

FINDINGS ON THE IMPACT OF SELF ASSESSMENT ON THE COMPLIANCE BEHAVIOUR OF INDIVIDUAL TAXPAYERS IN MALAYSIA: A CASE STUDY APPROACH

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It is evident that many tax authorities throughout the world have become increasingly reliant on taxpayer self assessment as a means to improving administrative efficiency and effectiveness. However, the effect of self assessment on the compliance behaviour of taxpayers is not well understood. Self assessment generally assumes that taxpayers have the knowledge and skills required to fulfil their legal obligations, but in reality, this may not be the case. Self assessment for salary and wage earners and the self-employed was introduced in Malaysia from the 2004 year of assessment. This change in assessment method provided an ideal situation in which a deeper understanding of the impact of self assessment on compliance behaviour could be gained by undertaking qualitative research.

This article presents research findings based on the conduct of 74 case studies with individual taxpayers at the time that self assessment was introduced in Malaysia. Generally, it was found that subjects now exercised more care when filing their income tax returns to ensure that they only paid the tax required and that penalties were not imposed for non-compliance. Some subjects found the tax law to be too complicated and were unable to keep abreast of its frequent changes. Further, the

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return forms were found to be confusing and difficult to comprehend and the accompanying instructions were too brief and inadequate as a guide to self assessment.

1. INTRODUCTION

Prior to the implementation of self assessment (SA) in Malaysia for individual taxpayers in 2004, income tax was assessed under the official assessment system (OAS).¹ Under the OAS, the filing rate of tax returns and the level of compliance by taxpayers were regarded as unsatisfactory due to delayed and lost revenue collections that resulted.² These undesirable outcomes were further exacerbated by the Inland Revenue Board³ of Malaysia's inability to finalise assessments within the stipulated timeframe.⁴ SA was introduced to address these shortcomings. In particular, it was anticipated SA would improve taxpayer compliance rates, speed up the processing of assessments, reduce compliance costs and facilitate revenue collection.⁵

¹ SA was applicable from the year of assessment 2001 for companies and from the year of assessment 2004 for individuals.

² SN Sheikh Obid, 'Some problems of income taxation encountered by the Malaysian self-employed business taxpayers' *Akauntan Nasional* (November/December 1996) 34-40; J Kasipillai, M Mohd-Hanefah, N Mat-Din and M. Marimuthu, 'Are Malaysian Taxpayers prepared for the self assessment system?' *Tax Nasional* (September 1999) 9-17; Inland Revenue Board Malaysia (IRB) 2002, *Annual Report*, viewed 2 January 2006 <<http://www.hasilnet.org.my>>; R Mottiakavandar, T Ramayah, H Haron and J Ang, 'Factors influencing compliance behaviour of small business entrepreneurs' *Tax Nasional* (1st Quarter 2003) 20-26; and S Shanmugam, 'Managing self assessment - an appraisal' *Tax Nasional* (1st Quarter 2003) 30-32.

³ (Hereafter 'IRB').

⁴ See Sheikh Obid and Shanmugam, above n 2.

⁵ V Singh and R Bhupalan, 'The Malaysian self-assessment system of taxation, issues and challenges' *Tax Nasional* (3rd Quarter 2001) 12-17; NR Somasundram, 'Tax evasion and tax investigation - a study on tax compliance management' *The Chartered Secretary Malaysia* (July 2003) 20-24.

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To be successful, SA relies on high levels of voluntary compliance by taxpayers.⁶ That is, SA requires taxpayers to understand the tax system and its procedures, to possess adequate tax knowledge, to be aware of their compliance obligations and to be prepared to comply.⁷ How taxpayers respond to SA has important implications for their compliance behaviour.

The purpose of this article is to present research findings on the impact of the introduction of SA on compliance behaviour of individual taxpayers in Malaysia. Together, the scale of the research, its qualitative nature and the timing of its conduct, make it unique and an important contribution to the compliance literature. The article is presented in five parts. Following on from the Introduction in Part 1, Part 2 reviews prior literature on factors associated with compliance behaviour and identifies the objectives of the research. Part 3 describes the method used in the research and the results are presented in Part 4. Finally, the conclusions and implications of this research are discussed in Part 5.

