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The Interplay between Risk Management and Internal Control Towards Corporate Tax Aggressiveness

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Abstract: Corporate tax aggressiveness has become a major issue in the international business environment as they exploit the loopholes of legitimate tax avoidance. Although these techniques can increase revenues, they are viewed critically by regulators and society. Due to the reputational and fiscal impact associated with aggressive tax planning, effective measures are required to manage the risks and ensure compliance with tax laws. In addressing the issue of corporate tax aggressiveness, this paper examines the role played by risk management and the effectiveness of internal controls. Based on agency theory, tax aggressiveness often represents an agency problem between agent and principal. Therefore, effective risk management provides a systematic approach to recognizing and mitigating the potential pitfalls of aggressive tax strategies. Meanwhile, robust internal controls ensure compliance and align tax practices with governance standards. This study underscores the critical need for companies to view tax aggressiveness not just as a financial strategy, but as a governance challenge that requires robust risk mitigation and control systems. Although it can bring financial benefits and competitive advantages, it also carries financial, reputational, and regulatory risks that may jeopardize long-term value. Hence, companies should pursue a balanced approach to tax planning that harmonizes profitability targets with social expectations and regulatory standards.

Keywords: *Tax Aggressiveness, Risk Management, Internal Control, Corporate Governance*

1. Introduction

Corporate tax aggressiveness involves strategies employed by companies to minimize their tax liabilities, ranging from legal tax avoidance to illegal tax evasion. Corporate tax aggressiveness has received significant attention in accounting, finance, and corporate governance, as it raises critical issues related to ethical practices, regulatory compliance, and societal impact. Examining the factors that impact corporate tax aggressiveness is crucial for key stakeholders, including investors, regulators, and the broader public. According to Lymer and Oats, (2009), taxation is a mandatory charge levied by a government or other tax-collecting authority on income, expenditure, or capital assets, for which the taxpayer receives no particular benefit. Tax planning should be executed within legal boundaries to advantage the taxpayer by reducing tax obligations without contravening tax regulations, as excessive tax aggressiveness may lead to unlawful activities such as falsifying returns or failure to report income, and both constitute tax evasion. Aggressive corporate tax strategies, frequently driven by advanced tax evasion techniques, can significantly reduce government revenue reserves.

Several accounting scandals have shown that companies can use tax shelters to increase earnings and reduce taxable income, often through aggressive tax planning techniques. This finding was evident in the case of Transmile Group Berhad, where income was inflated through deferred tax and invoicing, endangering the accuracy of financial data, and misrepresenting the true financial condition and business performance. Similarly, companies such as Enron and Tyco that used high-risk tax strategies without adequate internal monitoring or controls faced dire consequences, resulting in their demise and underlining the dangers of uncontrolled aggressive tax positions.

As a result, strong internal controls ensure a comprehensive assessment of the tax strategy, thus reducing the possibility of adopting an overly aggressive approach that could threaten the financial stability of the organization. Conversely, companies that lack adequate internal controls face a higher risk of error, non-compliance, and misjudgment. This result can increase the adverse effects of aggressive tax methods, including regulatory penalties, reputational damage, and costly litigation. Therefore, effective risk management and

internal control are essential elements in business operations and governance (MCCG, 2021). A study by Ali and Nasir, (2018) also claimed that risk management is an additional important component of corporate governance, especially based on the Malaysian Code of Corporate Governance 2012 (MCCG 2012).

Klassen and Ruiz, (2022) also suggest that robust internal controls ensure that proactive tax measures are implemented in a compliant and controlled manner, while efficient risk management facilitates the identification of possible risks. Companies may take an overly aggressive tax strategy without considering the risks associated with it, which may result in errors, non-compliance, and legal penalties due to improper risk management and internal controls. The implementation of robust governance and risk management systems allows firms to balance avoiding the negative consequences of tax evasion, including regulatory penalties and reputational damage, with the pursuit of tax efficiency.

