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The Effect of Profitability on Tax Avoidance Among Companies in Malaysia: A Conceptual Model

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***Abstract*— *This study is to develop a conceptual model on the effect of profitability on tax avoidance among companies in Malaysia. Tax avoidance poses significant challenges for government revenue and raises questions about corporate ethics. The relationship between corporate profitability and tax avoidance is multifaceted; higher profitability often encourages companies to pursue aggressive tax planning strategies to reduce tax liabilities. Drawing on the Income Tax Act of 1967 and relevant corporate governance frameworks, this research investigates how financial attributes and corporate governance mechanisms moderate this relationship. Utilizing data from Malaysian corporations, the study analyses the extent to which profitability influences tax avoidance, focusing on board structure, director competence, and ownership concentration. The findings aim to provide valuable insights into how effective corporate governance practices can mitigate tax avoidance tendencies in profitable companies, informing policy development to enhance tax compliance and governance standards.*

***Keywords*— *Profitability, Corporate Tax Avoidance, Corporate Governance, Board Size, Tax Compliance, Director Competency, Board Structure.*

I. Introduction

Corporate tax avoidance has garnered significant attention due to its implications on national economies and corporate transparency. In Malaysia, corporate tax remains one of the primary sources of government revenue, contributing substantially to funding public infrastructure and services. However, tax avoidance, particularly among multinational corporations and large domestic companies, has sparked debates on the ethical and legal boundaries of corporate tax planning. This study explores how financial attributes like profitability and leverage influence corporate tax avoidance in Malaysia. Additionally, the role of corporate governance mechanisms—such as board size, director competency, and the presence of female directors—is examined to assess how these factors contribute to tax strategies. Given Malaysia's evolving tax policies and corporate governance reforms, understanding the dynamics between profitability, governance, and tax avoidance offers valuable insights into how companies navigate tax regulations while maximizing shareholder wealth.

Taxation plays a vital role in the economic development of nations, providing the necessary revenue for public services and infrastructure. In Malaysia, corporate tax remains a significant source of government revenue, contributing substantially to funding social welfare, healthcare, and education initiatives (Mosuin, 2024). Despite its importance, Malaysia faces challenges regarding tax collection efficiency, particularly in comparison to other Southeast Asian nations. The corporate tax rate, currently among the highest in the region at 24%, has drawn criticism for fostering tax avoidance strategies among companies, particularly multinational corporations and large domestic entities (Salawati, 2021). This issue has sparked ongoing debates about the ethical and legal boundaries of corporate tax planning.

Corporate tax avoidance refers to strategies employed by companies to minimize their tax liabilities within the legal framework, a practice that raises concerns about transparency and fairness in the tax system (Duhoon & Singh, 2023; Hanlon & Heitzman, 2010). The existing literature highlights that higher profitability often incentivizes companies to engage in aggressive tax planning, as companies seek to optimize their financial performance by reducing tax expenditures (Duhoon & Singh, 2023; Dyreng et al., 2010). While tax avoidance can lead to increased profits and shareholder wealth, it poses significant risks to government revenue and can undermine public trust in corporate governance practices (Duhoon & Singh, 2023; Huang et al., 2018; Putra et al., 2018). In Malaysia, the corporate governance landscape has evolved significantly since the introduction of the Malaysian Code of Corporate Governance (MCCG) in 2000, aimed at improving corporate transparency and accountability. Subsequent revisions in 2007, 2012, and 2022 have placed increased emphasis on the roles and responsibilities of corporate boards, fostering an environment conducive to ethical business practices. However, the effectiveness of these governance mechanisms in curbing tax avoidance remains a topic of inquiry, especially considering the intricate interplay between profitability, financial attributes, and corporate governance structures (Kalbuana et al., 2023; Jensen & Meckling, 1976).

