CORPORATE GOVERNANCE AND TAX AGGRESSIVENESS: EVIDENCE FROM MALAYSIA

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CORPORATE GOVERNANCE AND TAX AGGRESSIVENESS: EVIDENCE FROM MALAYSIA

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ABSTRAK

This study examines the extent of tax aggressiveness and its relationship to corporate governance mechanism. Five established corporate governance mechanism are examined in this study consist of duality, board independence, board size, institutional investors and external auditor. This study was conducted based on annual report of Malaysian Firm listed on the main board of Bursa Malaysia from year 2000 to 2009 consist of 2376 firm-year observations. Tax aggressiveness was identified using the firm’s effective tax rates (ETR). It is expected that corporate governance mechanism negatively related to tax aggressiveness. Consistent with the prediction, the regression analysis provides significant evidence that board size and institutional investors are negatively related to tax aggressiveness. Other variables (duality, board independence and external auditors) not appear as the factor influencing tax aggressiveness in this study.
CHAPTER 1

INTRODUCTION

1.0 Introduction

The purpose of this study is to examine the extent of tax aggressiveness in Malaysian Corporation and to investigate the relationship between corporate governance mechanism and tax aggressiveness. Section 1.1 provides the introduction to the study with the discussion of the background of the study. Section 1.2 discussing the problem statement and in the later section (section 1.3), outline the research questions. Then, section 1.4 discussed on the research objectives and followed by section 1.5 which explains the significance of the study. Section 1.6 provides the definition of keys term in connection with this study. At the end of the chapter, section 1.7 outlines the organisation of the study.

1.1 Background of the Study

Taxes are the major contributor to government”s revenue and become an important issue in every country; therefore taxes are a crucial element in a firm. In maximizing shareholders” wealth, company tries to minimize its tax burden. Shareholders would like to minimize corporate tax payments net of the private costs to maximize the firm value (Hanlon & Slemrod, 2007). The minimization of the tax payment is called tax aggressiveness or tax planning.
Tax aggressiveness is defined by Chen, Chen, Cheng and Shevlin (2008), as a downward management of taxable income through tax planning with respect to reducing tax paid to tax authority. The tax planning activities refer to legal activities which usually provides by the auditor or tax agent, or can be classified as gray area activities, as well as illegal activities (Chen, Chen, Cheng, & Shevlin, 2008). In Malaysian context, example of tax planning activities including excessive claim of tax incentives\(^1\) or claiming incentives which company are not entitled to. Furthermore, company also claiming unallowable expenses which are not allowed by Income Tax Act, 1967.

Taxes and corporate governance may intercept in many angle. Corporate governance is the interplay of the governors in managing and controlling a firm; while taxes influence firm financial decision making including in determined the organisational form, restructuring decisions, payout policy, compensation policy and risk management decision (Desai and Dharmapala, 2004). In connection with that, corporate governance is view as a factor influencing tax aggressiveness since minimizing tax payment may increase company’s cash flow and the governors play major role in allocating the fund and also in decision making. Hence this study was conducted to investigate the extent of tax aggressiveness and its relationship with corporate governance.

Over the years, there are studies that examine the relationship between tax aggressiveness and corporate governance mechanism such as board of director composition (Lanis & Richardson, 2009), form of ownership (Chen, et al., 2008; Chen, Chen, Cheng, & Shevlin, 2010) corporate governance and tax environment changes (Jimenez-Angueira & Eriel, 2007),

\(^1\) Tax incentives in Malaysia such as pioneer status, reinvestment allowance, group relief, double deduction and increase export allowance.
the influence of ownership structure and the corporate governance mechanisms of Malaysian
PLCs on tax avoidance (Mahenthrian & Kasipillai, 2011), equity risk incentives and tax
planning activities (Rego & Wilson, 2011) and the role of executive in determining the level
of tax avoidance (Dyreng, Hanlon, & Maydew, 2009).

This study is based on panel data consist of the information from annual report of Malaysian
Firm listed on The Main Board of Bursa Malaysia from year 2000 to 2009. The data consists
of 2376 firm-year observation. Five established corporate governance mechanism are
examined in this study namely of duality, board independence, board size, institutional
investors and external auditor. The hypotheses were developed based on review and
empirical evidence provide by the literature. In addition, the study also provides brief view on
Malaysian taxation and the corporate governance reform in Malaysia.