Previous studies, such as those performed by Muhmad et al. (2020) and Nasir et al. (2024) mostly focused on firm characteristics and tax planning, with limited attention given to the importance of risk management and internal control systems in this context. This oversight fails to account for how risk management and robust internal controls can reduce opportunistic behavior that contributes to tax aggressiveness, potentially leaving a critical gap in the literature. Accordingly, it is important to study the relationship between the organization's risk management and internal control system and corporate tax aggressiveness.

2. Literature Review

Corporate Tax Aggressiveness

Corporate tax aggressiveness includes a range of tax-saving practices, from legitimate tax planning to approaches bordering on tax evasion. Hanlon and Heitzman, (2010) define tax aggressiveness as a controversial form of tax planning that aims to minimize explicit tax liability. Similarly, Richardson et al. (2013) characterize it as the extent to which companies exploit legal ambiguities to reduce tax liabilities. Companies often engage in aggressive corporate tax planning to take advantage of available tax incentives and benefits to minimize taxable income and reduce tax liability (Nasir et al., 2024). As a result, this aggressive tax strategy diminishes the state's tax income, and obstructs social advancement, and public skepticism toward large corporations. Consequently, aggressive business tax planning poses a significant issue for governments, as corporate tax constitutes the primary and greatest source of government revenue. This phenomenon underscores the necessity of adhering to tax regulations.

The 1990s saw a significant increase in self-aware financial reporting, driven by the Enron and Worldcom scandals. Simultaneously, a rise in tax avoidance was observed, indicative of the prevalent implementation of aggressive corporate reporting practices. Starbucks has faced criticism in recent cases involving multinational firms for employing aggressive tax planning strategies that lead to reduced tax liability. This corporation has faced criticism from people and consumers for its negligible tax contributions relative to its substantial profits. Recent academic research indicates that aggressive company tax planning negatively impacts the overall quality of the corporate information environment, resulting in heightened opacity of corporate information. The relationship between changes in corporate taxes and economic growth remains a controversial topic in academic and policy discussions (Halim & Rahman, 2022). As a result of aggressive tax planning, grey areas will emerge, which in turn offers opportunities for illegal tax evasion (Jaffar et al., 2021). Similarly, Septiawan et al. (2021) point out that tax avoidance, a component of tax planning, poses a challenge to government tax collection efforts, regardless of its legal status.

Tax aggressiveness frequently corresponds with lower effective tax rates (ETR) that also serve as a proxy for a company's tax strategy in empirical studies (Frank et al., 2009; Jaffar et al., 2021; Zainazor et al., 2023; Shamil et al., 2024; Nasir et al., 2024). Previous studies reveal that certain organizations are more motivated to get involved in aggressive tax planning than others. Zeng, (2018) studied the extent of the Effective Tax Rate (ETR) among organizations in 40 different countries and discovered that organizations reported a lower ETR compared to the Statutory Tax Rate (STR). This indicates that an organization's internal controls significantly impact the extent of its engagement in aggressive tax planning.

Corporate tax aggressiveness is a strategic tool that can provide benefits, such as better financial performance and competitive advantage, but it also carries significant risks. Chen et al. (2010) outline several advantages of corporate tax aggressiveness. It helps with tax savings which increases shareholder returns and allows managers to earn high salaries due to reduced tax liability for the firm. Therefore, aggressive corporate tax methods to minimize tax payments can increase profits and allow firms to allocate resources to innovation, research, and shareholder payouts.

Aggressive tax planning can lead to public condemnation, especially when perceived as unethical or contrary to societal ideals. Entities committed to corporate social responsibility may encounter increased examination of their tax approaches which could be viewed as inconsistent with their public commitments. This reputational damage can result in diminished consumer loyalty, reduced employee morale, and decreased investor confidence (Lanis & Richardson, 2012). Conversely, corporations must proactively foresee and evaluate the potential dangers and consequences of aggressive tax planning strategies. The risks arise from the increased probability of a discrepancy between the company's filed tax return and the real tax owed to the authorities (Ftouhi & Ghardallou, 2020). Corporations are exposed to increased regulatory scrutiny as a result of aggressive tax planning, and this includes tax audits and investigations. As such, profits can be reduced by penalties and fines for noncompliance.

