing amounts of attention within the literature as researchers seek improved approaches to modelling non-compliance (Korobow, Johnson & Axtell, 2007). A similar approach of modelling non-compliance is adopted in the present study to investigate the potential determinants of corporate tax avoidance[1]. This approach is deemed crucial as findings of tax compliance studies provide little understanding about the factors responsible for non-compliance (Slemrod, 2004).

Corporate tax avoidance, in a broad sense, is the reduction in the explicit[2] corporate tax liabilities (Dyreng, Hanlon & Maydew, 2008; Hanlon & Heitzman, 2010). With this all-inclusive definition, no distinction is made among intended tax benefits from lobbying, tax-deductible real activities and avoidance activities aimed at reducing tax liability. Furthermore, the nuance between illicit tax evasion and lawful tax avoidance is ignored for probably three reasons. Firstly, the technicality of transactions around which avoidance or evasion behaviour is perceived is always legal. Secondly, the fact about tax avoidance transactions takes precedence over its legal determination, as such; Weisbach (2003) concluded that the classification of an avoidance as a legal tax planning and an evasion as an illegal tax planning by lawyers and economists is a quick action as the legality of any tax structure cannot be easily determined. Lastly, both tax evasion and avoidance result into loss of revenue to the government.

Additionally, the public perceptions about corporate tax non-compliance regard not the popular distinction between tax avoidance (as legal) and tax evasion (as unlawful). For instance, a poll among Britons by Financial Times on their perceptions of corporate tax non-compliance shows that sixty percent of the respondents believe that companies employing controversial but legal ways of reducing their tax liabilities are not patriotic[3]. In furtherance, Hardymant, Truesdule and Tuffrey (2011:2)

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[1] The term tax avoidance is used throughout the present study, though it could be interchangeably used with tax management, tax planning and tax aggressiveness.
[2] Explicit taxes are direct taxes levied by government. These are taxes the companies could manipulate through accounting entries.
[3] *Financial Times*, Harris Poll, 11 February, 2011.

described the situation more explicitly while saying “the traditional defence of compliance is dead; the distinction between evasion (illegal) and avoidance (lawful) has dissolved in the eyes of governments, NGOs and citizens”. Thus, the dichotomy between tax avoidance and tax evasion is given less emphasis in the present study as reflected in the above definition.

In any case, tax avoidance has been identified as one of the biggest issues of our generation especially at corporate level (Hundal, 2011). “It is widely recognized that the costs of non-compliance with the federal income tax laws in the US are sizable” (Henderson & Kaplan, 2005:39), as the estimated tax gap exceeds $300 billion per year (before enforcements and late payments) based on 2001 estimation (IRS, 2007). This is greater than 10 percent of the total annual revenue usually collected (Snow & Warren, 2005). Worse still, the Inland Revenue Service (IRS) estimated $345 billion (amounting to 16.3 percent of collectable taxes) as unpaid tax liability in 2006 (Slemrod, 2007). All these issues corroborate the earlier statement by Lawrence H. Summer, the 71st United States Secretary of the Treasury and former director of United States National Economic Council, on corporate tax avoidance. Summer, while addressing the congregation of the US Federal Bar Association, stated that corporate tax avoidance has constituted “what may be the most serious compliance issue threatening the American Tax System” (US Department of Treasury, 2000). For instance, a report by New York Time (NYT) reveals that General Electric – one of the American’s largest corporations – not only paid zero tax on $14.2 billion profits, but it actually received tax credits of $3.2 billion and also asked the union workers to make wage and benefits concessions (Hundal, 2011).

In United Kingdom, the situation is not different. The best summary of the issue as obtainable in the UK could be described as follows:

> while the [UK] coalition Government is forced to slash spending on punch services private companies contrive to cut the tax they hand to the Exchequer.…there is something immoral about businesses that can employ expensive accountants to find increasing complicated ways of paying less tax (Daily Mail, 2010).

In France, the large companies have been accused of paying less tax compared to the small ones[4]. Also, it has been argued that sixty percent of large corporations in Australia do not pay their fair share of tax (Braithwaite, 1998). While Alm and McKee (2006) suspected the existence of similar or even larger tax gaps in other countries, Tedds (2006) provided evidence for the existence of corporate tax non-compliance in all regions around the world.