2. LITERATURE REVIEW

The taxpayer compliance literature is a broad and developing body of knowledge and encompasses many disciplines, including economics and psychology. Its foundations lie in the economics of crime and expected utility literature, in which it is assumed that taxpayers are amoral rational economic evaders who would assess the likely costs and benefits of evasion behaviour compared to those

⁶ D Vos and T Mihail, 'The Importance of Certainty and Fairness in a Self-Assessing Environment', in M McKerchar and M. Walpole (eds), *Further Global Challenges in Tax Administration* (2006) 69-90.

⁷ EC Loo, M McKerchar, and A Hansford, 'An International Comparative Analysis of Self Assessment: What Lessons are there for Tax Administrators?' (2005) 20 *Australian Tax Forum* 669.

of compliance.⁸ Typically, these costs and benefits are associated with the tax rate, audit rate (i.e. percentage of returns subject to audit), the probability of detection and the penalties for non-compliance. However, findings on the effect of each of these factors generally lack consistency.

In respect of tax rates, it has been argued that an increase in tax rates encourages individuals to declare more income.⁹ In contrast, others have argued that an increase in tax rate leads to an increase of the probability of underreporting income¹⁰ and to larger non-payment problems,¹¹ particularly in the case of high income taxpayers.¹² It has also been suggested that the level of after tax income and marginal tax rates have a significant negative effect on compliance¹³ and this has been supported by subsequent studies.¹⁴ However, there is evidence of a significant negative relationship between the marginal

⁸ S Klepper and D Nagin, 'The criminal deterrence literature: implications for research on taxpayer compliance' in JA Roth and JT Scholz (eds), *Taxpayer Compliance Vol. 2: Social Science Perspective* (1989) 126-155; J Hasseldine, 'How do revenue audits affect taxpayer compliance?' *International Bureau of Fiscal Documentation* (July/August 1993) 424-435.

⁹ S Yitzhaki, 'Income tax evasion: A theoretical analysis' (1974) 3 *Journal of Public Economics* 201-202.

¹⁰ N Friedland, S Maital and A Rutenberg, 'A simulation study of income tax evasion' (1978) 10 *Journal of Public Economics* 107.

¹¹ T Besley, I Preston and M Ridge, 'Fiscal anarchy in the UK: modelling poll tax non-compliance' (1997) 64 *Journal of Public Economics* 137.

¹² MM Ali, HW Cecil and JA Knoblett, 'The effects of tax rate and enforcement policies on taxpayer compliance: a study of self-employed taxpayers' (2001) 29 *American Economic Journal* 186.

¹³ CT Clotfelter, 'Tax evasion and tax rates: an analysis of individual returns' (1983) 65 *The Review of Economics and Statistics* 363.

¹⁴ See AD Witte and DF Woodbury, 'The effect of tax law and tax administration on tax compliance: the case of the U.S. individual income tax' (1985) 38 *National Tax Journal* 1; JA Dubin and LL Wilde, 'An empirical analysis of federal income tax auditing and compliance' (1988) 41 *National Tax Journal* .61; A Das-Gupta, R Lahiri and D Mookherjee, 'Income tax compliance in India: an empirical analysis' (1995) 23 *World Development* 2051.

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tax rate and non-compliance, and that no significant relationship exists between non-compliance and income.¹⁵

In respect of using tax audits as an enforcement strategy, there is evidence that supports their effectiveness in SA systems,¹⁶ though they may need to be specifically designed for the intended taxpayer group.¹⁷ While Witte and Woodbury¹⁸ noted that tax audit effects were more significant among small proprietors than others, Beron et al¹⁹ found that taxpayers significantly underreported adjusted gross income and that the increased probability of audit increased both reported income and tax liability. Further, it was concluded that tax audits were more effective at inducing accurate reporting of deductions rather than of income.