The Relationship between the Risk Management Framework and Corporate Tax Aggressiveness

The association between risk management frameworks and corporate tax aggressiveness is a significant area of research that examines how corporations address the intricacies of tax planning while mitigating the related risks. The integration of risk management frameworks and corporate tax aggressiveness is crucial for corporations wishing to enhance their financial performance while mitigating potential tax-related issues. According to MCCG 2021, the board must implement a thorough risk management and internal control framework to enhance risk management and maintain organizational accountability. An effective risk management framework enhances the oversight of tax-related activities, facilitates the identification of inconsistencies, and ensures proper documentation. The study by Menchaoui and Hssouna, (2022) demonstrates that tax risk assessment in the risk management framework is crucial for aligning tax strategies with the organization's risk appetite and operational goals. Menchaoui and Hssouna, (2022) assert that good risk management is essential for supervising tax risk management techniques and ensuring adherence to tax legislation.

A risk management framework is essential for minimizing uncertainties and risks, but many managers consider it too expensive and ineffective (Kwak & Stoddard, 2004; Mikes, 2009). This perception often arises because they feel that the costs and efforts required to implement such a framework do not yield immediate or visible benefits. However, Li et al. (2023) argue that effective risk management can improve the accuracy and reliability of profit forecasts. A well-structured risk management framework promotes collaboration across corporate units, helping them identify opportunities, manage risks, and develop effective tax strategies. By integrating risk management systems, tax departments can access accurate, real-time information, which enhances the efficiency of tax planning and reduces tax-related risks. On the other hand, Gallemore and Labro (2015) suggest that while efficient risk management supported by high-quality internal information can improve decision-making, it may inadvertently facilitate tax evasion.

Speitmann, (2021) asserts that the relationship between risk management and corporate tax aggressiveness is complex, requiring organizations to use a holistic approach that considers both potential benefits and risks associated with tax strategies. By integrating tax risk management into an organization's overall governance framework, organizations can improve their ability to achieve optimal financial results while minimizing exposure to tax-related risks. Corporate tax planning can increase savings but poses a risk of breaking the law and becoming illegal tax evasion if not managed well. Therefore, organizations need to implement real-time monitoring and robust internal control systems. Employing the systems can assist organizations in accurately identifying risky practices and ensuring regulatory compliance while offering data for decision-making. Additionally, consistent audits and employee training on tax compliance can reduce regulatory scrutiny and protect an organization's reputation by fostering a culture of ethical tax planning and risk prevention.

The Relationship between the Appointment of the Risk Management Committee and Corporate Tax Aggressiveness

It is important to have a Risk Management Committee (RMC) that reports directly to the audit committee to ensure effective risk management and internal controls are in place. According to MCCG 2021, the board of directors is mandated to establish a risk management committee (RMC) consisting of many independent directors. The RMC will be responsible for overseeing the organization's operations and its risk management framework. The RMC has the objective of monitoring and mitigating various risks, including those related to tax strategy. Their role becomes more important when it comes to tax aggressiveness, which refers to techniques that take advantage of loopholes in tax legislation to reduce tax payments. Younas et al. (2020) and Jia and Bradbury, (2020) emphasized that RMC is an important corporate governance mechanism that reduces financial, regulatory, and reputational concerns to direct and supervise the company's tax planning. Establishing an RMC is essential in developing an organization-wide risk management strategy, particularly in dealing with tax-related risks, including non-compliance, regulatory changes, and possible legal consequences.

In addition, a study conducted by Aronmwan and Ogbaisi, (2022) claims that companies with effective RMC are less likely to use risky tax avoidance techniques-because the establishment of RMC in the organization helps in the reduction of financial risks and the improvement of the governance framework. In the same vein, Hsu et al. (2018) argue that companies often make decisions about tax without fully considering the tax consequences because they do not have enough knowledge about tax strategies. As a result, establishing the RMC improves coordination and communication, ensuring the tax department has the necessary resources to make sound judgments. RMC creates a cohesive risk management approach, promotes tax efficiency, and incorporates tax considerations into decision-making at all levels. This results in an informed, compliant, and strategically aligned tax practice.