Tax aggressive firms were identified by using effective tax rates (ETR) method. Then the
relationship of corporate governance mechanism\(^2\) and tax aggressiveness were examined
using E-views statistical tools. It is expected that tax aggressiveness has negative relationship
with corporate governance mechanism, hence proves that better governance deter the
likelihood of tax aggressiveness. Consistent with the prediction, the empirical result appears
that board size and institutional investors shows a significant negative relationship with tax
aggressiveness.

\(^2\) For the purpose of this study, duality, board independence, board size, institutional investors and external
auditor were identify as corporate governance mechanism.
1.2 Problem Statement

Malaysia has beginning the new era of tax assessment by implementing a Self-assessment System (SAS) on companies in 2001. By implementation of self assessment system, taxpayers is responsible to estimating their own income tax payable for the current year of assessment, informing the tax authorities of the estimate, paying the tax monthly, and submitting a tax return to Inland Revenue Board Malaysia (IRBM).

Self-assessment has been defined as the administration of the tax regime where the tax assessment is solely based on voluntary information given by the taxpayer (Marshall, Smith, & Armstrong, 1997).

SAS has opened a new agenda to company in planning their tax activities. In Malaysia, government takes 25 percent of company’s profit as corporate tax. According to Chen et al. (2008), the government takes a greater than one-third share of a firm’s pre-tax profits. Thus tax aggressiveness reduces the tax paid by firm. Therefore, tax aggressiveness may have a significant tax implication because it possibly leads to tax evasion. The consequence of evasion results loss of revenue to the nation and affect public spending.

Over the years, very few studies have been conducted pertaining to the topics in the local context. Since this study may provides more information concerning the effect of corporate governance mechanism on tax aggressive corporation in Malaysia, more focus research attempts need to be carried out.
In this connection, this study aim to examine the extent of tax aggressiveness in Malaysian corporation as well as to investigate the relationship between corporate governance mechanism and tax aggressiveness in Malaysian Public Listed Companies.

1.3 Research Questions

In order to perform this study, the following research questions are necessary to be address:

I. To what extent tax aggressiveness activities in Malaysian Public Listed Companies have been practice? (To examine the level of tax aggressiveness activities among Public Listed Firm in Malaysia).

II. To investigate whether corporate governance mechanism influencing tax aggressiveness in Malaysia. Particularly, this study attempt to answer this question:
   
   • Does duality influence tax aggressiveness?
   
   • Does having high proportion of independence director (non-executive director) on the board deter the likelihood of tax aggressiveness?
   
   • Does having larger board size reducing the tax aggressiveness?
   
   • Does institutional investor have negative relationship with tax aggressiveness?
   
   • Does external auditor have influence on tax aggressiveness activities?
1.4 Research Objectives

The general objective of this study is to examine the extent of tax aggressiveness in Malaysian Corporation. Specifically, the study tries to achieve the following objectives:

- To examine the relationship between duality and tax aggressiveness.
- To examine the relationship between board independence and tax aggressiveness.
- To examine the relationship between board size and tax aggressiveness.
- To examine the relationship between institutional investors and tax aggressiveness.
- To examine the relationship between external auditor and tax aggressiveness.

1.5 Significance of the Study

Taxes are the major contributor to government’s revenue. In 2009, the government has collected a gross amount in direct taxes totalling RM88.40 billion. This amount is a decrease of RM2.25 billion from the previous year as a result of the global economic crisis beginning from the third quarter of 2008. In year 2008, the collection was RM90.651 billion and RM74.703 billion was collected in 2007. The collection of direct taxes contributed 54.53% from the total income of the Federal Government of RM162.10 billion in year 2009 and 56.11% of RM161.558 billion of the Federal Government's overall revenue for 2008 (Lembaga Hasil Dalam Negeri Malaysia, 2010a, 2010b).

The government takes a greater than one-third share of a firm’s pre-tax profits. Thus tax aggressiveness reduces the government’s take (Chen, et al., 2010). Tax aggressiveness represents a value maximizing activity for a firm it entails a transfer of wealth from
government to a firm’s stakeholders (Khurana & Moser, 2009). So, it’s considerable as taxes loss to the government.

