





DIRECTORS REMUNERATION AND TAX PLANNING OF LISTED COMPANIES



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ABSTRACT

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Remuneration may be given in the form of incentives for the directors to engage in tax planning activity. The purpose of this study is to examine the relationship between directors' remuneration and book tax differences (BTDs) as a proxy for tax planning. A sample of 500 Malaysian listed companies for the period of 2014-2016 were obtained and examined. Several control variables such as company size, leverage, capital intensity, and board size that have an impact on tax planning are used in this study. The directors' remuneration and board size data were collected from annual reports and all remaining financial data were collected from Eikon DataStream. The results show that there is a positive significant relationship on directors' cash remuneration on tax planning activity. Based on the findings, it is proven that directors' remuneration is an important factor in motivating directors to engage in tax planning activity in the company. However, directors' non-cash remuneration showed a negative significant relationship with tax planning. Non-cash remuneration may reduce directors' interest in engaging with tax planning because it exposes risk of stock fluctuation in price in the market and increase agency costs to minority shareholders. All control variables significantly impact company tax planning as well. Suggested future research include the use of other tax planning variables such as permanent and temporary BTDs, and deferred tax assets.

Contribution/ Originality: The contribution of this study is two-fold. Firstly, unlike previous study (Wahab *et al.*, 2011) which examines the relationship between total remuneration and tax planning, our study separates total remuneration into cash and non-cash remunerations. Secondly, we extend the findings of previous study (Wahab *et al.*, 2011) by using BTDs as the proxy for tax planning.

1. INTRODUCTION

Directors' remuneration has been an indicator of director performance in the eyes of the public, shareholders as well as to the policy makers. It also acts as a motivating factor for directors to be involved in tax planning to reduce the companies' effective tax rate (ETR). Shareholders generally consider the reasonableness of director remuneration packages so as not to over-remunerate them which may lead to complacency and hence an adverse

effect on motivation levels. Thus, companies are required to be more transparent in their remuneration disclosures such as amount of remuneration and the different remuneration components such as salaries, bonuses and benefit. The Malaysian Code on Corporate Governance (MCCG) also advises companies to disclose their remuneration details for each director and to link executive directors' remuneration to company performance, which involves efforts in tax planning.

In Malaysia, the limit for remuneration is non-existent. Utilizing or manipulating the level of remuneration would appear to be a potential tool to motivate directors to engage in tax planning to reduce tax expense. The *News Strait Time (2006)* reported that despite companies suffering losses over time, the said companies still rewarded or compensated their directors well. This indicates that the performance of the companies would have a negative influence on directors' remuneration. The reason behind the rewarding of directors despite suffering losses could be the efficient tax planning activity performed.

Corporate tax reform in Malaysia has also influenced the tax planning activity. Similar to other countries, Malaysia has undergone several tax reforms to lower the tax burden, thereby increasing the competitiveness of local businesses and attracting foreign investments. However this will also reduce government tax revenue as the effective tax rate (ETR) is reduced. ETR refers to the percentage of taxes that the corporation must pay on their taxable income; companies can utilize the tax credits and incentives given from Malaysian Government to reduce their ETR. In Malaysia, tax incentives can be given through income exemption or allowances. Normally, shareholders will receive dividends tax-free when the relevant income is exempted. Where incentives are given in the form of allowances, any unused allowances can be carried forward to be set-off against future statutory income. A number of incentives are available to industries in Malaysia such as Pioneer status (PS) and Investment Tax Allowance (ITA) (*PricewaterhouseCoopers, 2019*). There are a variety of methods available to the companies to reduce their effective tax rate and taking advantage of tax credits is one way, as well as directors' engagement in tax planning activity. Prior studies showed that a positive level of significance of directors' remuneration as a tax-motivated expense *Wahab et al. (2011)*. The authors used tax savings as a tax planning proxy. The results were consistent for the period 2007-2009. Remunerations are given to compensate the directors and serves as a motivation boost for the directors to perform tax planning efficiently. Nevertheless, tax planning is difficult to achieve if a crisis affects the company in the form of corporate tax reforms, lower or complete abolishment of tax incentives, corruption within the companies, falling revenue, high level of expenses and/or liabilities, and other factors directly or indirectly affecting corporate activities.