Beasley et al. (2021) further illustrate that companies with enhanced board risk oversight display lower effective tax rates and less volatility. This shows that it is important for organizations to have RMC in the firm because the effectiveness of the company's tax planning is-influenced by robust corporate governance, through the RMC function. A well-managed business does not seek to avoid tax responsibilities in any way. Instead, they use low-risk tax tactics to reduce their tax liability and ensure the consistency of their tax decisions. This observation reflects RMC's strong interest in ensuring that tax strategies align with long-term goals.

The Relationship between the Internal Audit Department and Corporate Tax Aggressiveness

In addition, the internal audit department plays a significant role in supporting the board of directors and the audit committee by systematically improving the effectiveness of the internal control and governance framework, as stipulated by the MCCG 2021. The internal audit department will evaluate and improve the internal effectiveness of the company’s internal controls, including those related to tax compliance and tax planning. Amri et al. (2022) claim that by evaluating the effectiveness of tax controls, internal auditors can assist management in developing strategies that minimize tax liability while ensuring compliance with tax laws. Amri et al. (2022) also indicate that internal audit departments facilitate the alignment of organizational tax practices with established standards, thus strengthening sustainable governance and ethical accountability.

Deslandes et al. (2019) highlight that audit committee characteristics, especially their independence and expertise, are significantly associated with tax aggressiveness. Their findings suggest that firms with more independent and knowledgeable audit committee members are less likely to engage in aggressive tax planning, as strong oversight mechanisms help reduce tax-related risks. Similarly, Niniek et al. (2018) emphasize that the supervisory role of the board of commissioners, including the independence of the internal audit committee, can influence tax aggressiveness. This finding underlines the importance of a robust internal governance structure in preventing aggressive tax strategies.

According to Wei, (2023), integrating the internal audit function with the tax management strategy is important to improve compliance and reduce tax-related risks. Wei, (2023) also pointed out that when tax management aligns closely with the internal audit process, it can lead to more effective oversight and stronger compliance with regulatory requirements. This highlights the important role that the internal audit department plays in ensuring compliance and shaping tax strategies that support corporate governance goals. Likewise, Rae et al. (2017) and Rakhmayani et al. (2024) argue that the success of an internal control system depends on the quality

of oversight provided by internal auditors. With their deep knowledge of an organization's culture, risks, and operational challenges, internal auditors are well-positioned to support good decision-making. In addition, Rakhmayani et al. (2024) emphasize that the internal audit function is key to identifying fraud, addressing tax discrepancies, ensuring regulatory compliance, and helping to reduce financial risk.

The Relationship between Internal Control Activities and Corporate Tax Aggressiveness

Internal controls are crucial for guaranteeing adherence to tax legislation, enhancing the accuracy of financial reporting, and mitigating risks related to tax planning. These factors are especially pertinent for aggressive tax methods, as companies may operate within the limits of legal tax avoidance. An essential function of internal controls is to protect the integrity of financial reporting, which is vital for precise tax compliance. Effective internal controls enhance the dependability of financial statements, thereby reducing the possibility of errors or misstatements that may promote aggressive tax strategies. Moreover, corporate tax departments are crucial in formulating tax planning strategies. Chen et al. (2020) assert that internal tax teams are fundamental to reconciling tax minimization efforts with efficient tax risk management.

A well-functioning tax department can enhance the effectiveness of internal controls by ensuring compliance with tax laws and regulations while identifying legitimate tax planning opportunities. Additionally, the effectiveness of internal controls can be affected by the level of disclosure regarding contingent tax liabilities. Shen, (2023) suggests that when companies share more details about potential tax risks, they may feel more confident in their strategies and engage in more tax avoidance. This highlights the importance of having strong internal controls, for managing tax strategies and effectively communicating tax risks to stakeholders.

These internal controls are crucial for lowering risks, maintaining operational efficiency, and coordinating corporate activities with strategic goals. Organizations with strong tax-related internal controls are more likely to engage in higher levels of tax avoidance, according to Bauer, (2016), because these controls make it easier to identify opportunities for tax savings while also guaranteeing compliance. This finding demonstrates how strong internal controls and governance frameworks may enhance a business's ability to use tax strategies and manage risks, ensuring operational integrity and financial optimization.