Financial attributes, particularly profitability and leverage, play a crucial role in determining a company's approach to tax planning. Profitable companies are more likely to utilize sophisticated tax strategies to enhance shareholder wealth, which may include engaging in tax avoidance (Sofiamanan et al., 2023; Muniroh, 2022). Additionally, leverage, or the use of debt financing, can influence tax planning decisions, as interest expenses on debt can be deducted from taxable income, thereby reducing overall tax liabilities (Safiinatunnajah & Setiyawati, 2022; Wafirli, 2017). Understanding how these financial characteristics influence tax behavior is critical for assessing the broader implications for corporate governance and regulatory compliance. Furthermore, the role of corporate governance mechanisms—such as board size, director competency, the presence of female directors, and ownership concentration—needs to be examined to understand their impact on corporate tax avoidance (Chukwu et al., 2022; Yuniarsih, 2018). Strong governance practices can potentially mitigate aggressive tax planning behavior by promoting ethical decision-making and enhancing accountability among directors and executives (Agusti & Rahman, 2023). Recent studies indicate that companies with diverse boards and competent directors may be less inclined to engage in tax avoidance due to heightened awareness of ethical responsibilities and potential reputational risks involved (Safiinatunnajah & Setiyawati, 2022; Kurniasih & Sari, 2013).

As Malaysia's tax policies and corporate governance frameworks continue to evolve, this study aims to contribute to the understanding of how profitability and governance interact to influence corporate tax avoidance. By exploring the complexity of these relationships, the findings will provide valuable insights for policymakers and corporate leaders seeking to enhance compliance, foster transparency, and ensure equitable tax contributions from corporations. Ultimately, this research endeavors to highlight the critical role of corporate governance in shaping tax strategies within a rapidly changing economic landscape, aiming to balance the interests of shareholders and the wider societal implications of tax practices.

II. LITERATURE REVIEW

The relationship between corporate profitability and tax avoidance has garnered significant attention in both academic and policy circles. As nations seek to enhance tax revenues and improve compliance, understanding the factors influencing corporate tax behaviour is critical. Research indicates that companies with higher profitability are more likely to engage in tax planning activities to minimize their tax liabilities. According to Duhoon and Singh (2023) and Dyreng et al. (2010), profitable companies may perceive tax avoidance as a means to maximize shareholder wealth, thereby incentivizing aggressive tax planning. Conversely, some studies suggest that highly profitable companies may not necessarily engage in tax avoidance, as they can afford to pay taxes without jeopardizing their financial health (Umar et al., 2021). This contradiction highlights the complex relationship between profitability and tax avoidance, necessitating further exploration. Sopiyana (2022) supports the notion that profitability influences tax avoidance, indicating that companies with higher returns on assets (ROA) are more inclined to employ tax avoidance strategies. In contrast, a study by Habib et al. (2022) and Mulyati et al. (2019) found that increased profitability may lead to heightened tax obligations, resulting in reduced tax avoidance behaviours. These findings underline the necessity for complexed research that considers various dimensions of profitability and tax strategies. Furthermore, leverage, defined as the use of borrowed capital to finance operations, plays a significant role in shaping corporate tax behaviour. Companies with high leverage may engage in tax avoidance because interest payments on debt are tax-deductible, thus reducing the taxable income of a firm (Safiinatunnajah & Setiyawati, 2023; Wafirli, 2017). The strategic use of leverage can create a financial incentive for companies to minimize their tax burdens through various avoidance strategies. This is particularly evident in companies operating in sectors with substantial capital expenditures where the cost of debt can be offset by tax savings.

In Malaysia, the corporate governance landscape has evolved significantly, influenced by the implementation of the Malaysian Code of Corporate Governance (MCCG). Effective corporate governance mechanisms are essential for ensuring accountability and transparency in corporate operations, potentially mitigating tax avoidance behaviours. The roles and responsibilities of corporate boards are critical in determining tax strategies. Larger boards may enhance oversight and control mechanisms, reducing the likelihood of aggressive tax avoidance practices. Research by Egbunike et al. (2021) indicates that board size and composition can significantly influence a company's tax planning behaviour. Moreover, director competency, which pertains to the skills and knowledge of board members, is crucial for effective oversight in complex areas such as tax strategy. Competent directors are more likely to promote ethical decision-making and discourage aggressive tax avoidance. The presence of female directors on corporate boards also represents an important aspect of diversity in governance. Studies suggest that gender diversity can positively influence corporate governance by fostering different perspectives and enhancing ethical decision-making, potentially leading to reduced tax avoidance behaviour (Zhang et al., 2022). Companies with diverse boards may be more attuned to the ethical implications of tax strategies and may prioritize long-term sustainability over short-term financial gains. This suggests that promoting diversity on corporate boards could be an effective strategy for enhancing corporate governance and reducing aggressive tax planning.