The contribution of this study is two-fold. Firstly, unlike previous studies (*Wahab et al., 2011*) which examines the relationship between total remuneration and tax planning, our study separates total remuneration into cash and non-cash remunerations. *Razali et al. (2018)* mentioned that the non-cash remuneration makes the directors more committed to the company which leads to better performance. Secondly, we extend the findings of previous study (*Wahab et al., 2011*) by using BTDs as the proxy for tax planning. Therefore, the main objective of this study is to examine the relationship between directors' remuneration and tax planning. This study also examines other factors that could affect tax planning such as company size, leverage, capital intensity; board size is used as a control variable.

2. LITERATURE REVIEW

2.1. Stakeholder Theory

The stakeholder theory (*Jensen, 2001*) makes reference to the responsibility of a director to control and maintain positive work ethics. Stakeholders can be divided into two: external stakeholders which include suppliers, society, government, creditors, shareholders, and customers who do not have any involvement with the business processes but contribute indirectly to the company's business, and internal stakeholders which comprise employees, managers, and owners. Each of the stakeholders can influence the business decision making process and progress.

For example, the government is responsible for regulating new laws (such as corporate tax reforms) that either benefit or endanger the business. On the other hand, if the director's remuneration is increasing it may cause conflict between directors and employees. This is especially so if company profits are increasing but the employees are not rewarded accordingly, while directors' remuneration is maintained or even increased.

Garcia-Torea *et al.* (2016) showed that the board of directors would cater to both the shareholders and stakeholders in a balanced way. This is due to the fact that the financial reports of the company can be viewed and assessed by anyone, internal or external to the company.

The directors need to ensure that the companies have a positive relationship between them and fellow stakeholders and the tax planning activity should be conducted based on the interests of all. Jensen (2001) also mentioned that the company must ensure that everyone's interest is aligned with the company's objectives so that high performance business activity is achieved. As such, efficient tax planning would increase overall profitability and long-term company value, which in return contributes to the remuneration of directors.

2.2. Agency Theory

Agency theory is a concept whereby an agent (normally, Chief Executive Officer or management) works on behalf of principals (shareholders); an agent is given the trust and resources to maximize shareholders' wealth. By controlling their incentives, the principals can motivate agents to perform (Amernic, 1984; Eisenhardt, 1989; Gomez-Mejia and Balkin, 1992a; Gomez-Mejia and Balkin, 1992b). As shareholders are the owners of the company, they have the authority to hire and fired management as and when necessary. This shows that shareholders have the power and resources that are needed by management to run the company efficiently since shareholders are normally not operationally involved.

However, as agents and principals may have different approaches towards specific problems or issues, serious conflicts may occur. Managers tend to work towards fulfilling their self-interests rather than maximizing shareholders' wealth (Jensen and Meckling, 1976). As shareholders are not normally involved in management, the information possessed by shareholders and management may differ when it comes to problem solving. Harris and Raviv (1979) mentioned that manager preferred to be remunerated that does not bear any additional risk.

Chyz and White (2014) showed that companies with a lack of monitoring on CEO activity exhibit agency conflicts and tax avoidance. However, such conflict would not exist in larger companies due to the high level of monitoring. Directors who are actively involved in tax planning could be misaligned with risk-adverse directors who may prefer not to be involved in high-risk activity, potentially adversely impacting the company, shareholders and their own remuneration structure. However, by actively engaging in tax planning activity, the amount of remuneration received by both directors and shareholders could be catered for. This could motivate the director to engage in tax planning activity as the remuneration can be adjusted by eliminating unnecessary purchases and generating more revenue effectively.

However, some might perceive tax planning activity to represent tax aggressiveness or even tax avoidance (reduction in taxes through tax planning) as defined by Frank *et al.* (2009) although it can be beneficial for both company management and shareholders. However Halioui *et al.* (2016) noted a negative relationship between corporate governance components such as board size, CEO compensation, stock options and tax aggressiveness on ETR, indicating that there is no agency problem relating to tax planning activity.