Effective internal control procedures, according to Oppong et al. (2024), are essential for carrying out management instructions, preserving legal compliance, and reducing hazards that impede corporate goals. Appropriate authorization, documentation, and independent verification among other controls help to lower risks connected to changes in tax laws, inadequate compliance, and tax computation errors. They help businesses to apply sensible, risk-aware tax policies and guard against penalties and damage to reputation. Strong internal controls ensure a thorough review of tax strategies, therefore lowering the risk of aggressive tax policies that can cause legal problems or noncompliance.

Internal controls help reduce the risks tied to aggressive tax planning by ensuring that tax practices meet legal and ethical standards through proper oversight and accountability. They also equip organizations with tools to monitor, evaluate, and execute tax plans effectively, allowing for assertive yet lawful tax strategies. This approach aligns with Jemaa, (2022), who highlights that companies with strong governance frameworks manage risks more effectively, making their tax avoidance strategies more sustainable while lowering the chances of penalties or reputational harm.

3. Agency theory as the Theoretical Lens for Corporate Tax Aggressiveness

The agency theory developed by Jensen and Meckling (1976) serves as a fundamental framework for analyzing the relationship between shareholders (principals) and managers (agents). It emphasizes how conflicts of interest and knowledge asymmetries between the two parties can lead to management decisions that do not consistently align with shareholders' views. According to Khatun et al. (2022), agency theory states that companies are controlled by a governing body entrusted by the organization’s owner with preparing financial statements, reviewing operational efficiency, and evaluating overall performance. This theory is particularly relevant for analyzing corporate tax aggressiveness, where the incentives and decision-making of management can be at odds with long-term shareholder value.

Managers often know the company's tax plans and the associated risks better than shareholders. This discrepancy allows them to engage in risky tax practices without sufficient oversight. These problems arise from the information asymmetry between managers and shareholders associated with the agency principle (Jensen & Meckling, 1976). Internal controls create a systematic framework to ensure compliance and mitigate the risk of aggressive tax planning. Organizations with effective internal controls can identify and prevent risky behaviors, reducing the negative impact of managerial discretion. Hence, robust internal controls and risk management frameworks are essential to reduce this disconnect and ensure that tax strategies are aligned with shareholder interests (Bauer, 2016).

Corporate tax aggressiveness is a strategic practice that increases after-tax returns to shareholders by potentially increasing a company's cash flow. Agency theory states that the company should increase its value. Companies want to optimize their probability of survival while minimizing transaction-related costs (Aljughaiman et al., 2023). Therefore, companies strive to reduce taxable income through effective cash flow management to achieve immediate and long-term goals.

This study uses agency theory to analyze the role of internal control and risk management in mitigating the principal-agent problem in the context of corporate tax aggressiveness. In particular, it analyses how these mechanisms alleviate information asymmetry, align management's behavior with shareholders' interests, and minimize the agency costs associated with tax practices. Integrating governance structures with proactive risk management enables companies to mitigate the negative effects of aggressive tax policies, thereby preserving shareholder value and public trust.

