Measuring Internal And External Corporate Governance Mechanisms On Companies Tax Planning: Evidence From Shariah-Compliant Companies In Malaysia

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ABSTRACT

There is an increased attention towards a need for good corporate governance which will lead to better firm performance. Hence, this study attempts to examine whether good corporate governance mechanisms can result in better tax planning strategies, thus resulting in lower corporate effective tax rate (ETR) paid by companies. The main objective of this study is to examine the relationship between internal and external corporate governance mechanisms towards tax planning involvement. A micro backward-looking approach is used, comprising of a balanced panel data for 397 listed companies during the years 2007-2010. This study examines whether there is any impact as a result of a revision of the Malaysian Code of Corporate Governance (MCCG) and active shareholder activism in recent years towards greater mechanism of corporate governance. Thus, the study would provide some solution for the agency problems that exist between the management and shareholders, particularly in tax related matters. Narrowing the sample to Shariah-compliant companies and taking into consideration the government-linked companies (GLCs) classifications, the empirical results reveal that internal and external corporate governance mechanism does not influence corporate tax planning. Hence, the evidence implies that less interference among the top management in the companies’ tax planning activities.

Keywords: Tax Planning, Corporate Governance, Corporate Effective Tax Rates, Malaysian Code of Corporate Governance (MCCG) and shareholder activism.
Introduction

Taxes are feared by most people in today’s world. However, from the government’s point of view, taxation is of great concern as it contributes the most to the public expenditure. On the other hand, from the taxpayers’ perception, especially that of corporations, taxes is a burden not only to the firm but to the stakeholders as well. As most people are skeptical of paying huge amount of taxes to the tax authorities, they will engage in aggressive tax planning strategies to minimize, eliminate or defer their tax liabilities.

The importance of tax planning has been viewed in two different perspectives. First, as the negative impact of managerial opportunism (Frieser, Link & Mayer, 2006; Minnick & Noga, 2010); by which people see tax planning as similar to that of tax avoidance. Past studies have shown that managers of firms who engage in tax avoidance as a means of tax sheltering activities do so to satisfy their own self interest rather than for the sake of the principal (shareholders). Meanwhile, the latter serves a more meaningful benefit in the long run rather than immediate benefits for the firms to engage in tax planning, particularly as a long-term investment (Minnick & Noga, 2010). Focus on the above matters is strongly associated with agency theory; where the owner and manager of the firm are separated or not wholly managerial ownership, creating agency problems between both parties. Thus, the second view somehow provides the solution for the problem. Tax planning activities, if properly conducted within taxation laws, will benefit both the managers (agent) and shareholders (principal), as the burden of tax suffered by both parties could be minimized as a result of effective tax planning strategies.

The current study uses corporate effective tax rates (ETR), a proxy for tax planning which is similar to the previous studies done by Phillips (2003), Cook, Huston and Omer (2008), Md Noor, Mastuki and Bardai (2008), Md Noor, M. Fadzillah and Mastuki (2010). Prior studies in Malaysia mostly viewed the effect of firms’ characteristics towards corporate ETR as a measure for tax planning. Hence, this study is conducted to specifically address the impact of corporate governance towards corporate ETR. There has been no research on the direct relationship between tax planning and corporate governance as past studies were only concerned with the interaction effect of corporate governance towards taxation. Thus, the current study aims to fill the gap by focusing on both internal and external corporate governance mechanisms’ effect towards corporate ETR. Taking into consideration the agency problem that exists between the management as an agent and shareholders as the principal, these two main mechanisms are expected to be the pushing factors for the management to engage in tax planning. This will then help to satisfy the shareholders’ interest in achieving lower tax and higher after tax returns. Compliance with corporate governance results in stronger regulations, as reflected by the revised Malaysian Code of Corporate Governance (MCCG) and active shareholder activism played by means of Minority Shareholder Watchdog Group (MSWG). They therefore bring greater anticipation of corporate governance’s role as a solution for the above agency problems, mainly in tax matters.

The remainder of this paper is structured as follows; the second section involves literature review of past studies relating to the subject matters in this study, then proceeds with a discussion on research framework and hypotheses development. The third section covers research methodology, which discuss data collection, with the model and measurement of each variable used in order to realize the objective of this study. The fourth section reports the empirical results of the study along with related discussion about the results. The final section covers the conclusion, implications, and limitations faced in this study, as well as, future research expected to be explored apart from or as an extension of the current study.
Literature Review

Malaysian Corporate Tax System and Tax Reform

Malaysia is one of the Asian countries affected by the 1997 Asian financial crisis, which resulted in a huge loss of the government’s revenue during that period. Since then, the Malaysian government has strived to regain its fiscal policy strength through extensive revenue collection. This is done by improving the efficiency of tax administration (Luigi, Laura, & Luca, 2005). Up to 2009, tax revenue was still the main source of income for the country. There are two major types of taxes; direct and indirect taxes, by which direct taxes continue to contribute as a major proportion of the country revenue (Chapter 4: Public Sector Finance, 2010/2011; Ridzuan, 2006). Corporate taxation is one of the main portions of direct taxes collected by the tax authorities; which is also known as the Inland Revenue Board of Malaysia (IRBM).

Meanwhile, the Malaysian tax system has undergone several phases of tax reforms in line with the global tax reforms (Md. Noor et al., 2008). Ridzuan (2006) supported the statement and observed that the Malaysian tax reform is adopting an incremental approach rather than a package approach. The tax reforms focus on the corporate tax system as it contributes 45% to Malaysian’s income tax revenue (Md. Noor et al., 2010). Besides lowering the statutory tax rate, the government has continuously offered various incentives with the objective of not only promoting economic growth, but to provide a conducive business environment and also to reduce the tax burdens of existing and new business players in the market.

