A Framework To Analyze Tax Non-Compliance Among Corporations In Malaysia

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ABSTRACT

Tax non-compliance is a serious issue highlighted by most of the tax authorities around the world. The negative impact from tax non-compliance not only diminishes taxpayers' confidence in the tax system; but it can affect the economic and social development. In Malaysia, although tax authorities have initiated tax audit regularly and impose tax penalties, the issue of tax non-compliance among corporations still persist. This study proposes a framework for studying corporate tax non-compliance in Malaysia using resolved audited corporate cases and by surveying tax auditors' experience with tax non-compliance. This study proposes that penalty rate, audit frequency, financial performance, the use of tax agents, firm size and size of company's auditor will have effect on corporate tax non-compliance. The developed conceptual model in this paper and future empirical findings using this model will hopefully contribute towards the efficiency and effectiveness of the Inland Revenue Board of Malaysia (IRBM) in detection and prevention tax non-compliance among taxpayers.

Key Words: Tax non-compliance, resolved audited cases, tax auditors, tax audit.

1.0 INTRODUCTION

Tax non-compliance is a serious issue highlighted by most of the tax authorities around the world. The negative impact from tax non-compliance not only diminishes taxpayers' confidence in the tax system; but it can affect the economic and social development. For example, in the United States (US), the collapsed of Enron and the subsequent accounting and tax scandals with WorldCom and Tyco in the early 2000s have caused tax authorities to suffer huge tax revenue loss due to unpaid income tax (Bloommberg-News, 2011). A brief report on the cost of tax evasion (a form of intentional tax non-compliance) worldwide by Murphy (2011) revealed that the US was ranked top in terms of tax revenue loss that carries a sum of USD337, 349 million, followed by Brazil (USD280, 111 million) and Italy (USD238, 723 million). Regardless of the effect of tax non-compliance to revenues of country, surprisingly, little attention of this issue has been attempted in Malaysia, especially among corporate taxpayers, plausibly due to its sensitive nature.

In deterring tax non-compliance, many tax authorities carry out tax audit and tax investigation as their enforcement tools. In Malaysia, although the Inland Revenue Board of Malaysia (IRBM) carries out tax audit regularly every year to deter tax non-compliance, yet tax non-compliance among corporations still persist. According to Murphy (2011), Malaysia is ranked 44th in the world and 11th in the Asia region in terms of tax revenue loss due to intentional tax non-compliance. Murphy's (2011) finding is quite surprising as there are some developing countries in the Asia region such as Vietnam, Bangladesh and Cambodia that are ranked lower than Malaysia. Besides, the numbers of resolved audited corporate cases are on the rise. For instance, in 2015 and 2016, the numbers of resolved audited corporate cases were 49,654 and 57,430 respectively which contributes RM448.77 million and RM434.07 million of additional taxes and penalty respectively (IRBM, 2016).

Although the above two facts does not imply tax non-compliance as a whole, but some non-compliance may be indicated. Despite the existence and the impact of tax non-compliance among corporate taxpayers, not much theoretical or empirical research have been conducted in Malaysia except for Loo and Ho (2005), Jeyapalan and Hijatullah (2006), Loo, McKerchar and Hansford (2009), Rohaya, Nor'Azam, Norashikin and Alizan (2009) and Juahir, Norsiah and Norman (2010). As a result, several issues against corporate tax non-compliance still remains answered and perhaps may continue as long as taxes exist. Therefore, this study aims to present a conceptual model to identify tax non-compliance among corporate taxpayers in Malaysia.