2.3. Director Remuneration and Tax Planning

Tax planning is how a corporation manages or exercises their tax activity to yield more after-tax returns. Past literature has consistently shown that effective tax planning (ETR) has a significant impact on the total amount of remuneration received by the directors. Kawor and Holy (2014) noted that the companies' tax savings decreased as the government reduced the statutory corporate income tax rate; this infers that a low tax rate is conducive for best

tax planning activity. Furthermore, Wahab *et al.* (2015) noticed that having directors of the Chief Executive Officer ilk and departing CEO tenure are factors in influencing tax planning. This indicates that the background of the CEO is an important thing to be considered when appointing a CEO, as an experienced one is worth more than one who is inexperienced (Zahra and Pearce, 1989; Hart, 1995). This was concurred by Dyreng *et al.* (2010). Desai and Dharmapala (2006) also highlight the potential impact of remuneration on tax planning. Based on these studies, there is a potential indication that a directors' remuneration is a factor that influences their motivation in pursuing tax planning activities. Furthermore, the net cash flow, operational, and tax planning activity can increase or decrease based on changes in corporate tax rates (Ewert and Niemann, 2014). These findings can be explained from the motivation shown by directors in complying with tax planning needs to reduce the effective tax rate (ETR) and potentially increasing remuneration received. Lestari and Wardhani (2015) noted a positive correlation between tax planning and company value which indicates that efficient tax planning activity would have an incremental increase in company value which would then affect the directors' compensation.

The companies' goal is generally to minimize their tax expense and this is where tax planning is important. In short, a lower ETR is beneficial for corporate survivability as they would receive more reward. As such companies would compensate their directors' efforts in minimizing the company's ETR. In fact, most companies would expect their directors to efficiently manage the tax planning activity as it is an implied condition from shareholders to the directors. Phillips (2003) found that tax planning activity in lowering the corporation's ETR is influenced by CEO compensation, coupled with high remuneration incentives for the directors (Armstrong *et al.*, 2012).

Gaertner (2014) noted a negative relationship between after-tax incentives and ETR. However, the utilization of after-tax measurement in directors' remuneration results in higher tax savings for the corporation. Thus, companies that use after-tax compensation should pay their executives additional incentives for the extra risk faced; otherwise, the executives would not settle for such terms (Schmittiel, 2014). The level of tax planning activity is dependent on the size of the company and offshore operations as larger companies pay higher taxes compared to smaller companies; and hence the former would actively engage in tax planning activity to reduce the amount of taxes payable.

3. METHODOLOGY

3.1. Sample Description and Data Collection

For sample selection, data is collected from the Bursa Malaysia website as well as from DataStream. The final sample of this study comprised of 500 Malaysian listed companies excluding the bank and financial sectors over a 3-year period between 2014 to 2016. The director remunerations and board size information are manually collected from the company annual reports. Data on leverage, capital intensity and company size was drawn from DataStream.

3.2. Regression Analysis

The model used to test the hypothesis is as follows:

Functional Form:

Book-Tax-Difference = Cash Directors Remuneration + Non-Cash Directors Remuneration + Company Size + Capital Intensity + Leverage + Board Size

Alternative Form:

$$BTD_{it} = C + \beta_1 C_DR_{it} + \beta_2 NC_DR_{it} + \beta_3 CSIZE_{it} + \beta_4 CAPINT_{it} + \beta_5 LEV_{it} - \beta_6 BSIZE_{it} + \epsilon_{it}$$

Dependent Variable

BTDs = Book-Tax-Differences

Independent Variable

C_DR = Cash Director Remuneration
 NC_DR = Non-Cash Director Remuneration

Company-specific characteristics

FSIZE = Company Size
 CAPINT = Capital Intensity
 LEV = Leverage

Board Characteristic

BSIZE = Board Size

Others

i = Company
 t = Time
 ε = Error Term

4. RESULTS AND DISCUSSIONS

Table-1. Descriptive statistics.

Variable	Mean	Median	Maximum	Minimum	Std. deviation
Dependent variable					
BTDs	-9.79	19.26	-0.0608	0.97222	-9.79
Independent variables					
C_DR (RM)	6,659,736	2,237,410	1,130,000,000	191,820	31262552.81
NC_BIK (RM)	101,297.7	27,510	2,989,000	0	273550.06
Company-characteristics					
CSIZE	8.6490	8.5965	10.6381	6.0208	0.6640
CAPINT	2.8747	1.5282	34.6752	0.2588	4.3907
LEV	0.4090	0.4075	0.9130	0.0304	0.1952
Board-characteristic					
BSIZE	7.5	7	22	3	2.093

Table 1 represents descriptive statistics of all variable from our sample. The mean value of book tax differences (BTDs) is -9.79 times. The BTDs is calculated by deducing estimate taxable income from profit before tax and then divide the value with the previous year's total asset of each companies. The cash directors' remuneration (C_DR) is calculated by salary and bonus and the mean is RM6, 659,736 while the range is from RM191,820 (minimum) to RM1,130,000,000 (maximum). The second independent variable is non-cash directors' remuneration (NC_DR) which is a form of incentive not in cash form and may consist of bonds, stocks and options. Benefits-in-kind is also part of NC_DR and can be obtained from the annual report. The average NC_DR for sample companies is RM101,297.70 and ranges from 0 to RM2,989,000.