Md. Noor et al. (2008) reported the unfairness of tax treatment and incentives provided to selected industries, which resulted in lower operating costs to these industries. Further, Luigi et al. (2005) concluded that the tax incentives available to companies did not seriously affect the tax revenues collected by the tax authorities. This conclusion was supported by the 2011 Asia Pacific Tax Policy Outlook published by Ernst and Young, which highlighted the reasons behind this stable tax revenue environment, does not occur only in Malaysia, but also in other countries globally. The Government has not only taken a downward action by lowering the statutory tax rate for both personal and corporate tax as a concern to the nation, as well as offering vast incentives to various sectors in the market. But at the same time, they have implemented an upward action by broadening the tax base through legislative and administrative adjustments (2011 Asia Pacific Tax Policy Outlook, 2011).

In Malaysia, the provision of various tax incentives and benefits by the government are mainly to boost the development of certain industries by attracting active investment from inside and outside the country. However, there is a change of trend in recent years by which the focus of tax incentives offered now is more towards the service sectors rather than manufacturing and agricultural sectors (Hoe, 2011). Year by year, the government has offered an increasing number of tax incentives. However, the three prominent incentives are Pioneer Status, Investment Tax Allowance and Reinvestment Allowance (Hoe, 2011). For instance, in order to promote green environment and lessen climate changes due to greenhouse gas emissions, tax exemptions has been provided to the Malaysian companies involved in selling the Certified Emission Reductions (CERs) from Clean Development Mechanism (CDM) projects approved by the Ministry of Natural Resources and Environment (Hoe, 2011; Kasipillai, 2010).
Corporate Tax Planning

Pniowsky (2010) defined tax planning as the process of structuring one’s affairs in order to defer, reduce or even eliminate the amount of tax payable to the government. In Malaysia, tax planning is permissible as long as it is done within the provision of the Income Tax Act (ITA) 1967. Fallan, Hammervold and Gronhaud (1995) had viewed tax planning as the choice of optimal tax instruments within legal rules in order to reduce the tax burden; either by way of varying tax rates across different economic activities and legal jurisdictions, or from the numerous tax incentives provided within the tax laws.

Prior studies have highlighted the role of top management with regard to the conduct of corporate tax planning. For instance, Jr. (1999) has stressed the important role of compensating operating managers on the basis of after-tax operating unit. This is advocated by the assumption that operating managers and corporate tax professionals could work together seeking for various tax planning opportunities, thus leading to its success. However, Armstrong, Blouin and Larcker (2011) have focused their view on the tax director, who is directly responsible in monitoring the firm’s tax administration and performance, despite low annual compensation as compared to other top executives. According to Armstrong et al. (2011), among the three main roles of tax directors; 1) compliant role, 2) advisory role and 3) active planning role, the third role somehow agrees with the arguments above as it relates closely to the conduct of investment opportunities for tax planning purposes.

Corporate Effective Tax Rate (ETR)

Corporate ETR is chosen as the common measure used in tax reform debates (Gupta & Newberry, 1997; Richardson & Lanis, 2007). According to Md Noor et al. (2010), corporate ETR is selected as a measure for tax planning as it summarizes the cumulative effects of various tax incentives as well as identify the level of neutrality of the tax system in companies with different tax burdens. The inequality of the tax system as a result of unfair provision of tax incentives can best be explained by ETR in order to identify the level of tax burden as well as the nature of firms facing those burdens (Harris & Feeny, 2000). Buijink, Janssen and Schols (1999) on the other hand, had highlighted the effect of the provision of tax incentives on the gap between ETR (the actual tax rate paid by companies) and the statutory tax rate (the official tax rate that companies supposed to pay). According to Buijink et al. (1999), the greater the differences between both rates indicate extensive tax incentives given by the government to a particular industry, which then results in more injustice in the tax system.

With regards to the types of corporate ETR to be used, Spooner (1986) has described two main types of ETR; average and marginal ETR. According to the author, average ETR is preferable due to several factors; 1) provide substantial impact of any tax-policy decision and 2) enable the measurement of tax burden distribution by means of tax incentives given. Liu and Cao (2007) also favoured average ETR as it measures tax burden as a whole for related firms rather than marginal ETR which was only for particular projects.

Internal corporate governance mechanism (Independent directors)

Paragraph 1.01 of the Listing Requirement of Bursa Malaysia Securities Berhad defined independent director as, “a director who is independent of management and free from any business or other relationship which could interfere with the exercise of independent judgment or the ability to act in the best interests of an applicant or a listed issuer” (Listing Requirements of Bursa Malaysia Securities Berhad, 2008).
There is vast research in the past which suggest the important role of independent directors in a particular board of directors. Bonazzi and Islam (2007), for instance, highlighted the need for effective board of directors as the most prominent option for good corporate governance mechanism, particularly, with regards to the inside factors of the corporation. Ferris and Yan (2007) on the other hand, viewed the role of independent directors in mutual fund governance. According to the authors, the independence in mind and appearance held by these types of directors has prevented them from taking a bias decision which may affect the shareholders’ interest. Yet, the results appeared to be in contrast with prior research expectations. One good example was from similar studies done by Ding and Wermers (2005), which discovered that more independent directors on the board would enhance the governance quality of firms.

In Malaysia, Bursa Malaysia also requires the existence of at least two directors, or one third of the board (whichever is higher) who are independent directors to sit on the board of Malaysian listed companies. This has shown the strict compliance by the statutory body like Bursa Malaysia in ensuring board independence and its monitoring role towards the top management. However, a question should be placed on whether the minimum requirement of one third independent director on the board is sufficient enough to ensure their active role as a monitor and observer towards managerial actions. This is based on the empirical results of a study done by Johari, Mohd Salleh, Jaffar and Hassan (2008) which suggests this controlled inadequacy towards earning management practices.