4. Proposed Conceptual Framework

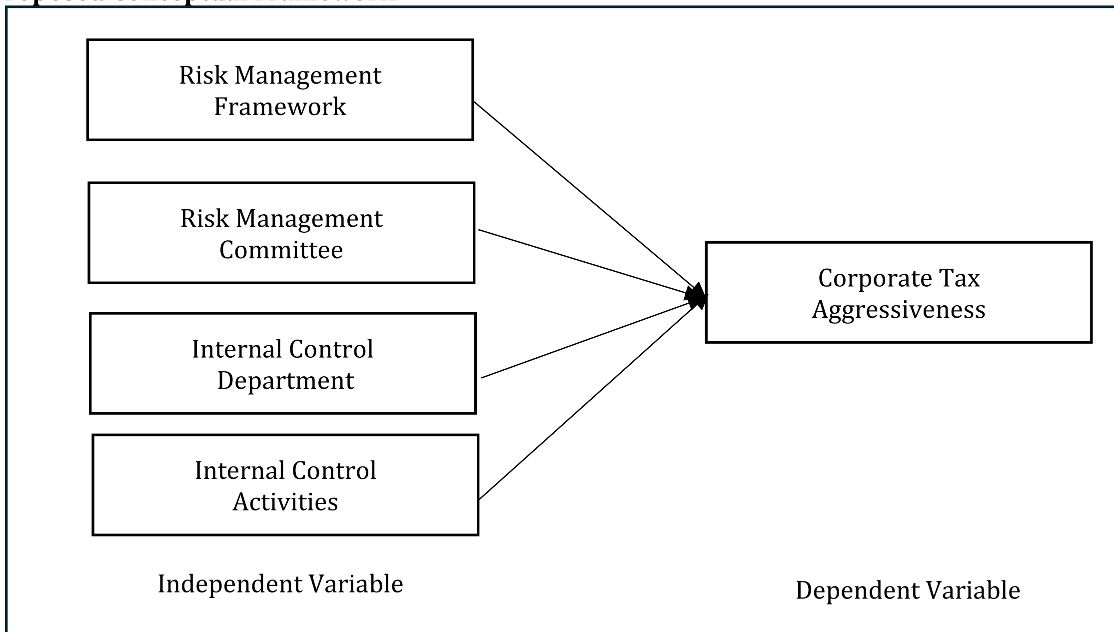

Figure 1 presents the proposed conceptual framework of this study, depicting the relationship between corporate tax aggressiveness as the dependent variable, and the four primary independent variables which comprise risk management framework, risk management committee, internal control department, and internal control activities. This framework illustrates the interaction of these components in shaping corporate tax behavior and determining the inclination toward tax aggression. The findings of the study help accounting academics and legislators to understand each other better and enable the development of focused policies to strengthen governance.

5. Conclusion

The scarce study investigating the relationship between risk management, internal control systems, and corporate tax aggressiveness highlights a significant gap in explaining how these variables affect corporate tax aggressiveness. This study examines the impact of risk management strategies and internal control structures on corporate tax aggressiveness. Although risk management and internal control systems are essential for minimizing organizational threats, their influence on corporate tax strategies has not been thoroughly examined. Tax aggressiveness, motivated by the minimization of tax obligations, can significantly impact financial transparency, legal adherence, and a company's reputation. The mechanisms by which risk management and internal controls affect such behavior remain poorly understood. This study aims to address this gap by deeply exploring the influence of internal governance systems on corporate tax aggressiveness.

The limited body of research examining the intricate interplay between risk management, internal control systems, and corporate tax aggressiveness underscores a critical gap in understanding how these factors collectively shape aggressive tax behavior. This study explores the influence of risk management practices and internal control frameworks on corporate tax decision-making. While risk management and internal control systems are fundamental in mitigating organizational risks, their specific impact on corporate tax strategies remains insufficiently explored. Tax aggressiveness, driven by reducing tax liabilities, can have significant implications for financial transparency, legal compliance, and a company's reputation. However, the mechanisms through which risk management and internal controls influence such behavior remain unclear. This study seeks to fill this gap by systematically analyzing the role of these internal governance structures in shaping corporate tax decision-making.

The proposed conceptual framework, which incorporates key components such as the risk management framework, risk management committee, internal audit department, and internal audit function, will serve as the foundation for the forthcoming empirical investigation. These components are essential in creating an environment that identifies and mitigates risks associated with aggressive tax practices, ensuring that tax strategies align with legal and ethical standards. Risk management frameworks provide the infrastructure to assess and address potential tax-related risks, while the risk management committee plays a pivotal role in overseeing the broader governance structure. Meanwhile, the internal audit department and its functions ensure transparency and accountability in the company's financial reporting, which can directly influence tax-related decisions.

The insights gained from this research can potentially guide companies, policymakers, and regulators in developing targeted strategies to mitigate tax aggression, enhance compliance, and foster responsible corporate governance. By addressing the complex relationship between risk management, internal control, and tax behavior, this research has the potential to not only contribute to academic literature but to inform practical solutions that enhance the overall integrity of corporate tax practices. The results could serve as a cornerstone for developing comprehensive corporate governance frameworks that prioritize ethical tax behavior while ensuring compliance with national and international tax regulations.

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