2.0 LITERATURE REVIEW

2.1 The Concepts of Tax Non-Compliance

The term tax compliance has been defined by Roth, Scholz and Witte (1989) as filing all required tax returns at the proper time and that the returns accurately report tax liability in accordance with the tax code, regulations and court decisions applicable at time the return is filed. In Australia, Australian Tax Office defined tax "non-compliance" as any tax lodgement or debt behaviour that did not adhere to the definition of tax compliance (Kirchler, Niemirowski and Wearing, 2006, p. 506); and whether or not those failures are intentional (Kirchler,2007). Premised from Roth et al. (1989)'s definition, in Malaysia, Jeyapalan and Hijatullah (2006) stated that non-compliance may take several forms which include:

i. Failure to submit a tax return within the stipulated period or non-submission;
ii. Understatement of income;
iii. Overstatement of deductions; and
iv. Failure to pay assessed taxes by the due date.

There are various schemes of non-compliance. It is range from the percentage of high to low occurrence which are unreported income, overstated subtractions, non-filling and arithmetic errors (Roth et al., 1989). According to Sivamoorthy (2004), unreported income, shifting of income among entities, false and improper deductions, fraudulent stock manipulation, diversion of business assets for personal benefit and kickbacks and payoffs are among the methods used to evade taxes. While, in Malaysia, the study by Juahir et al. (2010) found that understatement of sales, overstatement of purchases, transfer-pricing, charging unallowable expenses and allowances as well as stock adjustment are several acts of financial statement fraud used to reduce income tax liability.

2.2 Prior Studies on Tax Non-Compliance

A formal theory of tax evasion (deliberate non-compliance) has been developed over 30 years ago by Allingham and Sandmo in 1972, who adapted Becker's model of economic analysis of crime into tax compliance (Allingham & Sandmo,1972; Sandmo, 2004). This model often being known as economic deterrence model, economics of crime model and game-theoretic model (Andreoni, Erard & Feinstein, 1998; Kamdar, 1997). The economic deterrence model assumes rational behaviour among taxpayers. Taxpayers will perform a cost-benefit analysis to see whether the expected utility of non-compliance exceeds the utility of complying. Becker (1968) stated that some people turn into criminals due to the different in costs and benefits and not because of their different in basic motivation with others. This imply that taxpayers will make decision either to evade or not to evade taxes whenever the benefits of not comply exceeds the cost of non-compliance.

A study by Allingham and Sandmo (1972) found that probability of detection and the penalty increases the reported income by United States taxpayers. Hasseldine and Bebbington (1991) argued that the economic deterrence model incorporates two aspects that are firstly; taxpayers has some level of risk aversion, therefore, the more risk averse the taxpayer is, the less likely he is to evade taxes. The second aspect is knowledge. Taxpayer needs to have knowledge about taxation system to assess the probability of being detection and the extant of penalties that will be imposed upon detection.

However, this economic deterrence model has been criticized by many researchers for example Alm, McClelland and Schulze (1992); Frey and Feld (2002); Torgler (2004); and Feld and Frey (2007). They argued that this model has predicted too little tax evasion. For example, Alm et al. claimed that, in United States, since economic deterrence model assumes rational behaviour among taxpayers, therefore most taxpayers will evade if they are 'rational' because there are only small percentage of taxpayers which is less than one per cent that will be audited. Moreover, the penalty imposed on fraudulent evasion is only 75 per cent of unpaid taxes and even less penalty imposed on fraudulent evasion.

In line with the above argument, another issue is the willingness of tax authority themselves to impose a higher penalty rate to taxpayers. For example, in Malaysia, for the first time offence found during tax audit, the IRBM will impose penalty at the concessionary rate of 45% with the intention to encourage and educate taxpayer to comply with tax laws. Moreover, maximum penalty rate for the amount of tax undercharged also had been reduced from 300% to 100% effective from year of assessment 2008, 2009 and 2010 (IRBM, 2009). Although the IRBM has a good intention to educate taxpayer by imposing a lower penalty rate, it is not possible that somehow in future, high risky taxpayer tends to pay the penalty rate rather than reporting his true income.