External corporate governance mechanism (Institutional investors)

Institutional investors play an active role in enhancing a firm’s corporate governance. The greater the proportion of their shareholdings in a particular firm; whether domestic or international, the more powerful they are in influencing management’s decision. Davis (2002) highlighted in his study the large equities held by institutional investors, mainly in the United Kingdom and United States. Their dominant status in equity holdings signified their duties not only as owner, but also to monitor and keep an eye on the inside management’s work.

In addition, Gillan and Starks (2000) stress the role of institutional investors in urging the management for better governance in the corporations. Elyasiani and Jia (2010) have described three possible roles that institutional investors can play in a corporation, one of them being an active monitor. According to the authors, with the incentive and expertise they have to monitor the management, they might also be able to influence the firm’s future actions including the changes in its governance structure.

On the other hand, Hellman (2005) emphasizes the demands of institutional investors for better firm performance and profitability in order to ensure maximum returns enjoyed by their beneficiaries. This, in some way, has pushed managers to act in a positive way to enhance shareholders’ value and its related stakeholders, as well as the beneficiaries. Their heavy reliance on external advisors would enable them to provide important information on stock market performance to the management for better business and investment decisions (Hellman, 2005).

The Role of Independent Directors and Institutional Investors in Corporate tax Planning

The Board of Directors is said to be a monitoring mechanism to mitigate the agency problem, which will subsequently reduce any residual loss to shareholders (Fama & Jensen, 1983; Lanis & Richardson, 2011). More specifically, Abdul Rahman and Salim (2010) have also
stressed the role of independent or outside directors’ domination in the board as one of the effective solutions for agency problems which could occur between the management and the shareholders. According to the authors, if there is more outside directors leading the board, the less power the management has to make them bias towards insiders’ interest, thus ensuring a good monitoring role for the top management to fully work in the best interest of shareholders.

Yet, there still exist ambiguous views on how the board composition plays this monitoring role, therefore, affecting the firm’s performance as a whole (Minnick & Noga, 2010). One way is by looking at their role in tax management strategy. Minnick and Noga (2010) also add that in choosing tax management strategy, directors and CEOs are the ones responsible for resourcing allocation as well as increasing firm’s performance and shareholder’s value. The investment of resources into value-maximizing activities such as tax planning will result in lower taxes, i.e. lower the corporate ETR and subsequently provide higher after tax value of the firm.

Meanwhile, with regards to external corporate governance mechanisms, Lim (2011) highlights on how corporate governance by means of institutional investors’ active role could mitigate the agency problem between the management and debt holders when engaging in tax planning or tax avoidance activities. Thus, firm value would be high when cost of debts arising from the above conflict is reduced. As they assist indirectly in increasing the pretax income of the firm, they would also demand for high after tax income for higher profit distribution to its beneficiaries. Thus, they would expect managers to conduct tax planning which would result in lower current tax expenses to be paid.

Research Framework and Hypotheses Development

Research Framework

Figure 1 demonstrates the theoretical framework examined in this study. With reference to the framework, the current study assesses the relationship between the internal corporate governance mechanisms (i.e. proportion of outside or independent directors in the board), and external corporate governance mechanisms (i.e. institutional investors), which are the independent variables, and tax planning, which is the dependent variable. Currently, this study tries to look on the elements suggested by Md. Noor et al. (2010) for future research. This study attempts to control the firms’ characteristics that have been tested before by various scholars in various countries (Dyreng, Hanlon & Maydew, 2008; Gupta & Newberry, 1997; Md Noor et al. 2010; Minnick & Noga, 2010). This is to specifically look at the independent effect of the corporate governance mechanism variables as mentioned above.
Hypotheses Development

Prior studies have found evidences that firm’s size and composition of the board of directors are an effective internal mechanism to monitor the agency problem that exist between managers and shareholders (Minnick and Noga, 2010). Meanwhile, Bonazzi and Islam (2007) also report on the good monitoring role played by outside and independent board of directors towards the managerial and firm performance. In contrast, Lanis and Richardson (2011) view the management domination of board of directors in a negative light, i.e. to encourage managers to expropriate the shareholders’ wealth through fraudulent transactions. While, Minnick and Noga (2010) see a more positive aspect concerning the after tax value of the firm, which then increase shareholders’ wealth as well as providing a significant driver of bottom line performance. They are concerned that it is the duty of the board, mainly the independent directors, to ensure consistent profitability is achieved by the firm. One possible way is by engaging in appropriate tax planning or tax management strategies which will result in a lower tax burden for the company, as proxied by the corporate ETR. This then leads to the first hypothesis:

H1: Firms with greater numbers of independent board of directors are more likely to engage in tax planning, which resulted in lower corporate ETR.

Lim (2011) views the agency theory in relation to the managers, bondholders and shareholders. The existence of institutional shareholders in a Korean business environment moderates the negative effects of tax avoidance on the cost of debt. According to Lim, shareholder activism, through greater involvement of institutional investors would help reduce the deviation of action on rent diversion by the managers, thus increasing the tax avoidance effect in favor of the shareholders’ interest (lower tax burden).

Desai and Dharmapala (2009) on the other hand, views institutional investors, as a primary measure for corporate governance to mediate the effect of corporate tax avoidance on...
firm value, thus leading to higher tax savings in well-governed firms. The authors stressed that a higher degree of control and scrutiny from institutional investors as an external corporate governance mechanism towards the managerial actions would help to provide a positive aspect of tax avoidance, i.e. better tax planning, which will subsequently lead to lower tax payable and higher net effect of firm value.

