

Effective Tax Rates of Shariah Compliant Companies: Importance of Tax Related Expenses and Zakat Contribution

¹Nik Mohd Norfadzilah Nik Mohd Rashid, ²Mohd Fadzlee Malik,
¹Rohaya Md Noor, ²Zuraidah Mohd Sanusi and ¹Nadiah Abd Hamid

¹Faculty Economics & Management Science,
Universiti Sultan Zainal Abidin, Terengganu, Malaysia

²Faculty of Accountancy,
Universiti Teknologi MARA, Puncak Alam, Selangor, Malaysia

Abstract: This paper empirically examined the level of tax compliance of shariah compliant companies in Malaysia. The study further. A final sample of 59 shariah companies were selected from top 100 best-performing shariah compliant companies listed on Bursa Malaysia from the years 2009 until 2013. A balanced panel data from 59 shariah compliant companies provided evidence that only seven companies have reported zakat payment. The statistical results also disclosed that the average ETRs for 59 shariah companies during the years 2009 to 2013 was 22% as compared to the STR of 25% which indicate 3% of tax gap below the tax compliance level. Multiple regressions results further provided evidence that factors contributed to the ETRs level were exempted income & tax incentives, disallowable expenses, zakat, deferred tax, leverage, capital intensity and tax consultants. Hence, the study provided useful feedbacks to the policymakers for future reformation of tax policies.

Key words: Shariah Compliant companies • Zakat • Tax Compliance and ETRs

INTRODUCTION

The Malaysian Prime Minister, Datuk Seri Najib Razak has recently announced the launching of the Malaysian Shariah Index, a complete Islamic shariah yardstick that supplements the requirements of Islamic governance. This index has initiated Malaysia to a new milestone by being the very first country in the world to implement the shariah index which expects to be used as a benchmark by other nations for its Islamic accomplishments and law implementation (Bernama report [1]).

This announcement is a continuous effort of the Malaysian government to improve its Islamic business regulations in Malaysia. Tan Sri Dr. Zeti Akhtar Aziz, Governor of the Central Bank of Malaysia has expressed the same views in her keynote address in the Financial Intelligence Summit [2]. According to her, the Islamic financial landscape has evolved over the years. With the

robust institutional arrangement and regulatory standards, it will enhance the potential of Islamic principles to achieve sustainability in a challenging environment.

Akram [3] cited that shariah signifies a source of water or a path to it. The shariah comprises of: rulings (*ahkam*) that covers all aspects of belief system (*aqidah*); the relationship between individuals and God (*ibadah*); and connection between both parties (*muamalah*). It is also related to the morality and ethic issues (*akhlaq*). The shariah in Islamic perspective is an extensive framework that represents the entire set of norms, value and laws that governs all aspects of life (Quran 42:13, 21, 45:18) [4, 5]. Accordingly, it can be said that shariah comprises of achieving both the goals and objectives of Islamic principles in our life. In this regards, they are the standards, criteria, value and direction to be applied in handling the daily, worldly problems faced by mankind and nurture the direction of life for hereafter.

Abiding to the Islamic path, the Muslim stakeholders are supposed to play their role in ensuring the accountability and responsibility to seek Allah's pleasure (*redha*) and his rewards in the hereafter. Hence, it is well understood that the Islamic financial reporting have significant impact on the Malaysian capital market since it not only benefits the corporate governance issues but also provides guidance on the transparency of the financial statement and tax reporting. If such goals can be achieved, it is believed that the shariah principles may influence the robustness of the capital market so as to create more awareness of management accountability among businesses or entrepreneurs in Malaysia.

The purpose for this paper is to achieve two basic objectives. The first objective is to examine the level of tax compliance of shariah compliant companies in Malaysia. The second objective is to examine how tax related expenses and zakat influenced the level of effective tax rates (ETRs) of shariah compliant companies. The list of the shariah compliant companies reported as at 30th May 2014 was obtained from the Shariah Advisory Council, Security Commission of Malaysia (hereafter SAC).