The study provides useful information to the tax authority in understanding more about tax aggressive corporation. In Malaysia, tax audit are perform by the tax authority to improve tax compliances and on the other hand to detect tax evasion or tax avoidance. Various audit programs is implemented to ensure the taxpayers comply with the legal provisions and the current tax regulations within Self Assessment System.

In 2009, the number of company and non-company cases audited was 1,399,660 compared to 1,052,939 cases in 2008. The amount of additional taxes and penalties earned from the resolution of audits in 2009 increased to RM3,054.95 million from RM1,697.16 million in 2008 (Lembaga Hasil Dalam Negeri Malaysia, 2010b). Table below present the statistics of tax audit resolved by IRBM.

*TABLE 1-1: Tax Audit Resolved by IRBM.*

<table>
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<th></th>
<th></th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td>Company Cases</td>
<td>27843</td>
<td>68456</td>
<td>185.99</td>
<td>529.67</td>
</tr>
<tr>
<td>Non Company Cases</td>
<td>1,025,096</td>
<td>1,331,204</td>
<td>1,511.17</td>
<td>2,525.28</td>
</tr>
<tr>
<td>Total</td>
<td>1,052,939</td>
<td>1,399,660</td>
<td>1,697.16</td>
<td>3,054.95</td>
</tr>
</tbody>
</table>

*Source: (Lembaga Hasil Dalam Negeri Malaysia, 2010b)*
In connection with that, this study may help the tax administration to organize an efficient enforcement task as well as redesign and revamp effective tax system especially in certain crucial sectors or industries.

Furthermore, corporate governance mechanism is seen as significant indicators that influence tax aggressiveness. Taxes are part of operating cost to a corporation and its shareholders (Desai & Dharmapala, 2007). Governance directly plays a role in tax management as the governors (board of directors) are responsible for resource allocation, performance and increase shareholder wealth (Minnick & Noga, 2009). It might be possible that tax aggressiveness is desired by shareholder to improve corporate value (Desai & Dharmapala, 2007).

In connection with that, corporate governance are view as an important factor that influencing tax aggressiveness. Thus, this study can provides greater understanding on the role of corporate governance to tax matters. In addition, since the tax department is an important financial statement user, this study can provides them better understandings on information stated in the annual report. Besides that corporate information such as board of directors, shareholders, statement on corporate governance and others can be use as a new channel to run the risk analysis in detecting tax avoidance and to perform tax audit.
1.6 Definition of Key Terms

The following section provides explanation on the variables used in the study and how they are used for the purpose of this study.

1.6.1 Tax Aggressiveness
Tax aggressiveness refers to the tax planning activities which is legal, illegal or activities that fall into gray area (Chen, et al., 2010), includes tax avoidance (Desai & Dharmapala, 2004), tax sheltering (Yeung, 2010) and tax cheating (Hanlon & Slemrod, 2007).

1.6.2 Corporate Governance
Corporate governance is the process and structure used to direct and manage the business and affairs of the company in order to maximize the shareholder value as well as consider the stakeholders’ interest (MCCG, 2007).

1.6.3 Duality
Duality exist when a single persons hold position as the CEO of the firm and also the chairman of board of directors (Wan Mohamad & Sulong, 2010).

1.6.4 Board Independence
Board independent refers to non-executive directors. Independence directors can be describe as independence from management and independence from the significant shareholders (Zulkaflı, Samad, & Ismail, 2006).
1.6.5 Board Size

Board size represents the number of directors on the board.

1.6.6 Institutional Investors

Institutional investors refers to the major investors in Malaysian public listed companies which are Employee Provident Fund (EPF), Permodalan Nasional Berhad (PNB), Lembaga Tabung Angkatan Tentera (LTAT), Lembaga Tabung Haji (LTH) and Social Security Organisation (SOCSO) (E.A. Abdul Wahab, 2010).

1.6.7 External Auditor

External auditor used in this study refers to big six firm which are Arthur Andersen, Coopers & Lybrand, Deloitte Touche, Ernst & Young, KPMG Peat Marwick, Price Waterhouse.