Chung, Firth and Kim (2002) however, find that the presence of large institutional shareholdings may hinder managers from manipulating the reported profits in order to reach the desired level or range of profits. Abdul Wahab, How and Verhoeven (2008) view the role of institutional shareholders in the Malaysian context. They suggest that institutional investors could arise simultaneously with corporate governance as two monitoring agents. However, the current study views them directly as an external governance mechanism rather than treating them separately from corporate governance. Cornett, Marcus, Saunders and Tehranian (2007) among others, highlight the power of large institutional investors to pressure managers to meet their rights and interests, and yet, they found a significant relationship between the pressure-insensitive institutional investor involvement and operating cash flow returns. Therefore, it can be said that in order to mitigate the agency problem and to achieve a higher bottom line profit that ensures their continuous investment in the firm, tax should be lowered through active tax planning; which institutional investors are pushing for. Hence, the second hypothesis is formulated as follows:

H2: Firms with greater involvement of institutional shareholders, through shareholder activism are more likely to engage in tax planning, which resulted in lower corporate ETR.

Research Methodology

Data Collection

For the purpose of this study, data were collected on public companies whose shares are listed on Bursa Malaysia. The collection of this data involved two stages: 1) Thomson Datastream, which provides financial related data on several items in the balance sheet and profit and loss account; and 2) Annual reports of public listed companies (PLCs) for information on independent board of directors, as well as the proportion of shares held by institutional investors (i.e. institutional ownership). The samples comprised of Shariah-compliant companies from nine different sectors as follows: consumer products, industrial products, properties, hotel, infrastructure (IPC), trading and services, construction, plantation, and technology; whose annual reports are available for the years 2007 until 2010. Companies in financial intermediation such as banking, insurance and shipping are removed because the taxation scope for companies in these industries is based on world income (Section 60, 60C, 54(2) (a), Income Tax Act 1967). In addition, these finance-related companies, together with unit trusts and utilities companies as well as distressed firms, are also excluded from the sample due to their differences in the regulatory requirements.

The final sample comprised of 397 companies after filtering out companies with non-availability of data, non-Shariah Compliant as well as those with negative pretax income in the four year period. A balanced panel data approach is used in order to have an observation on similar firms during the years 2007 until 2010. The current study also identified the effect of Government-Linked Companies (GLCs) towards this tax planning activity. From 33 listed companies that are categorized as GLCs, only 26 companies are taking into consideration
after excluding the finance-related companies. Hence, out of these 26 companies, only 17 companies matched with the final 397 companies for each investigated year, thus making it a sum of 68 GLCs identified for firm-years observation.

The current study has selected 397 companies comprising of Shariah-compliant companies which made up about 89% of listed companies in Bursa Malaysia (Securities Commission Malaysia, 2011), and Government-Linked companies (GLCs) during the post period of revised MCCG (2007 to 2010).

The selection of the sample of Shariah-compliant companies in this study is highly important as it represents the majority of the listed companies in Malaysia. They are expected to apply greater compliance to corporate governance requirement in engaging legal tax planning activities in order to reduce the tax payable. This is because the status of Shariah-compliant has been granted by the Securities Commission after passing several business activity benchmarks; plus two additional criteria which are good company’s image and the companies’ main activities should be beneficial to Muslims and the country as a whole (http://www.sc.com.my/frequently-asked-questions/). Moreover, taking into consideration the GLCs categorization is to examine the realisation of the key principles of “GLC Transformation Programme” which highlight the implementation of policy measures that in line with good governance (http://www.khazanah.com.my/FAQ.HTM#ques16).

Investigation Period

The period of this study is chosen to cover the revision made in the Malaysian Code of Corporate Governance (MCCG) in the year 2007 which has highlighted the independence of directors, and its further development. The increased importance on the role of directors has led the code to highly stress the need for a balanced composition of the board of directors, where independent non-executive directors should make up at least one third of the board membership, in order to ensure no domination exists by any directors, mainly the insiders (Malaysian Code of Corporate Governance (revised 2007). Thus, it is significant to research the role of the internal corporate governance mechanism within the 2007-2010 period in order to observe the subsequent effects of the revised code.

Meanwhile, with regards to the external corporate governance mechanism, i.e. institutional investors, despite the long establishment of Minority Shareholder Watchdog Group (MSWG) in 2001 to protect the interest of minorities, mainly the institutional investors, the current study highlights the need for shareholder activism in voicing their right for effective tax planning in order to ensure high distribution of profits to the shareholders, after looking at its active conduct in recent years.

Empirical Model and Measurement of Variables

The current study uses the ETR regression model to test the research hypotheses (Gupta & Newberry, 1997; and Md Noor et al., 2010), which is stated as follows:

$$ETR_t = \beta_0 + \beta_1IND_t + \beta_2IS_t + \beta_3SIZE_t + \beta_4LEV_t + \beta_5ROA_t + \beta_7CAPINT_t + \beta_8SECTORDummy_t + \beta_9YEARDummy_t + \beta_{10}GLCDummy_t + \epsilon_t$$

To have a general understanding on the above model, dependent variable, i.e. tax planning is proxied by ETRt, two independent variables include proxies for independent board of directors (IND) and institutional ownership (IS) while another four variables are for control variables. Dummy variables are also being included in the above ETR model which will take
into account sector and year dummies, and consistent with a prior study done by Md Noor et al. (2010). However, for this current study, it will consider another dummy variable, i.e. the GLCs dummy to see whether GLC categorization will bring additional effect to the actual model. In addition to the main model, another two models have also been conducted to test the strength of the independent directors’ variable, by making it as dummy and categorical variables in terms of board independence required by the revised MCCG as well as based on the different level of board independence respectively. Hence, the main model, ETR Model 1 considers IND1 variable, the ETR Model 2 on the other hand uses IND2 variable, and the ETR Model 3 covers INDCAT1, INDCAT2, INDCAT3 and INDCAT4 variables. Table 1 outlines the measurement for each variable used in the study.