Others have argued that the results of empirical evidence have been inconsistent and that there was no clear pattern for different audit classes or different taxpayers.²⁰ For instance, based on data from the period 1977-1986 Dubin et al²¹ concluded that audit rates had a significant positive effect on reported tax per return and that the effect was even stronger in the case of assessed liabilities per return with the implication being that increased compliance resulted because of the deterrent effect of tax audits. However, Long and

¹⁵ Feinstein (1991) cited in JW Sawkins and VA Dickie, 'Modelling council tax non-payment in Scotland and Wales: Preliminary results' (2003) Report prepared for The University of Stirling, 5 (viewed 8 March 2009, <<http://www.scotecon.net>>).

¹⁶ BR Jackson and PR Jaouen, 'Influencing taxpayer compliance through sanction threat or appeals to conscience' (1989) 2 *Advances in Taxation*, 131; Shanmugam above n 2.

¹⁷ Witte and Woodbury, above n 14; KL Beron, HV Tauchen and AD Witte, 'The effect of audits and social-economic variables on compliance' in J Slemrod (ed), *Why People Pay Taxes: Tax Compliance and Enforcement* (1992) 67-89.

¹⁸ See above n 14.

¹⁹ See above n 17.

²⁰ Dubin and Wilde, above n 14; IG Wallschutzky, 'Achieving compliance' (1992) *APTIRC Bulletin* 143-149.

²¹ JA Dubin, MJ Graetz and LL Wilde, 'The effect of audit rates on the federal individual income tax, 1977-1986' (1990) 43 *National Tax Journal* 395.

Burnham²² argued that it was difficult to determine the effect of tax audit and the varying probabilities of detection on taxpayer compliance as other possibly influential factors (including other enforcement strategies) generally did not remain constant.

Further, Tauchen et al²³ concluded that raising the audit rate had greater impact on high-income wage and salary workers than on taxpayers overall. Other experimental studies have tended to suggest more generally that a higher audit rate leads to improved compliance²⁴ and has a direct effect on tax collections of reported amount, additional taxes and penalties.²⁵ These studies are supported by claims that the decline in audit rate in the United States has had an adverse effect on the level of voluntary compliance.²⁶

In respect of the probability of being audited, experimental research has found that the effect of an increased probability in being audited varied with the level of income with the effect being more marked in the case of high income earners and particularly where there was an opportunity to evade tax.²⁷ However, due to the

²² SB Long and D Burham, 'Solving the nation's budget deficit with a bigger, tougher IRS: what are the realities?' *Tax Notes* (6 August 1990) 741-757.

²³ HV Tauchen, AD Witte and KJ Beron, 'Tax compliance: an investigation using individual TCMP Data' (Working Paper No 3078, National Bureau of Economic Research, August 1989).

²⁴ B Torgler, 'Speaking to theorist and searching for facts: tax morale and tax compliance in experiments' (2002) 16 *Journal of Economic Surveys* 657.

²⁵ JA Dubin, 'Criminal investigation enforcement activities and taxpayer non-compliance' (Paper presented at Internal Revenue Service Research Conference, Washington DC, June 2004).

²⁶ J Alm, BR Jackson and M McKee, 'Audit information dissemination, taxpayer communication, and compliance: an experimental approach' (Paper presented at 2004 Internal Revenue Service Research Conference, Washington DC, June 2004); S Johnson, 'The 1998 Act and the resources link between tax compliance and tax simplification' (2003) 51 *Kansas Law Review* 1013.

²⁷ J Slemrod, M Blumenthal and C. Christian, 'Taxpayer response to an increased probability of audit: evidence from a controlled experiment in Minnesota' (2001) 79 *Journal of Public Economics* 455.