1.7 Organization of the Study

This study is arranged into seven main chapters and the outlines of the remaining chapters are as follows:

Chapter 2: Institutional Setting

This chapter present on the overview of the Malaysian institutional setting consist of the background and details of taxation and corporate governance reform in Malaysia.

Chapter 3: Literature Review

This chapter contains the review of the related literature in relation to the theories and empirical evidence pertaining to tax aggressiveness and corporate governance mechanism. The discussion on the corporate governance is focusing on board structure and composition
consists of duality, directors’ independent and board size and external mechanism which are institutional investor and external auditor.

Chapter 4: Theoretical Framework and Hypothesis Development

This chapter presents the discussion on theoretical framework, list of variables and followed by the development of the hypothesis.

Chapter 5: Research Methodology

This chapter presents discussion on research methodology and research design. The chapter starts with the research design and followed by the measurement of variables; also the statistical techniques in examining the relationship between tax aggressiveness and corporate governance mechanism.

Chapter 6: Results and Data Analysis

This chapter starts with the descriptive analysis for this study. The EViews statistical analysis is used in order to run the regression model and the results are summarized in the comprehensive table format for easier interpretation and justification.

Chapter 7: Conclusion

This chapter concludes the overall findings of this study. In addition, it also provides the implications and the limitations of the findings. The suggestions for future research are also recommended in this chapter.
CHAPTER 2
INSTITUTIONAL BACKGROUND

2.0 Introduction

This chapter represents an overview of Malaysian institutional settings. The background and details of Malaysian taxation is given in section 2.1 consist of the general information and background of taxation in Malaysia including detail of the income tax practices in Malaysia. Section 2.2 provides the background and details of Corporate Governance in Malaysia include the definition and the Malaysian Code on Corporate Governance as well as the Capital Market Master Plan in section 2.2.3. Finally section 2.3 concludes this chapter.

2.1 Taxation in Malaysia

2.1.1 Introduction

Taxation is one of the important elements in managing national income, especially in developed countries. Most of the countries around the world develop their nation primarily from income tax sources, either direct taxes or indirect taxes.

A direct tax is a tax which is paid directly by those on whom is levied, for examples; income tax or real property gains tax. On the other hand, indirect taxes is a tax which generally collected via some third party such as sales tax, service tax, excise duty, import and export duties and value added tax and service tax. Indirect tax is generally an additional to the price of a product or service and is collected by an intermediary who will then pay it over to the tax authorities (Singh, 2011). Table 2-1 below present the types of direct tax and indirect tax in Malaysia.
### TABLE 2-1: Types of Taxes in Malaysia

**Types of Direct Tax**

i. Income tax  

ii. Excess Profit Tax (EPT) – *abolished with effect year assessment 1991*  

iii. Supplementary Income Tax – *abolished with effect year assessment 1993*  

iv. Petroleum Income Tax  

v. Real Property Gains Tax (RPGT)  

vi. Share Transfer Tax (STT) – *repealed with effect from 21/10/1988*  

vii. Stamp Duty  

viii. Estate Duty – *repealed with effect from 01/11/1991*

**Types of Indirect Tax**

i. Custom Duties  

ii. Excise Duties  

iii. Service Tax  

iv. Sales Tax  

v. Goods & Service Tax (Future Development)

*Source: Veerinder on Taxation (Singh, 2011).*
Taxes are a source of income to the government. Government raise revenue through taxes in order to govern the nation effectively. Direct tax collection by Inland Revenue Board Malaysia (IRBM) contributes to 54.53% from the total income of the Federal Government in 2009 (Lembaga Hasil Dalam Negeri Malaysia, 2010b).

The Inland Revenue Board of Malaysia (IRBM) is one of the main revenue collecting agencies of the Ministry of Finance. IRBM was established in accordance with the Inland Revenue Board of Malaysia Act 1995 to give it more autonomy especially in financial and personnel management as well as to improve the quality and effectiveness of tax administration (Lembaga Hasil Dalam Negeri Malaysia, 2010a). The agency is responsible for the overall administration of direct taxes under the following Acts:

i. Income Tax Act 1967\(^\text{3}\),

ii. Petroleum (Income Tax) Act 1967\(^\text{4}\),

iii. Real Property Gains Tax Act 1976\(^\text{5}\),

iv. Promotion of Investments Act 1986\(^\text{6}\),

v. Stamp Act 1949\(^\text{7}\),

vi. Labuan Offshore Business Activity Tax Act 1990\(^\text{8}\).