On the other hand, from the social psychological model, the interaction between taxpayers and tax authority do affect tax compliance. This interaction can be understood as implicit or as a psychological contract whereby the stronger the participation rights are developed, the more important the contract is, the tax morale will be higher (Feld & Frey, 2002). Previous studies such as Frey and Feld (2002); Torgler (2004); and Feld and Frey (2007) claimed that tax morale can serve as an explanation for compliance rates. Frey and Feld (2002) reported that psychological tax contract is influenced by government policy, tax authority's behaviour and state institutions.

In analyzing tax compliance, the most critical part is the lack of availability of tax compliance data. After all, tax non-compliance is illegal; therefore, none of taxpayers want to reveal their true identity as tax non-compliers. Long and Swingen (1991) described that there are five different methods that can be employed to measure tax compliance (or non-compliance) at the level of individual taxpayers. The methods are direct observation, audit-based measures, self-reports, changes in return characteristics and prediction indices.

Alm (2011) classified approaches to measurement tax non-compliance into two category that are 'traditional' and 'modern' approach. Under traditional approach, it consists of 'direct', 'indirect' and 'model' approaches. Direct approach includes actual audits of individual returns and survey evidence, while indirect approach estimates evasion via the 'gap' such as the gap between income reported on tax returns and income in the national income accounts. With regard to model approach, this approach is based on statistical theory of unobserved variables that concerns about multiple causes and indicators of the phenomenon to be measured. Modern approaches use a lot of methods such as measured of reported income from individual tax returns as a proxy for evasion, conducted controlled field experiments. Both Long and Swingen (1991) and Alm (2011) asserted that the measurement of tax non-compliance via the actual tax return is the most accurate source of information.

In general, tax data is private and confidential. Many researchers found difficult to get permission to access the data. Not much scholarly studies can get utilized to the government reported data except for Rice (1992); Joulfaian (2000); Hanlon, Mills and Slemrod (2005); Rohaya, Nor'azam, Norashikin and Alizan (2009); and Juahir, Norsiah and Norman (2010). For example, in United States, Kamdar (1997) claimed that Internal Revenue Service has restricted access to compliance micro data in order to keep their secret in audit selection cases. As a result, many studies opted to another methods such as survey questionnaire (Devos, 2009; Fjeldstad & Semboja, 2001; Richardson, 2006); laboratory experiments (Alm et al., 2010; Alm et al., 1992; Jackson & Jones, 2001) and hypothetical tax scenarios (Wenzel, 2005) to investigate tax compliance .

A review of past literature found most tax compliance literature focused mainly on individual taxpayers, to name a few, Alm, Cherry, Jones and McKee (2010); Alm et al. (1992); Clotfelter (1983); Devos (2009); Fjeldstad and Semboja (2001); Mukhtar, Cecil and Knoblett (2001); Snow and Warren (2005); Torgler and Schneider (2007); Wenzel (2005); and Siti Normala (2004); very few focused on corporate tax non-compliance. Rice (1992) claimed that the availability of corporate income tax compliance micro data to the research community has made no scholarly analysis on corporate tax non-compliance .Therefore, literature on corporate tax compliance is scarce and little study has been conducted on corporate tax non-compliance.

The earliest attempt to examine corporate tax non-compliance was conducted in United States (US). Rice (1992) utilized data from corporate tax compliance micro data obtained from the Tax Compliance Measurement Program. By using a stratified random sample of 30,000 small corporations, Rice (1992) found that compliance is positively associated with a publicly traded firm and a firm which belonging to a highly regulated industry.[13] Besides, Rice found that firm profitability exerted a positive effect on tax compliance, followed by the marginal tax rate which is exerted a negative effect on tax compliance.

Whilst, Kamdar (1997) conducted a study to examine the magnitude and determinants of corporate income tax compliance in the US. By using an economic deterrence model, she used aggregate time series data from Annual Report of the Commissioner of the Internal Revenue Service for years 1961-1987, data from Economic Report of the President and statistics on income corporate tax return. Her findings show that

[13]Rice (1992) defined highly regulated industry as service industry that refers to banking, real estate, investment holding, communications, insurance, securities brokerage and utilities.

audit acts as an effective deterrent to non-compliance and wider audit coverage would increase additional revenue collections. However, her findings failed to support that increased in penalties and lower tax rate would help to reduce tax non-compliance.