Table 1: Measurement of variables

<table>
<thead>
<tr>
<th>Variables</th>
<th>Measurement</th>
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<tbody>
<tr>
<td><strong>Dependent Variable:</strong></td>
<td></td>
</tr>
<tr>
<td>Tax planning</td>
<td>• Income tax expense (current tax expense plus deferred tax expense) divided by pre-tax income</td>
</tr>
<tr>
<td>- Corporate ETR</td>
<td></td>
</tr>
<tr>
<td><strong>Independent Variables:</strong></td>
<td></td>
</tr>
<tr>
<td>Internal governance mechanism:</td>
<td></td>
</tr>
<tr>
<td>Proportion of outside / independent board of directors (IND)</td>
<td>• Proportion of independent directorship out of total board of directors</td>
</tr>
<tr>
<td>IND1 (ETR Model 1)</td>
<td></td>
</tr>
<tr>
<td>IND2 (ETR Model 2)</td>
<td></td>
</tr>
<tr>
<td>(ETR Model 3)</td>
<td></td>
</tr>
<tr>
<td>INDCAT1</td>
<td>• Actual proportion of independent directors on the board</td>
</tr>
<tr>
<td>INDCAT2</td>
<td>• ‘1’ for companies with board independence of one third and above, ‘0’ for otherwise</td>
</tr>
<tr>
<td>INDCAT3</td>
<td>• ‘1’ for independent directorship of less than one third or 33%, ‘0’ for otherwise</td>
</tr>
<tr>
<td>INDCAT4</td>
<td>• ‘1’ for independent directorship of 33% to 50%, ‘0’ for otherwise</td>
</tr>
<tr>
<td>External governance mechanism:</td>
<td></td>
</tr>
<tr>
<td>Institutional investors (IS)</td>
<td>• ‘1’ for independent directorship of 51% to 60%, ‘0’ for otherwise</td>
</tr>
<tr>
<td></td>
<td>• ‘1’ for independent directorship of 61% to 74%, ‘0’ for otherwise</td>
</tr>
<tr>
<td>Control Variables:</td>
<td></td>
</tr>
<tr>
<td>a. Firm’s size (SIZE)</td>
<td>• Log of total assets</td>
</tr>
<tr>
<td>b. Leverage (LEV)</td>
<td>• Total debts divided by total assets</td>
</tr>
<tr>
<td>c. Return on Assets (ROA)</td>
<td>• Pretax income divided by total assets</td>
</tr>
<tr>
<td>d. Capital Intensity (CAPINT)</td>
<td>• Fixed assets (property, plant and equipment) divided by total assets</td>
</tr>
</tbody>
</table>
Data in this study was analysed using a software called Statistical Package for Social Science (SPSS) version 17.0. Analyses were conducted by using several statistical tests. Beginning with descriptive statistic tests, the study then performed Univariate tests involving T-test and ANOVA test, together with Pearson correlation analysis separately on dependent and its explanatory independent and control variables. Then, in order to answer the research questions and test the hypotheses in this current study, the final main test was undertaken, i.e. multiple regression analysis in identifying the linear relationship between the dependent variables and two independent variables used in the current study. Sensitivity test was also conducted which covers the two additional ETR Models to have a thorough look at the effect of independent directorship in several different angles.

Statistical Results

Corporate ETR in Shariah-compliant Companies

The analysis of the results focuses on the corporate ETR of Shariah-compliant companies during the years 2007 to 2010. This period of study is actually an extension of the Self Assessment System (SAS) period for companies which were implemented in the year 2001. Previously, a past study done by Md. Noor et al. (2010) has already looked into the early period of SAS from the years 2001 until 2006. Hence, this current study examines the later years 2007 until 2010. To begin the discussion, this study tries to figure out whether tax planning activities do exist in these Shariah-compliant companies. To justify the above statement, as mentioned in the first chapter, there are 89% of Shariah-compliant companies listed in the Bursa Malaysia, thus making it possible for the current study to see the extended effect of the past study done by Md. Noor et al. (2010).

Descriptive Statistics Results – Comparison between Statutory Tax Rate (STR) and Corporate Effective Tax Rate (ETR)

Table 2 outlines the mean value for each year under investigation (i.e. years 2007 until 2010) for the corporate ETR and STR which includes its minimum and maximum value, the mean and standard deviation value. This first test is to provide a brief overview of the data set as well as to describe the main features of the data. To determine whether the engagement or conduct of tax planning activities exists among these Shariah-compliant companies, the mean for accrual-based ETR should be below the mean for STR for each fiscal year. From Table 2, it can be seen that the average values for accrual-based ETR used in this study are below the STR for all years investigated. This means that, on average, the average ETR for Shariah-compliant companies examined in this study is 20.39% for the year 2007, and 23.18%, 24.27% and 23.89% for the years 2008, 2009 and 2010 respectively, are lower than STR for all year (i.e. 27% for 2007, 26% for 2008 and 25% for both 2009 and 2010). The results indicate that despite their status as Shariah-compliant companies, they also take advantage of the tax incentives offered by the government to engage in tax planning activities as shown by the lower ETR mean as compared to STR mean for the four-year period under study.