---

\(^{3}\) The act is the binding law for tax assessments on individual, sole proprietor, partnership, company, cooperative, trust and association in Malaysia.

\(^{4}\) The tax imposed on Petroleum Companies.

\(^{5}\) This act is the binding law for the purpose of tax chargeable on gains of disposal of real property such as land, buildings and etc.

\(^{6}\) This act purposely gives outline of tax incentives given by the Government specifically on the Pioneer Status, Investment Tax Allowance, Infrastructure Allowance, Industrial Adjustment Allowance and Double Deduction for Promotion of Exports.

\(^{7}\) Stamp duty is a tax levied on a variety of written instruments specifically on legal, commercial and financial instruments.

\(^{8}\) Tax imposed on an offshore company in or from Labuan that is carrying out offshore business activities.
2.1.2 Taxation in Malaysia

The administration of the tax organization in Malaya during the early stages of its inception was headed by a Comptroller General appointed under the Income Tax Ordinance, 1947 to administer both the tax offices in the Federated Malay States and in Singapore. Income tax was first introduced in the Federated Malay States on 1 January 1948 with the enforcement of the Income Tax Ordinance, 1947. In 1967, this Ordinance was merged with the Income Tax Ordinance, 1956 of Sabah and the Income Tax Ordinance, 1960 of Sarawak to become the Income Tax Act, 1967 which came into force on 1 January 1968.

At the beginning, The Income Tax Office became known as the Income Tax Department and was then renamed the Inland Revenue Department (IRD) in 1957. Then on 1 March 1996, The Department of Inland Revenue Malaysia became a board and is now formally known as Inland Revenue Board Malaysia (IRBM) (Lembaga Hasil Dalam Negeri Malaysia, 2010a).

Since the enforcement of Income Tax Act 1967, Malaysia adopts an Official Assessment System (also referred to as 'Formal System') whereby IRBM will issue the annual tax returns and taxpayers have to submit the form within 30 days from the issuance date. It is the taxpayers' statutory duty to declare all the necessary information and particulars of their income and expenses for that particular year of assessment and submit the completed returns to the IRBM. Under the Formal System, it is assumed that taxpayers do not possess the necessary knowledge to compute their tax payable. The tax authority will assess taxes based on the information given by the tax payers (Palil, 2005).
Then, IRBM introduced Self Assessment System (SAS) and change the way of tax assessments. SAS has been implemented in Malaysia since 2001 by companies and were followed by business, partnerships, co-operatives, associations and also by employment income individuals in year 2004. The implementation of SAS is to enhance rate of voluntary compliance and minimize tax non-compliance. Under SAS, taxpayers have to compute and determine their tax liability according to the tax laws and Public Rulings, paying tax amount and filing tax returns within stipulated time frame. Furthermore, taxpayers are required to keep business records and maintain sufficient documentations for seven years (Md Said, 2010).

2.1.3 Income Tax

Income tax in Malaysia imposed only on Malaysian source of income. As defined by Section 3 of Income Tax Act 1967;

“A tax to be known as income tax shall be charged for each year of assessment upon the income of any person accruing in or derived from Malaysia or received in Malaysia from outside Malaysia”.

(Section 3, ITA 1967)

In other words, income tax is chargeable on income of any person (including individuals and company) which is made in Malaysia or received by a resident person in Malaysia from outside Malaysia. In addition, a company, whether resident or not, is assessable on income accrued in or derived from Malaysia. Income derived from sources outside Malaysia and remitted by a resident company is not subject to tax, except in the case of banking and insurance business and sea and air transport undertakings.
A company is considered a resident in Malaysia if the control and management of its affairs are exercised in Malaysia. Places of control and management are considered on the basis of where meetings of the Board of Directors are held. A tax rate of 25% is applicable to both resident and non-resident companies from 2009 and subsequent years of assessment. In the case of a company carrying on petroleum production, the applicable tax rate is 38%. Table below present the effective tax rates for company in Malaysia starts from year assessment 1988 to current update.