The remainder of this paper is organized as follows. Section 2 discussed the literature review of the previous studies related to *zakat* reporting, tax compliance and factors that influenced ETRs level of shariah compliant companies in Malaysia. The research model is explained in Section 3 while findings and analyses are elaborated in Section 4. Finally, Section 5 summarise the findings of this study.

Related Literature: Islamic finance refers to a mode or system of the businesses or organisations that complies with Islamic law (SCM, 2014). Based on Islamic law known as shariah, it governs the principles of mutual risk and profit sharing between parties, prohibits interest payments, ensure the effectiveness of commitment towards the fairness of all kinds of business transactions activities. These principles are in line with the Islamic core values for business and the financial system by prohibiting activities that involved interest (*riba'*), gambling (*maisir*) and speculation (*gharar*). Liberalisation in the Islamic finance market has also made Malaysia as a destination hub for Islamic banking business thus creating a full fledged Islamic banking and finance institution including local and international Islamic financial institutions in Malaysia [6].

Kusuma and Sukmana [7] highlighted that zakat is one of the five pillars of Islam and is a key aspect of the Muslim economy. The accumulation of wealth and the practise of zakat contribution should eradicate one of the

most perennial problems in Muslims society which is poverty [8]. The determination for the amount of zakat is measured from the financial report based on individuals or organization's benefits and liabilities. Under normal circumstances, taxable income is computed based on the items on the financial report specifically net profit or income produced [9].

The disclosure of zakat in the financial reporting is referred to as *maslahahmu'tabarrah*. This term according to Yusoff Al-Qardhawi cited in Hashim [10] refers to justification of necessary legislations or tax legislations that either upheld or nullified them. This has caused the zakat disclosure to be a significant component in the financial reporting of shariah compliant companies in Malaysia. This is due to the fact that the Muslim stakeholders of these shariah compliant companies need to know how their investments are used, for what purpose and whether the usage of the business resources have been spent according to Islamic shariah principles. According to Lewis [11], Islamic business organisations must be operated in view of Islamic values in order to be fair, honest and just towards others. Therefore, a wider concept of shariah compliant companies is needed to lead companies in managing their resources and ownership as an *amanah* to the shareholders and society [12].

Theoretically, most of the researchers argued that aggressive tax planning is one of the push factors for expanding gaps between ETRs and STR. Indeed, there is a need for the tax authorities to investigate any wrongdoings or irregularities incurred during the year of assessment where tax reporting is submitted. According to Lev and Nissim [13], temporary differences applied when business income or expenses are recognised in different periods of the financial statement as compared to the tax returns submitted to the tax authorities. On the other hand, permanent differences occurred when expenses recognised in the financial statement are not allowed for tax deduction purposes. Hanlon, Laplante and Shevlin [14] reported that the gap between both systems has attracted much attention nowadays. Frank, Lynch and Rego [15] discovered that the existence of tax planning in financial reporting have resulted in the increasing of tax shelter activities in the corporate world. In contrast, Mills and Newberry [16] depict that the gap shows the reflection or earnings management compared to tax planning activity.

A number of literatures have also described that large differences or known as a tax gap between financial statement reports to the shareholders varies to the report submitted to the tax authority as a symptom of

deterioration of earnings quality [13, 16]. Hoffttman [17] indicated that tax business planning is the capacity of the business to manage its operations either for the purpose of personal income or business activities in which to minimize the tax burden. Frank *et al.* [16] revealed that companies are more willing to report higher financial reporting to the shareholders but in contrast are eager to report lower tax reporting income to the authorities. Mill and Newberry [18] opined that the company may execute tax planning strategies by reducing their tax reporting income but at the same time did not lower their financial reporting income as well. Abde Alfatah Slehat [18] stressed that the reason why there is an existing gap between STR and ETRs among enterprises is the possibility of criminal fraud happening in the business world. Such criminal fraud activities occurs when the tax payers tried to reduce their tax burden since they feel that the normal rate of STR imposed on them is still too high. Plesko [19] argued that the tax gap can lead to differences in declaring income report to stakeholders.