Meanwhile, the minimum value of ETR (ETR=0) may be on the assumption that certain companies under consideration have fully utilized the tax incentives offered by the government in a particular sector, thus leading to zero tax payable by the company. This minimum value may also be due to late incorporation and the listing of a particular company to the Bursa Malaysia in the first or second years under study. On the other hand, the
maximum value of ETR, which is 100%, may be an indicator of inactive involvement of tax planning activities by certain companies, i.e. they do not utilize the opportunity of tax incentives given by the government. In other words, the amount of tax the company pays to the government is similar to the actual burden of tax payable faced by them. Yet, the true fact to explain the reason behind this minimum and maximum value of ETR faced by those particular companies still needs to be researched further to ensure the best and accurate prediction.

Table 2: Descriptive Statistic for Statutory Tax Rate (STR) and Accrual-Based ETR for Year 2007 - 2010

<table>
<thead>
<tr>
<th>Year</th>
<th>STR %</th>
<th>Accrual-based ETR %</th>
</tr>
</thead>
<tbody>
<tr>
<td>2007</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Mean</td>
<td>27.00</td>
<td>20.39</td>
</tr>
<tr>
<td>Median</td>
<td>27.00</td>
<td>21.00</td>
</tr>
<tr>
<td>Standard Deviation</td>
<td>0</td>
<td>14.56</td>
</tr>
<tr>
<td>Minimum</td>
<td>27.00</td>
<td>0</td>
</tr>
<tr>
<td>Maximum</td>
<td>27.00</td>
<td>100</td>
</tr>
<tr>
<td>2008</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Mean</td>
<td>26.00</td>
<td>23.18</td>
</tr>
<tr>
<td>Median</td>
<td>26.00</td>
<td>24.00</td>
</tr>
<tr>
<td>Standard Deviation</td>
<td>0</td>
<td>17.01</td>
</tr>
<tr>
<td>Minimum</td>
<td>26.00</td>
<td>0</td>
</tr>
<tr>
<td>Maximum</td>
<td>26.00</td>
<td>100</td>
</tr>
<tr>
<td>2009</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Mean</td>
<td>25.00</td>
<td>24.27</td>
</tr>
<tr>
<td>Median</td>
<td>25.00</td>
<td>24.00</td>
</tr>
<tr>
<td>Standard Deviation</td>
<td>0</td>
<td>16.40</td>
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<tr>
<td>Minimum</td>
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<td>0</td>
</tr>
<tr>
<td>Maximum</td>
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<td>100</td>
</tr>
<tr>
<td>2010</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Mean</td>
<td>25.00</td>
<td>23.89</td>
</tr>
<tr>
<td>Median</td>
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<td>24.00</td>
</tr>
<tr>
<td>Standard Deviation</td>
<td>0</td>
<td>15.45</td>
</tr>
<tr>
<td>Minimum</td>
<td>25.00</td>
<td>0</td>
</tr>
<tr>
<td>Maximum</td>
<td>25.00</td>
<td>100</td>
</tr>
</tbody>
</table>

Note:
Variable definition is as follows:
ETR = income tax expense (current tax expense plus deferred tax expense) / pretax income
Univariate Analysis - Comparisons of Means between ETR and STR

Table 3 reports the significant difference of mean between ETR and STR for the four-year period as shown by the T-Test results below. The T-Test results provided shows that there is significant difference in the mean value of both ETR and STR at 1% level with the t-statistic values for the variation is -3.66. The findings support the active engagement of tax planning activities by the companies in the sample study.

<table>
<thead>
<tr>
<th>Years</th>
<th>N</th>
<th>Mean ETR</th>
<th>Mean STR</th>
<th>t-stat</th>
<th>P-value</th>
</tr>
</thead>
<tbody>
<tr>
<td>2007-2010</td>
<td>1588</td>
<td>22.94 %</td>
<td>25.75 %</td>
<td>-3.66</td>
<td>.0003 ***</td>
</tr>
</tbody>
</table>

Note:
Variable definition is as follows:
ETR = income tax expense (current tax expense plus deferred tax expense) / pretax income

***Significance at 0.01 level; **Significance at 0.05 level; *Significance at 0.10 level

Univariate Analysis – Comparisons of Means between ETR and STR in two different periods of study

To see whether there is a larger deviation between mean for ETR and STR as per the study done by Md. Noor et al. (2010), mainly on the Self Assessment System (SAS) regime, i.e. year 2001 until 2006, Figure 2 depicts the comparison between the two periods of study, which are between 2001-2006 and the current sample from 2007-2010. From the chart, an overview on the mean comparison of ETR and STR has revealed a smaller variation in the 2007-2010 periods which is only 2.81% as compared to 6.9% difference in the earlier periods, i.e. 2001-2006. Moreover, as mentioned previously, each year’s observation shows large variations between ETR and STR mean only for the year 2007 in the current study, and not for the other three subsequent years. Therefore, it can be concluded that companies were more aggressively involved in tax planning activities during the previous periods of 2001-2006, rather than the period investigated in the current study, i.e. 2007-2010. This may be as a result of the higher tax rate imposed by the government in the earlier periods, thus placing a greater burden to the companies. As a solution, they tried to utilize as many incentives as possible given by the government in order to minimize their tax payable in those particular years. Based on the results and findings from the analysis Figure 2, it can be seen that the corporate ETR is a strong measurement for corporate tax planning to be used in this current study.
Multivariate Analysis – Regression Results

For the purpose of multiple regression analysis, this study tries to highlight on board independence. Three types of IND variables are also being considered and there would be 3 types of ETR model tested. They are ETR Model 1, which is the general one, and the other two models will be explained in the sensitivity test section. This model involves IND1, which is the continuous IND variable.