**TABLE 2-2 : Summary of Corporate Statutory Tax Rates in Malaysia**

<table>
<thead>
<tr>
<th>Year of Assessment</th>
<th>Tax Rates</th>
</tr>
</thead>
<tbody>
<tr>
<td>1988 and prior</td>
<td>40%</td>
</tr>
<tr>
<td>1989 to 1992</td>
<td>35%</td>
</tr>
<tr>
<td>1993</td>
<td>34%</td>
</tr>
<tr>
<td>1994</td>
<td>32%</td>
</tr>
<tr>
<td>1995 to 1997</td>
<td>30%</td>
</tr>
<tr>
<td>1998 to 2002</td>
<td>28%</td>
</tr>
</tbody>
</table>

2003 Company with paid up capital of RM2.5 million and below at the beginning of the basis period

- On first RM100,000 chargeable income - 20%
- On subsequent chargeable income – 28%

Company with paid up capital above RM2.5 million at the beginning of the basis period - 28%
<table>
<thead>
<tr>
<th>Year</th>
<th>Condition</th>
<th>On first RM500,000 chargeable income</th>
<th>On subsequent chargeable income</th>
</tr>
</thead>
<tbody>
<tr>
<td>2004 to 2006</td>
<td>Company with paid up capital of RM2.5 million and below at the beginning of the basis period</td>
<td>20%</td>
<td>28%</td>
</tr>
<tr>
<td>2007</td>
<td>Company with paid up capital of RM2.5 million and below at the beginning of the basis period</td>
<td>20%</td>
<td>27%</td>
</tr>
<tr>
<td>2008</td>
<td>Company with paid up capital of RM2.5 million and below at the beginning of the basis period</td>
<td>20%</td>
<td>26%</td>
</tr>
</tbody>
</table>


<table>
<thead>
<tr>
<th>2009 and subsequent</th>
<th>Company with paid up capital of RM2.5 million and below at the beginning of the basis period</th>
</tr>
</thead>
<tbody>
<tr>
<td>years</td>
<td></td>
</tr>
</tbody>
</table>

- On first RM500,000 chargeable income - 20%
- On subsequent chargeable income – 25%

Company with paid up capital above RM2.5 million at the beginning of the basis period - 25%


In Malaysia, Company’s income tax is the main contributor to direct tax collected which is according to IRBM in their Annual Report 2009; companies’ taxes contribute RM40.27 billion which is 45.55% of the total revenue collection. This was followed by petroleum income tax and individual income tax which contribute to 30.80% and 17.62% respectively. Figure 2-1 below provides the statistic of the direct tax collected by types in year 2009.

Due to the economic recession, the performance of collection for most direct tax components declined in year 2009 except for petroleum, individual and co-operative taxes. In year 2008, income tax collected from companies is RM46.90 billion which is 51.74% of the total collections. This was followed by petroleum income tax and individual income tax, contributing 26.69% and 15.83% respectively.
FIGURE 2-1: Direct Tax Collected By Components 2009

REVENUE (RM in Billion)

- Companies: RM40.27 (45.55%)
- Petroleum: RM27.23 (30.80%)
- Individual: RM15.57 (17.61%)
- Co-operative: RM0.55 (0.62%)
- Stamp Duty: RM3.37 (3.81%)
- Witholding Tax: RM1.33 (1.50%)
- RPGT: RM0.04 (0.05%)
- IOFC: RM0.02 (0.02%)
- Others: RM0.03 (0.03%)

Source: (Lembaga Hasil Dalam Negeri Malaysia, 2010b)
2.2 Corporate Governance in Malaysia

2.2.1 Introduction

Corporate governance is the whole system of controls for a firm. Its main focus lies on the role of the “governors” which is the board of directors in directing and control all the activities in the company (Haron, 2009).

A definition by the Finance Committee on Corporate Governance in Malaysia in the Report on Corporate Governance (2002) stated that:

“Corporate governance is the process and structure used to direct and manage the business and affairs of the company towards enhancing business prosperity and corporate accountability with the ultimate objective of realizing long term shareholder value, whilst taking account the interests of other stakeholders”.