Joulfaian (2000) investigated the role of managerial preferences in shaping corporate income tax evasion. Joulfaian used data obtained from a random sample of audited corporate income tax returns in US for tax year 1987; he found that managerial preferences played a major role in determining non-compliance. His study also showed that marginal tax rates, audit rate, firm size and income level do have a significant impact on evasion.

In another study done in the US, Hanlon et al. (2005) studied the extent and nature of corporate tax non-compliance. They analyzed two types of data; an operational data from the 'Voluntary Compliance Baseline Measurement' and appeals data that merged with confidential tax return data. Hanlon et al. found that corporate tax non-compliance amount was 13 per cent of 'true' tax liability. Besides, they found that non-compliance is related to corporate characteristics, for example; size, industry, publicly traded, multi-nationality, the presence of intangible assets and executive compensation.

On the other hand, by using questionnaire survey from the 'World Business Environment Survey', Tedds (2010) found that firms in all regions around the world engaged in under-reporting. He also found that there was a significant correlation between under-reporting and the legal organization of the business, size, age, ownership, competition and audit controls.

A review of literature found most of the studies that examined corporate tax non-compliance are conducted in the developed countries such as the United States, Australia, United Kingdom and New Zealand; very little studies has been done in developing country like Malaysia. There are many gaps in our understanding about corporate tax non-compliance issue in Malaysia, hence, there is a need to study the relevant and robust determinants or corporate tax non-compliance to detect and prevent tax non-compliance, in order to enhance voluntary compliance.

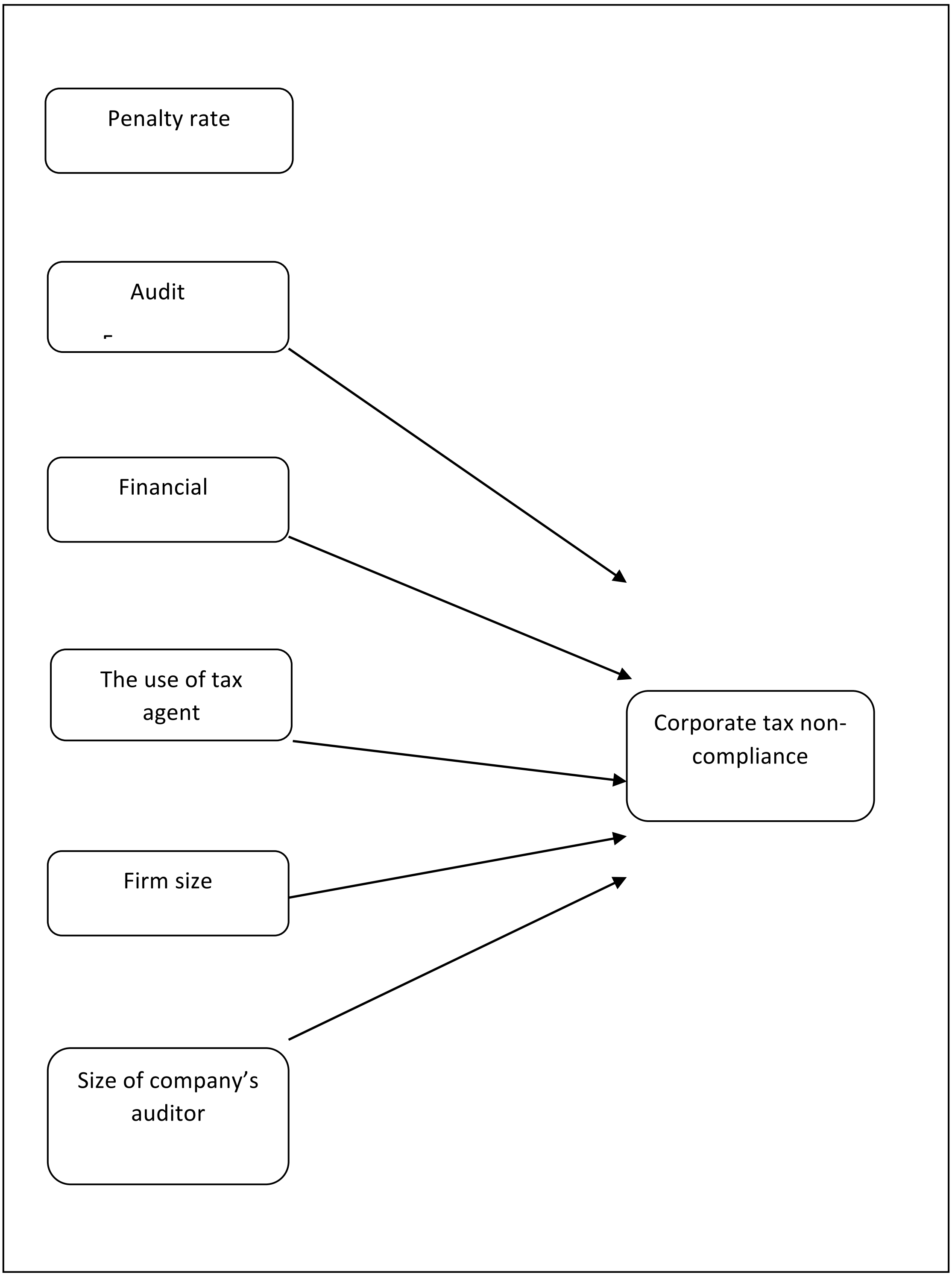
In summary, understanding the determinants of corporate tax non-compliance is important because it can lead to the better selection of cases for tax audit especially with the human resources limited. After all, tax audit is costly either to taxpayers or to tax authority. Thus, a good selection cases can lead to higher tax revenue collections as well as provide indicators triggered for tax investigation in future.