Similar conclusions were drawn by other literatures. Rohaya *et al.* [20] revealed that companies will opportunistically use the diverse rules between financial and tax reporting to strategise business tax planning. In addition, Rohaya, Fadzilah and Nor'Azam [21] suggest that the corporate tax system has caused the Malaysian companies to engage in aggressive tax planning as they will then be able to enjoy a substantial amount of tax incentives provided. Gupta and Newberry [22] mentioned that larger entities have more political power to enjoy benefits such as tax holidays and tax treatment compared to small entities. Derashid and Zhang [23] also pointed out that larger enterprises have more political power to control business operations and strategic directions since they have substantial resources available to them.

Data Collection: The measuring of data for statistical analysis used in this study was based on balanced panel data. A balanced panel data is a set of data that consists of all elements or variables needed for the observation of the study. The study consists of 59 shariah compliant companies from top 100 best-performing shariah compliant companies in Bursa Malaysia as at 31 December 2013 reported by the Shariah Advisory Council of Security Commission of Malaysia from the years 2009 until 2013. All financial data were extracted from Bursa Malaysia.

Tax Planning Model: 11 variables were identified to be used to answer the objective of this study. The

measurements of ETRs for dependent variable was measured based on tax expenses over profit before tax.

Meanwhile for independent variables, permanent differences and temporary differences which are exempted income and tax incentives (EXINCT), disallowable expenses (DISEXP), absorbed losses and capital allowance (LOSSCA), *zakat* payment (ZAKAT) and deferred tax (DEFERRED) were measured over profit before tax. Furthermore under control variables, size (SIZE) was measured by log of total assets while others identified as leverage (LEVERAGE), return on assets (ROA), capital intensity (CAPINT) and big 5 auditors (BIG 5) were measured over total assets. The tax planning model is stated as follows:

$$\text{ETRs: } \beta_0 + \beta_1 \text{EXINCT} + \beta_2 \text{DISEXP} + \beta_3 \text{LOSSCA} + \beta_4 \text{ZAKAT} + \beta_5 \text{DEFERRED} + \beta_6 \text{SIZE} + \beta_7 \text{LEVERAGE} + \beta_8 \text{ROA} + \beta_9 \text{CAPINT} + \beta_{10} \text{BIG5}$$

RESULTS AND DISCUSSION

The results from the study showed that very few of the shariah compliant companies which supposedly pay *zakat* have declared *zakat* reporting in their financial statement. The study revealed that only 7 companies or 11.9 percent from the final sample of 59 companies have reported and declared *zakat* in their financial statement.

The findings opposite to the study's expectation which assumes that the shariah compliant companies have paid *zakat* as well as would have disclosed *zakat* in their financial reports. The analysis discovered that most of the *zakat* paying companies are government or state related companies.

Table 1 below shows the result of paired samples test between ETRs and STR. The result proves that there was a significant relationship at 1%-level (2-tailed) or known as tax gap between ETRs and STR. The t-value stood at 6.344 at p-value of 0.000 (p-value < 0.01). This reinforces the argument which states the existence of a significant difference between ETRs and STR.

Table 2 presents the statistical summary for regression analysis of 59 shariah compliant companies with 295 firms-years. The results show that the model was statistically significant with the F-value at 10.173 and p-value at 0.000 (p < 0.01). The adjusted R squared was at the level of 0.238 which indicates that 23.8 percent of the changes in shariah compliant companies ETRs can be explained by the model as follows:

$$\text{ETRs: } 0.108 - 0.027 \text{EXINCT} + 0.602 \text{DISEXP} - 0.038 \text{ZAKAT} + 0.177 \text{DEFERRED} + 0.058 \text{LEVERAGE} + 0.072 \text{CAPINT} + 0.063 \text{BIG5}$$