The operations as well as the governance of companies in Malaysia is affected by laws, regulations and standards consist of company law; securities laws and regulations (including prohibitions on insider trading); exchange listing requirements; financial accounting standards, insolvency laws and regulations and on a wider level, contract, labour, employment, commercial laws and regulations and consumer protection laws (OECD, 1999). The Malaysian Companies Act 1965, administered by the Registrar of Companies, sets out requirements for the companies incorporated in Malaysia including the birth, death and existence of companies. It provides fundamental rules governing procedures for incorporation, the basic constitutional structure and the cessation of existence of companies.
The corporate governance initiative started in Malaysia with the establishment of Finance Committee on Corporate Governance (FCGG) by the Government in 1998 (Zulkafli, et al., 2006). In 1999, this committee made two important recommendations which is the passage of the Malaysian Code on Corporate Governance (MCCG) and the establishment the Minority Shareholders Watchdog Group (MSWG). Then, after a brief “self-regulatory” period, the MCCG became an integral part of the Bursa Malaysia (formerly known as KLSE) Listing Rules in the year 2001 (E.A. Abdul Wahab, How, & Verhoeven, 2007; E. A. Abdul Wahab, Mat Zain, & James, 2011).

Besides the MCCG, PLC”s corporate governance in Malaysia are clearly stated in Bursa Malaysia Listing requirements (Chapter 15) and also various acts and regulation such as the Companies Act 1965, The Companies Regulation 1966, The Security Industry Act 1983 and Securities Commission of Malaysia under the Ministry of Domestic Trade, Co-operatives and Consumerism (Haron, 2009).

In addition, Capital Market Master Plan (CMP) by Securities Commission and Financial Sector Master Plan (FSMP) by Bank Negara Malaysia on the financial sector is also the main contributor to the reformation of Corporate Governance in Malaysia (Zulkafli, et al., 2006).

2.2.2 Malaysian Code on Corporate Governance

Malaysian Code on Corporate Governance was officially released in March 2000. It provides new impetus in corporate governance reform in Malaysia. It sets out principles and best practices of good governance, and described the structure of corporate governance and internal process optimization. It provides direction for the implementation and charts the future prospects of corporate governance in Malaysia.
The code is hybrid in nature, which is similar to the Combined Code on Corporate Governance (United Kingdom). Under the approach, the companies in Malaysia should apply the broad principles of good corporate governance codified by the code flexibly and with common sense to the varying circumstances of individual companies.

The code has two primary objectives. The first objective was to encourage corporate disclosure by providing investors with sufficient and timely information when the investment decision is made. The second objective is to serve as guidance to the board of directors by clarifying their responsibilities and providing prescriptions to strengthen the control they used (E.A. Abdul Wahab, 2010).

Since the release of the Code, the Malaysian corporate scene has achieved significant improvement in corporate governance standards. The mandatory reporting of compliance with the Code has enabled shareholders and the public to evaluate and determine the standards of corporate governance by listed companies.

In addition, the code was reviewed in 2007 to further strengthen corporate governance practice in line with the developments in the domestic and international capital markets. It’s provides further guidance on the quality of the board of directors, the audit committee as well as the internal audit function of the Public Listed Companies. In particular, it’s stress on the important of five main areas which are expertise, communication, independency, disclosure and role of internal audit function.
Generally, the code was divided into 3 parts which is consist of Part 1 – The principle of Corporate Governance, Part 2 – Best practices in Corporate Governance and Part 3 – Principles and best practices for the other corporate participants.

Part 1 sets out broad principle of good corporate governance for a firm. Continuity from this part has become guideline in the Bursa Malaysia Listing Requirement. The principles underlying the report focus on four areas including: board of directors, director’s remuneration, shareholders and accountability and audit. It’s a narrative explanation of how the relevant principles have been applied in the company and have to be stated clearly in the annual report as a disclosure sufficiently for investors to assess the firm.

Part 2 sets out the best practice in corporate governance consist of the guidelines of best practices in connection with the board of directors, accountability and audit, shareholders. It’s stated clearly the responsibility, best conduct, procedure and limitations of corporate governance.

Part 3 is principles and best practices for other corporate participants is addressed primarily to institutional investors and auditors and is aimed at enhancing their role in corporate governance. Table 2-3 provides the principle of corporate governance stated in MCCG.