2.3 Determinants of Corporate Tax Non-Compliance

In the context of Malaysian taxation, research on corporate taxpayers has been neglected; leaving so many questions to be answered. Closer examination of the various determinants of tax non-compliance against corporation is important because corporations contribute to total revenue collections to Federal Government. Based on the theory and past studies discussed earlier, a framework is proposed for examining the determinants of tax non-compliance among corporations in Malaysia.

Figure 1 shows the proposed conceptual model which states the relationship between the dependent variable (tax non-compliance) and six independent variables that are penalty rate, audit frequency, financial performance, the use of tax agents, firm size and size of company's auditor. The relationship can be evidenced by using actual resolved tax audited data and surveying tax auditors' experience with tax non-compliance.

Figure 1 Proposed research framework



3. CONCLUSION

The impacts of tax non-compliance among corporations can reduce revenue collections directly, which detriment to national fund reserve as well. This paper presents a review of literature on the importance of examining tax non-compliance among corporations in managing limited resources when tax audits were undertaken. Some recent studies revealed many shortcomings of corporate tax non-compliance, especially in the context of developing country such as Malaysia on the determinants of tax non-compliance. Besides, there is a lack of tax compliance data either from the IRBM or corporate taxpayers themselves. Owing to the dearth of empirical studies on tax non-compliance among corporations, this paper proposes a framework for studying corporate tax non-compliance in Malaysia using resolved audited corporate cases and by surveying tax auditors' experience with tax non-compliance. In addition, the undertaking of an empirical study on corporate tax non-compliance will contribute towards a proper understanding of reasons for non-compliance amongst corporations, indicators for selection cases for tax audit and reasons triggered for tax investigation. The developed conceptual model in this paper and future empirical findings using this model will hopefully contribute towards the efficiency and effectiveness of the IRBM in detection and prevention tax non-compliance among taxpayers.

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