Based on Table 4 which describes the regression results of ETR Model 1, the adjusted r2 value of 9.5% means that overall, after taking into account sample size and number of independent variables, 9.5% of the variation in ETR value is explained by the variation in actual number of independent directors on the board, institutional ownerships and firm’s specific characteristics. This represents only a small effect of those explanatory variables towards the dependent variable in this study while about 90% of the variation in ETR is explained by other factors. Meanwhile, in order to observe the overall significance of the model, F-test is conducted by using Analysis of Variance (ANOVA). From the result in Table 4, the F-ratio value of 10.799 is significant at 1% and 5% level, indicating that at least one of the explanatory variables in the ETR Model 1 has an effect on the dependent variable, i.e. corporate ETR.
Table 4: Regression Results (ETR Model 1)

**ETR Model 1:**

\[ ETR_t = \beta_0 + \beta_1 IND_{1t} + \beta_2 IS_t + \beta_3 SIZE_t + \beta_4 LEV_t + \beta_5 ROA_t + \beta_6 CAPINT_t + \]
\[ \beta_7 SECTORDummy_t + \beta_8 YEARDummy_t + \beta_9 GLCDummy_t + \epsilon_t \]

<table>
<thead>
<tr>
<th>Variable</th>
<th>Predicted sign</th>
<th>Coefficient (t-stat)</th>
</tr>
</thead>
<tbody>
<tr>
<td>IND1</td>
<td>-</td>
<td>-0.019 [-0.628]</td>
</tr>
<tr>
<td>IS</td>
<td>-</td>
<td>0.019 [0.310]</td>
</tr>
<tr>
<td>SIZE</td>
<td>-</td>
<td>-0.017 *[-1.909]</td>
</tr>
<tr>
<td>LEV</td>
<td>-</td>
<td>-0.033 [-1.168]</td>
</tr>
<tr>
<td>ROA</td>
<td>-</td>
<td>-0.476 ***[-7.875]</td>
</tr>
<tr>
<td>CAPINT</td>
<td>-</td>
<td>-0.129 ***[-5.636]</td>
</tr>
<tr>
<td>SECTORDummy</td>
<td>Included</td>
<td></td>
</tr>
<tr>
<td>YEARDummy</td>
<td>Included</td>
<td></td>
</tr>
<tr>
<td>GLCDummy</td>
<td>Included</td>
<td></td>
</tr>
</tbody>
</table>

Adjusted R\(^2\)  9.5\%

F-Statistic (P-value)  10.799 (0.000)

Firm-years  1588

Note: *** Significant at the 0.01 level. ** Significant at the 0.05 level. * Significant at the 0.10 level.

**Corporate governance mechanism variables – independent directorship**

Again referring to Table 4, it reveals that most of the ETR coefficients agree with the predicted sign. Looking at the main relationship, i.e. between the ETR and its independent variables, which also represent the corporate governance mechanism variables, the results show that the corporate ETR which is measured by accrual based ETR, is negatively related to board independence, IND. In the first model, the current study views the effect of the actual proportion of independent directors on the board towards tax planning activity.

The coefficient value of -0.019 is somehow in line with what has been expected and hypothesized in this study. This means that the higher the proportion of independent directors on the board, the more likely they will ensure that management acts in the best interest of
shareholders, as defined by lower tax payable and higher returns to shareholders. This is ensured by good tax management or tax planning strategy as mentioned in the study done by Minnick and Noga (2010). Yet, the value is not statistically significant at all levels, thus rejected the first hypothesis, H1, i.e. firms with greater independent board of directors are more likely to engage in tax planning, which resulted in lower corporate ETR.

However, the insignificant effect of board independence, particularly with regards to Malaysian studies have been discussed and expected by Abdul Rahman and Salim (2010) as proven by past studies conducted on Malaysian listed companies. For instance, Abdullah (2004) who viewed the effect of board independence and CEO duality on firm performance in the early years of 1994 to 1996 has found no significant association between independent directorship and firm performance. Another evidence was contributed by Che Haat, Abdul Rahman and Mahenthiran (2008) who observed that despite all the internal corporate governance mechanism effect on performance of Malaysian firms in the year 2002, all internal governance mechanisms, including the board’s independence, did not provide significant influence towards the firm’s performance. One possible reason highlighted by Abdullah (2004) is due to the use of financial ratios, which reflect more on short term performance. In addition, the insufficiency effect may be a result of these independent directors’ lack of internal knowledge and unrelated skills unsuitable to the firm’s business. Therefore, as this current study is the pioneering study done in Malaysia, with no exact studies abroad measuring the direct relationship between corporate governance and corporate ETR, the weaknesses of these independent directors may result in their disability to pressure management to engage in tax planning activities, which will result in lower corporate ETR.

Corporate governance mechanism variables – institutional shareholdings

Meanwhile, with regards to the second independent variable, i.e. institutional shareholdings, the results indicate that there is a positive relationship between institutional shareholdings and tax planning as proxied by corporate ETR. The positive relationship, in fact, is in contrast with the sign predicted and hypothesized in the current study. Therefore, the result rejected the second hypothesis, H2, i.e. firms with greater involvement of institutional shareholders, through shareholder activism are more likely to engage in tax planning, which resulted in lower corporate ETR. The results also indicate that higher ownership of institutional investors do not pressure management to implement good tax planning activities, which resulted in lower ETR. The result also suggests that institutional investors are more concerned with the triple bottom line profits, which is defined by their concerns towards the environment and the community at large, despite their internal motives. Hence, this may result in higher taxes to be paid by companies, which signals that more public facilities can be provided by the government from the higher tax revenue collected.