The first company-specific-characteristic is company size (CSIZE). CSIZE is the log of total assets of the companies. The mean of CSIZE for the sample companies is 8.6490. The minimum and maximum values are 6.0208 and 10.63808 respectively. The next company-specific-characteristic is capital intensity (CAPINT) which is calculated by dividing total assets by sales. The mean of the capital intensity is 2.8747 times and the minimum and maximum values are 0.2588 and 34.6752 respectively. Leverage (LEV) is calculated by total liabilities divided by total assets and the mean is 40.90% while the minimum and maximum values are 3.042% and 91.30% respectively.

Lastly, board size (BSIZE) represents the number of people working as directors on the board. The mean of BSIZE is 7.5 and the range is from 4 (min) to 16 (max).

Table-2. Pearson correlations.

Variable	BTDs	C_DR	NC_DR	C Size	CAPINT	LEV	B size
BTDs	1						
C_DR	.000	1					
	.499						
NC_DR	-.349***	.208***	1				
	.000	.000					
CSIZE	.106***	.074***	.098**	1			
	.000	.003	.011				
CAPINT	.004	-.011	.049	.148***	1		
	.443	.337	.126	.000			
LEV	-.077***	.021	.080***	.194***	-.053**	1	
	.002	.222	.030	.000	.024		
BSIZE	-.049**	.091***	.103***	.264**	-.038*	.085***	1
	.034	.000	.008	.000	.079	.001	

***. Correlation is significant at the 0.01 level, **. Correlation is significant at the 0.05 level, and *. Correlation is significant at the 0.10 level.

Table 2 shows the Pearson correlation coefficients between the variables for the study sample. Correlation analysis is used to describe the strength and direction of the linear relationship between two variables. From the above table there is no high multicollinearity among the variables because the coefficient correlation is not near to -1 or +1. The BTDs has a negative relationship with NC_DR and LEV at 0.01 significant level. It also has a negative relationship with BSIZE at 0.05 significant level. The BTDs has only a positive relationship with CSIZE at 0.01 significant level. C_DR has a positive relationship with NC_DR, FSIZE and BSIZE at 0.01 significant level. NC_DR has a significant positive relationship with CSIZE, LEV and BSIZE at p-value less than 0.01. In relation to control variables, CSIZE has positive relationships with CAPINT, LEV, and BSIZE at 0.01 significant level. Both LEV and BSIZE has negative relationships with CAPINT at significant levels of 0.05 and 0.1 respectively. Finally, LEV has a positive relationship with BSIZE at 0.05 significant level.

Table-3. Regression random effect model analysis.

Variable		Overall
C	Coefficient	-4.4578***
	T-statistic	-7.447
	Prob	0.000
C_DR	Coefficient	0.070*
	T-statistic	1.808
	Prob	0.071
NC_DR	Coefficient	-0.360***
	T-statistic	-9.288
	Prob	0.000
FSIZE	Coefficient	0.352***
	T-statistic	8.481
	Prob	0.000
CAPINT	Coefficient	-0.097**
	T-statistic	-2.565
	Prob	0.011
LEV	Coefficient	-0.126***
	T-statistic	-3.173
	Prob	0.002
BSIZE	Coefficient	-0.162***
	T-statistic	-4.091
	Prob	0.000
R-squared		0.235
Adjusted R-squared		0.225
ANOVA P-value		0.000

***. Correlation is significant at the 0.01 level, **. Correlation is significant at the 0.05 level, and *. Correlation is significant at the 0.10 level.

Table 3 shows that the influence of book-tax differences (BTDs) as a proxy for tax planning together with the variables (cash director remunerations, cash director remunerations, board size, leverage, capital intensity, and company size) have a value of adjusted r-square of 0.225 and ANOVA P-value (F-Statistics) of 0.0000. The ANOVA value indicates that the model is fitted and suitable for academic purposes as it is less than 0.01. The adjusted r-square value of 22.5% indicates that overall test can explain the relationship between BTDs and all other variables.