Table 1: Paired Sample Test Result for the Years 2009 to 2013

Paired Samples Test							
Paired Differences							
95% Confidence Interval of the Difference							
Mean	Std. Deviation	Std. Error Mean	Lower	Upper	t	df	Sig. (2-tailed)
0.0309	0.0835	0.0049	0.0213	0.0404	6.344	294	.000

Table 2: Summary of Multiple Regression Results for the Years 2009 to 2013

Variables	β	T-Statistics	Sig
CONSTANT	0.108	1.637	0.103
EXINCT	-0.027	-2.395	0.017**
DISEXP	0.602	5.769	0.000***
LOSSCA	0.163	0.190	0.850
ZAKAT	-0.038	-2.123	0.035**
DEFERRED	0.177	3.535	0.000***
SIZE	-0.004	-0.376	0.707
LEVERAGE	0.058	2.256	0.025**
ROA	0.091	1.366	0.173
CAPINT	0.072	2.747	0.006***
BIG-5	0.063	3.534	0.000***
R ²	0.264		
Adjusted R ²	0.238		
F-Statistic	10.173		
P-Value	0.000***		
Durbin Watson	1.747		

***significant at 1%-level

**significant at 5%-level

Based on the result, there are significant positive relationship between DISEXP, DEFERRED, LEVERAGE, CAPINT and BIG 5 with ETRs while there are significant negative relationship incurred between EXINCT and ZAKAT with ETRs. No significant relationships were found between LOSSCA, SIZE and ROA with ETRs.

The positive sign on the variables indicated that companies with high disallowable expenses for the purpose of tax deduction may also have high ETRs and thus need to pay more taxes to the tax authority. Companies with high levels of deferred tax may also plan their tax planning by postponing the tax benefits for the future and are willing to pay high ETRs or income taxes to the tax authority for that particular financial year.

Likewise, companies with the higher leverage may also result with higher ETRs and thus more tax income will be imposed on the companies. At the same time, companies with high level of the investments made in the plant, property and equipment will result in higher ETRs and thus the companies will need to pay more tax. Furthermore, the use of influential auditors may also result in high ETRs since most of these auditors may utilize their

knowledge and experience to ensure the companies adhere to the rules and regulation set up by the government.

In the meantime, the more the companies enjoy their tax incentives and exempted income, the less tax income they need to pay to the government. The shariah compliant companies may also be practicing good business and tax planning in order to minimize tax impact on their financial performance. A negative relationship was also found between ZAKAT and ETRs that explain tax payers who pay *zakat* is allowed tax deductions and as the result may reduce the level of ETRs and pay less tax income to the tax authority.

CONCLUSION

The aim of this study is to investigate the extent of voluntary disclosure of *zakat* reporting and tax compliance from the financial statements of shariah compliant companies in Malaysia. The study also looks into factors that contribute to the level of influence for ETRs among the shariah compliant companies in Malaysia.

The results from the study showed that very few of the shariah compliant companies which supposedly pay *zakat* have declared *zakat* reporting in their financial statement. The results also support the suggestion that there is a significant difference in effective tax rates among shariah compliant companies listed in Bursa Malaysia and the effective tax rate diverges significantly from the statutory tax rate. Hence, it can be concluded that there are 5 factors that contributed to the ETRs in this study. They are disallowable expenses, the usage of established external auditors, deferred tax, leverage and capital intensity.

It is undeniable that *zakat* and tax compliance became factors that contribute to the fundamental issues for encouraging shariah compliant industries in Malaysia. These policies are depending on the government's philosophy and willingness; if the government still wants to promote the growth of the shariah industries in Malaysia, then the government needs to develop a comprehensive strategic planning and at the same time

needs to sacrifice its revenue through various tax incentives offered to finance the development planning as proposed. Perhaps with the strategic direction of the Malaysian government may result more development in terms of economics as well as infrastructure in parallel to achieve the aspiration of Malaysia to be developed nation by year 2020.

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