This positive sign however is in line with the empirical studies conducted by Ismail (2009) and Cornett et al. (2007), who saw the association between institutional shareholdings and risk management disclosure; and between the same variable, IS and corporate performance respectively. Again, the positive predicted sign discovered in a study done by Oh, Chang and Martynov (2011) which saw the institutional ownership relationship with corporate social responsibility (CSR) engagement. The results of their studies suggest that higher institutional ownership may encourage greater disclosure of corporate risk management, as well as better firm performance and higher CSR ratings in the companies’ engagement in CSR activities. However, despite the conformance to the predicted sign, the results of the first two studies above appear to be insignificant, which is again similar with the results of the current study, except that of the third study conducted by Oh et al. (2011).
Hence, it is assumed that the presence of institutional investors as one of the shareholders in the company is more towards complying with legal requirements, than to satisfy their beneficiaries’ interests.

Meanwhile, past studies on tax matters, which use institutional investors as their moderating variable, also seem to signal the monitoring role of these institutions. A study conducted by Lim (2011) revealed that this variable has moderated the positive effect of tax avoidance activities towards managerial rent diversion. The monitoring role played by these institutions may also explain the higher ETR value discovered in the current study. However, the insignificance of the result could be because of the lack of ownership these institutions have in the companies despite being among the 30 top largest shareholders. In addition, it may also signal that the five institutional investors, which are also the MSWG members, could not play an active monitoring role in protecting the interest of the minorities, who are the beneficiaries of the institutions to have lower tax payable and higher after tax returns.

Control variables

Meanwhile, looking at the same model, ETR Model 1, the current study discovers that firms’ specific characteristics still have a significant impact towards tax planning activities among Shariah-compliant companies tested in this study, which is similar to past studies, taking into account both Shariah and Non-Shariah compliant companies. However, as mentioned in an earlier section, almost 89% of the listed companies in Bursa Malaysia are classified as Shariah-compliant and only 11% are not, which therefore makes it possible and reasonable to make a comparison between the current and past studies. From the results illustrated in Table 4, three out of four control variables appeared to be significant at 10% and 1% level.

As expected, profitability and capital-intensive companies have a higher tendency to engage in tax planning activities, resulting in lower ETR payable, as reflected by the negative coefficients of both variables towards the dependent variable, ETR. This is in line with past studies conducted by Adhikari, Derashid and Zhang (2006), Md Noor et al. (2008) and Md Noor et al. (2010). However, despite similar results with past studies, the negative relationship between firm size and corporate ETR appears to be less significant, as reflected by p-value of less than 10% level, as compared to the previous one, which is more significant at 5% and 1% level respectively.

In addition, the current study discovers a contrasting finding with the previous one for LEV variable. Based on the results in Table 4, there is no significant relationship between LEV and ETR variable, despite the similar negative relationship. This means that, leveraged firms still do enjoy lower ETR as a consequence of deductible interest expenses. Nevertheless, the insignificance may be due to more firms using equity rather than debt as their source of financing, which then results in a lower interest tax deductible.

Sensitivity Analysis

Next, sensitivity tests were conducted on another two types of IND variables. ETR Model 2 involves IND2 variable, whereas ETR Model 3 takes into consideration INDCAT1, INDCAT2, INDCAT3 and INDCAT4 variables. ETR Model 2 and 3, on the other hand are different from ETR Model 1 by which they involve categorical, that is dummy IND variables, which are derived from the actual IND variable in the first model. However, the multiple regression analyses performed on both models produced similar results (not reported) ETR Model 1.
The non-significance of IND2 variable is actually in accordance with the results of an empirical study conducted by Ramli (2009). The rejected hypothesis was based on the insignificant results of positive relationship between independent directorship and firm performance as measured by Tobin’s Q. Hence, what could be concluded here is that, independent directors of listed companies have the least influence and capacity to make major decisions for the company, including engagement in tax planning activities. They just comply with the minimum listing requirement outlined by Bursa Malaysia, which is to have at least one third independent director on the board.

Conclusion

This study examined how corporate governance mechanisms have influenced corporate tax planning. The issues that arose concerning these two subject i.e. corporate governance and corporate tax planning have motivated the current study (Md Noor et al., 2010). Hence, this exploratory study which is a pioneering study conducted in Malaysia, has looked into the relationship between corporate governance and corporate tax planning. The descriptive and T-test results provided a significant difference between ETR and STR during the years 2007 to 2010, thus confirming the presence of tax planning involvement among the Shariah-compliant companies. Furthermore, the smallest deviation of corporate ETR i.e. the actual tax rate paid by companies, from the STR i.e. the official tax rate fixed by the government, found in the current study was due to the widening effect of tax regulations, rather than just a result of tax incentives provided to companies. This can be observed from the reduction in the statutory tax rate which has narrowed the gap between the effective tax rate and the statutory tax rate.

The multiple regression results provided insignificant relationship for both the internal and external corporate governance mechanism variables with the corporate ETR. However, this study found that the control variables such as the firm’s size, performance and capital investment have significant influence on corporate tax planning. Therefore, the current study concludes that the revised Malaysian Code of Corporate Governance which requires at least one third independent directorship for a company to be listed on the Bursa Malaysia have not seriously influenced the strategic decision of companies, especially in tax planning activities. Finally, the evidence found in this study implies that Shariah-compliant companies have a high reliance on professional tax assistance rather than top management in their tax planning activities.

The need to continually highlight future research on corporate governance is important as this issue is still being discussed globally. This study is vital to justify whether corporate governance can become one of the main determinants which may affect the corporate ETR. Moreover, the current study has confirmed prior studies’ discoveries that firms’ characteristics have a significant influence on corporate tax planning. Finally, looking from the broader perspective of internal and external corporate governance mechanism, there is a need to strengthen and confirm the effect of corporate governance mechanism towards corporate tax planning aggressiveness.
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