As such, the developing countries are not free from the issue of corporate tax non-compliance; in fact they experience worst cases. For instance, Cobham (2005) estimated $385 billion annual loss in domestic revenue of developing countries due to tax non-compliance. Tax non-compliance among taxpayers, thus represents a serious loss of revenue to the governments in many developed and developing economies (Akinboade, Kinfack, Mokwena & Kumo, 2009).

1.1.1 The Context of the Study

Like many countries of the world, corporate income tax, as a source of revenue, is one of the important means Malaysian Government obtains “a stable source of revenue” for its governance as the export prices of the country’s primary products fluctuate. As such, Noor, Mastuki and Bardai (2008) affirmed that corporate income tax constitutes almost seventy percent of the total income tax revenue of the country. Even though about 50 percent of the total direct income taxes in 2010 accrued from corporate

[4] Le Figaro, 14 December, 2009 (as cited in Hardyment et al., 2011).

income tax alone (Treasury of Malaysia, 2010). A similar proportion was recorded in year 2011 with even higher percentage in 2012 (Treasury of Malaysia, 2012).

It could therefore be inferred that corporate income tax is vital to Malaysian economy. That is the reason Malaysian Government has been following an aggressive industrial policy through various tax incentives to promote the country's economic and social goals (Alavi, 1996). Also, the Government, in order to diversify and industrialize the economy, has given various benefits including tax credits to strategic firms and favoured sectors through the Industrialization Strategy (Adhikari, Derashid & Zhang, 2005). Furthermore, the country had implemented a tax policy to gradually reduce the corporate statutory tax rate from forty percent in 1988 to twenty-eight percent in 2004 (Noor et al., 2008) and to twenty-five percent in 2009 (Kasipillai, 2010).

However, despite all these efforts to give the country a comparative advantage in tax competition, Noor et al., (2008:17) provided evidences for the "existence of aggressive tax planning activities" among Malaysian public listed companies. Also, in the yearly report of Inland Revenue Board of Malaysia (IRBM), a total tax non-compliance cases of 25,600 amounting to more than RM773.94 million was recorded in 2005 alone (IRBM, 2005a). Furthermore, Nor, Ahmad and Saleh (2010) affirmed that some corporate taxpayers in Malaysia are engaging in fraudulent financial reporting as a means of reducing their tax liabilities. They claimed that the auditing of 1,850 tax cases in 2002 resulted in additional tax and penalties amounting to RM 77.03 million compared to RM 51.25 million in the previous year.

A plausible reason for the recent tax aggressive planning activities could be associated with the adoption of Self-Assessment System (SAS) by IRBM in 2001 for companies (Kasipillai, 2010). Although, one of the main objectives for the introduction of SAS is to encourage voluntary compliance among the taxpayers, the system however, gives too much freedom to the taxpayers in reporting information regarding their incomes and relies much on their good faith in providing honest tax information (Marshall, Smith & Armstrong, 1997). As such, Noor, Fadzillah and Mastuki (2010) found the corporate effective tax rates of Malaysian companies during the SAS to be lower than what is obtainable under the Official Assessment System (OAS). Thus, in order to ensure a higher level of voluntary compliance under the SAS regime, IRBM conducts tax audit which has become one of its main activities since the introduction of SAS (IRBM, 2005b). It is therefore imperative that the tax authority has a good guide in selecting possible cases for tax audit for effective and efficient tax administration.

Thus, going by the recent approach of modelling non-compliance in the tax research literature, the present study examines the relationship between corporate tax avoidance and some firms' characteristics (focusing on corporate ownership structure with interactive effects of board of directors' attributes and audit quality) to provide a useful guide in predicting tax aggressive companies.

1.1.2 The Focus of the Study

While the role of taxes in diffusing corporate ownership in American economy has been identified as one of the major factors that inspired the study of Berle and Means (1932) on corporate agency problem (Desai, Dharmapala & Fung, 2007), corporate governance and taxation had been separately studied by researchers in subsequent decades despite the vast obvious interactions[5] between these two important aspects of an economy.

For instance, Desai and Dharmapala (2008), in a broad sense, identified three dimensional interactions between taxation and corporate governance mechanisms. Firstly, the structure of a tax system and its level of enforcement could determine the level of agency problem in a corporate setting given their effects on managerial actions; secondly, the corporate governance mechanisms – ownership structure, minority shareholders protection – could have effects on the structure of a tax system; and lastly, the rent extraction through managerial opportunism created as a result of tax avoidance activities could affect the tax revenue to the government. This third interaction provides a background to the present study on determinants of corporate tax avoidance.