Managerial ownership, defined as the proportion of a company's shares held by its executives and managers, plays a pivotal role in aligning the interests of management with those of shareholders. High managerial ownership can incentivize managers to adopt conservative tax strategies to enhance firm value and shareholder returns (Yang, 2022; Bebchuk & Cohen, 2005). Conversely, when managerial ownership is low, executives may prioritize personal financial gain over the company's long-term performance, potentially leading to increased tax avoidance behaviours. This relationship underscores the importance of understanding how ownership structure influences tax planning decisions within companies. Additionally, CEO duality, the phenomenon where the roles of the Chief Executive Officer and the Chairperson of the Board of Directors are held by the same individual, can impact corporate governance dynamics. This centralization of power may lead to conflicts of interest, resulting in less scrutiny of tax strategies and increased tax avoidance practices (Liedong & Rajwani, 2022; Finkelstein & Hambrick, 1996; Zajac & Westphal, 1996). The implications of CEO duality on tax behaviour warrant further investigation, particularly in light of evolving corporate governance frameworks aimed at enhancing accountability.

Tax compliance, defined as the degree to which taxpayers adhere to tax laws and regulations, is significantly influenced by corporate governance and tax avoidance behaviours. High levels of tax compliance contribute to government revenue and

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support the fair distribution of tax burdens among citizens (Dwi et al., 2024; Kirchler, 2007). Factors influencing tax compliance include taxpayer awareness, perceived fairness of the tax system, and the enforcement of tax regulations (Oktris et al., 2024; Torgler, 2007; Richard, 2014). Understanding how corporate governance mechanisms can enhance tax compliance is crucial for policymakers seeking to improve tax revenues while fostering an equitable tax system. As the literature demonstrates, the interplay between profitability, leverage, corporate governance mechanisms, and tax compliance is complex and multifaceted. While profitability often drives companies toward aggressive tax planning, the effectiveness of corporate governance practices can mitigate such behaviours. Moreover, managerial ownership and CEO duality further complicate the dynamics of tax avoidance strategies. Given the evolving landscape of corporate governance in Malaysia, it is essential to explore these relationships to provide valuable insights for policymakers and corporate leaders alike.

The existing literature emphasizes the need for a detailed understanding of how various financial and governance factors influence corporate tax avoidance. As Malaysia continues to refine its corporate governance frameworks and tax policies, further research is warranted to explore the implications of these relationships for enhancing tax compliance and promoting ethical business practices. By examining the intricate interplay between profitability, governance, and tax behavior, this study aims to contribute to the broader discourse on corporate tax avoidance. The findings from this research can provide valuable insights that inform future policy development and corporate strategies, ultimately fostering a more equitable tax environment and enhancing corporate accountability.

III. Methodology

This study uses a quantitative approach to examine the relationship between corporate tax avoidance and profitability in Malaysian companies listed on the Kuala Lumpur Stock Exchange (2021–2023). Secondary data from the annual financial reports of at least 150 purposively selected companies allows for empirical analysis. Profitability ratios measure each company's efficiency in generating earnings relative to costs, providing insight into how profitability influences tax avoidance behaviors. While some studies suggest that higher profitability reduces tax avoidance, others link increased profitability with greater tax-reduction efforts to maximize shareholder wealth. Using multiple linear regression, the study evaluates the impact of profitability on tax avoidance, with the Effective Tax Rate (ETR) as the primary measure. This model also controls factors such as company size and leverage. Additionally, corporate governance variables, including board size and CEO duality, are analyzed for their potential moderating effects on the profitability-tax avoidance relationship.

IV. Conclusion

This study seeks to illuminate the dynamic and multifaceted relationship between corporate profitability and tax avoidance in Malaysia, particularly through the lens of corporate governance practices. Preliminary findings suggest that while firms may engage in aggressive tax strategies to maximize shareholder wealth, robust governance mechanisms—such as board composition, director expertise, and ownership structures—appear to play a significant moderating role in these behaviors. The research underscores the pressing need for comprehensive corporate governance reforms, indicating that diverse and well-structured boards may help mitigate the inclination for tax avoidance among profitable firms. By integrating governance frameworks with financial performance, the study aims to provide valuable insights that can guide policymakers in enhancing tax compliance and fostering greater corporate accountability. Future phases of this research will focus on refining these insights and exploring the nuances of governance standards and ethical business practices. These efforts are essential not only for ensuring that corporations contribute equitably to national revenue but also for nurturing a sustainable economic environment in Malaysia. Ultimately, the study aspires to advocate for a collaborative approach that aligns corporate interests with societal welfare, paving the way for a more equitable and resilient economic future.

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