There is a positive significant relationship between cash directors remuneration (C_DR) and BTDs at 0.071 with 0.10 level of significance. This shows that directors' remuneration is the variable needed in managing tax planning activity. This result is consistent with Wahab *et al.* (2011). Khalid *et al.* (2014) noted that pay-for-performance has a positive impact on financial companies in Pakistan. Matolcsy (2000) found a positive relationship between directors' remuneration and company profitability which signifies the directors' motivation to engage in tax planning activity.

However, there is a negative relationship between non-cash director remuneration (NC_DR) and book tax differences (BTDs) at 0.01 significant level. Non-cash remuneration may reduce the directors' interest in engaging in tax planning because it exposes their benefits in kind (eg stock, options and etc) to brokerage costs, discount rate, and price fluctuation (Matsunaga *et al.*, 1992). Campbell *et al.* (2016) indicated that non-cash remunerations are linked more to market performance (market capitalization, share price, and EPS) rather than financial performance such as profitability, tax planning, and growth. Another possible reason is that Malaysian corporate ownership structure is highly concentrated and hence, remuneration in form of non-cash remuneration could increase director-shareholder control, leading to higher agency costs to minority shareholders.

The firm size has a significant positive relationship with tax planning at 0.01 significant level. This supports by Gaertner (2014). A large firm has the capability and resources to perform better compared to a smaller company especially in tax planning. Larger companies employ many tax experts and can pay a high cost for the said experts. Desai and Dharmapala (2006) argue that large companies also pay less tax due to dedicated efforts to tax planning.

There is a significant negative relationship between capital intensity (CAPINT) and tax planning activity at 0.05 significant level. This is not consistent with Cai and Liu (2009). High capital intensity ratio is due to high usage of company assets, or the business is more capital-intensive and less labour-intensive. A higher investment in capital assets would give rise to more capital allowance claims by the company, thereby reducing overall tax expense. However, this study shows that capital intensity has a negative significant relationship with tax planning. One possible reason as pointed by Muritala (2018) is assets do not have much impact on the business environment for companies not listed under the manufacturing sector.

There is a significant negative relationship between leverage (LEV) and tax planning activity at 0.01 significance level. This contradicts (Newberry and Dhaliwal, 2001) who noted that debt could act as a tax shield, and additional debt would cause incremental increase of cash outflows in the form of interest payments by an amount which is greater than the tax savings which the interest expense would yield. The negative relationship found in this study may be due to the debt holders restricting the companies from engaging in aggressive tax planning which could put their claims at risk.

The results show a positive significant relationship between board size (BSIZE) and tax planning, yielding a result of 0.000 at 0.01 significance level. This is in contrast with Halioui *et al.* (2016) which found a significant negative relationship between board size and tax planning (measured by ETR). It has to be noted that book-tax-difference and effective-tax-rate do not share any similarities, however both are used as measurement for tax planning activity. The negative relationship may be due to the lack of monitoring by a larger board which will lead to higher agency cost compared to a small board which is more flexible in its approach (Bonn *et al.*, 2004).

5. CONCLUSION AND RECOMMENDATION FOR FUTURE RESEARCH

The cash directors' remuneration tested in this study has a positive significant relationship with tax planning activity. This signifies that the directors' motivation to engage in tax planning activity is linked to cash remuneration received by them. Therefore, companies should increase directors' cash remuneration to obtain good tax planning performance which would increase overall company profitability.

However, there is a negative relationship between non-cash director remuneration and tax planning. Non-cash remuneration may reduce directors' interest in engaging tax planning because of the exposure to brokerage costs, discount rate and stock price fluctuation in the market. The stock market is volatile and due to this, the directors would not be interested in any kind of incentive that is not cash. Malaysian corporate capital ownership is also highly concentrated, and hence increase in non-cash remuneration could increase the controlling power of director-shareholders which could lead to higher agency costs to minority shareholders.

Company size and board size were noted to have relationships with tax planning, as found by prior studies. However, contradictory findings with prior studies were noted for control variables capital intensity and leverage. Capital intensity has a negative relationship with tax planning, possibly due to the fact that assets may not have much impact on the business environment in companies not in the manufacturing sector. High leverage in a company may lead to debt holders' restricting the companies from engaging in aggressive tax planning behaviour which could put their claims at risk.

For future research, variables such as return on asset (ROA), return on equity (ROE), and ownership structure can be tested on whether they have an impact on tax planning activity. Focus on certain industries such as manufacturing could give new insight because as different effects may be noted. Apart from that, various measures of tax planning performance could be explored such as permanent and temporary BTDS, and deferred tax assets.

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