Meanwhile, tax literatures historically took some time to recognize the dichotomy between the individual and corporate taxpayers' non-compliance (Slemrod, 2004; Tedds, 2006). While most of these literatures focused on the individual taxpayer's behaviour, the available literatures on corporate tax planning before Chen and Chu (2005)[6] assumed that firms make their tax reporting decision with no agency consideration (Crocker & Slemrod, 2005).

Although, some of the factors that determine tax compliance at individual level, such as tax rates, the probability of detection and punishment, penalties and risk-aversion (Allingham & Sandmo, 1972; Duncan, Larue & Reckers, 1989) as well as intrinsic motivation (Slemrod & Yitzhaki, 2002) are also applicable to the corporate taxpayers (Hanlon & Heitzman, 2010). However, because of the separation of

[5] For example, the in-depth reviews of the various interactions between taxes and corporate governance were provided in the edited book by Schon (2008).
[6] This was the first study to incorporate the agency consideration in corporate tax reporting in their seminal work (Chen & Chu, 2002) which was later published in RAND Journal of Economics in 2005.

ownership from control in a corporate setting, additional issues, such as agency problems and loss of efficiency in internal control[7] might arise (Slemrod, 2004). This is because tax avoidance involves some levels of complexity and obfuscation to prevent its detection by tax authority; it therefore creates room for managerial opportunism (Desai & Dharmapala, 2006a; 2008; 2009b). That is, a corporate tax reporting decision where the private interests of managers may preclude the owners' interests.

Thus, the general view of tax avoidance as a transfer of wealth from state to shareholders is questionable in the corporate environment due to the principal-agent relationship between shareholders and management (Desai, Dyck & Zingales, 2007). In line with this, Scholes, Wolfson, Erickson, Maydew and Shevlin (2005), Desai and Dharmapala (2006a) called for further studies on corporate tax avoidance with agency consideration and Chen and Chu (2005); Croker and Slemrod (2005); Slemrod (2004), provided the theoretical foundations for incorporating agency related issues into corporate tax planning.

From the above discussion it becomes clear that, while tax avoidance may benefit the firms in form of increased cash flow, there are potential negative consequences related to it (Hanlon & Heitzman, 2010). Apart from the opportunity cost of the capital invested in tax management and the agency cost highlighted above, there are other non-tax costs associated with a firm's tax avoidance (Scholes et al., 2005), that need to be considered for tax effective planning. For instance, a firm may be forced to pay additional taxes and even penalties resulting from tax related lawsuit after being detected by tax authority. This has an adverse effect on the firm's

[7] Chen and Chu (2005) argued that the decision of tax evasion by firm's owners would lead to incomplete compensation contract between the owners and the managers, which in turn might lead to loss of efficiency in internal control.

reputation and a consequential negative effect on its stocks' prices (Hanlon & Slemrod, 2009)[8]. On the part of authorities, tax avoidance represents a loss to government revenue and additional regulatory cost to tax authority. However, in spite of these negative consequences of tax avoidance for shareholders and regulators, there is limited understanding of its determinants (Chen, Chen, Cheng & Shevlin, 2010). Accordingly, Shackelford and Shevlin (2001), in their review of empirical tax research in accounting, point out the need for further investigations of organizational factors, such as ownership structure and insider controls, as important determinants of corporate tax avoidance. This was further emphasized in a later review of tax research by Hanlon and Heitzman (2010).

Further, the various corporate scandals and collapses of Enron, Dynegy, GlaxoSmithKline, WorldCom, and Tyco[9], involving tax aggressiveness through extensive uses of shelters have changed the tax profile from "traditional obscurity behind the scenes" to the mainstream of corporate concern and an agenda in the Boardroom (Freedman, 2003; KPMG, 2005:2). Also, because of the financial and reputational risks inherent in tax avoidance, the board of directors nowadays view tax issues with more serious concern than in the past (ATO, 2005). Accordingly, as an important component of corporate internal governance mechanism, Lanis and Richardson (2011); Minnick and Noga (2010) argued for and investigated the effects of certain board of directors' attributes on corporate tax avoidance.

Finally, as an important external governance mechanism, audit is expected to enhance the credibility and adequacy of financial information by supporting corporate transparency in financial reporting (Francis, Khurana & Pereira, 2003; Sloan, 2001).

[8] For instance, Hanlon and Slemrod (2009) found a decline in the stock prices of companies, consequent to news about their involvement in tax shelters.
[9] To mention but a few, as the list may be endless.