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relatively small sample size of high income earners, reliable inferences could not be drawn. There is also evidence that optimal enforcement policy requires randomness in the selection of audit cases.²⁸

In respect of the threat of penalties, it has been found that non-compliance decisions are indirectly related²⁹ and that large fines are a more effective deterrent than are frequent audits.³⁰ However, it has been found that threats of future enforcement actions, including penalties, have little impact on the compliance behaviour of taxpayers in countries where non-compliance is high.³¹ Clearly, understanding compliance behaviour is complex and it appears that the economics of crime and expected utility literature can assist in only a limited sense.

There is another body of literature that draws mainly from psychology and considers the impact of taxpayer attitudes on compliance behaviour. This too represents a complex field of study and diverse views and approaches exist. The underlying challenge is that any behaviour may represent a multiplicity of attitudes and that tax mentality (i.e. a person's willingness to pay tax) appears to be an important construct with more than one dimension.³²

²⁸ S Scotchmer and J Slemrod, 'Randomness in tax enforcement' (1989) 38 *Journal of Public Economics* 17.

²⁹ RD Schwartz and S Orleans, 'On legal sanctions' (1967) 34 *University of Chicago Law Review* 274.

³⁰ Friedland et al, above n 10.

³¹ C Silvani and K Baer, 'Designing a tax administration reform strategy: experiences and guidelines' *Tax Notes International* (August 1997) 375-395.

³² A Lewis, *The Psychology of Taxation* (1982); G Schmolders, 'Survey research in public finance: a behavioural approach to fiscal theory' (1970) 25 *Public Finance* 300.

An early experimental study into taxpayer attitudes by Song and Yarbrough³³ found that taxpayers with higher fiscal knowledge had a higher tax ethic than did those with lower fiscal knowledge. Similarly, other experimental and quasi-experimental studies have found that low fiscal knowledge correlated with negative attitudes towards taxation and that attitudes towards tax could be improved by better tax knowledge.³⁴ Further, where taxpayers used higher stages of moral reasoning, their attitudes towards the tax system were more favourable and they were more compliant.³⁵

Satisfaction with government and perceptions of fairness appear to play important roles in taxpayers' attitudes towards behaviour³⁶ and a positive relationship has been found between taxpayers' perception of fairness and their tax liabilities.³⁷ Cuccia and Carnes³⁸ argued that other factors, including tax law complexity, could affect perceptions of fairness. The relationship between complexity and compliance has been studied by various methods including surveys, experiments and case studies, and with mixed findings. Some studies

³³ Y Song and TE Yarborough, 'Tax ethics and taxpayers attitude: a survey' (1978) 38 *Public Administration Review* 435.

³⁴ Lewis, above n 32; K Eriksen and L Fallan, 'Tax knowledge and attitudes towards taxation: a report on a quasi-experiment' (1996) 17 *Journal of Economic Psychology* 387; J Kasipillai, N Aripin and NA Amran, 'The influence of education on tax avoidance and tax evasion' (2003) 1 *eJournal of Tax Research* 134.

³⁵ CW Chan, CS Troutman and D O'Bryan, 'An expanded model of taxpayer compliance: empirical evidence from the United States and Hong Kong' (2000) 2 *Journal of International Accounting and Taxation* 83.

³⁶ J Alm, 'A perspective on the experimental analysis of taxpayer reporting' (1991) 66 *The Accounting Review* 577; KW Smith and LJ Stalans, 'Encouraging tax compliance with positive incentives: a conceptual framework and research directions' (1991) 13 *Law & Policy* 35; LP Feld and JR Tyran, 'Tax evasion and voting: an experimental analysis' (2002) 55 *KYKLOS* 197.

³⁷ CM Ritsema, DW Thomas and GD Ferrier, 'Economic and behavioural determinants of tax compliance: evidence from the 1997 Arkansas tax penalty amnesty program' (Paper presented at the Internal Revenue Service Research Conference, Washington DC, June 2003).

³⁸ AD Cuccia and GA Carnes, 'A closer look at the relation between tax complexity and tax equity perceptions' (2001) 22 *Journal of Economic Psychology* 113.

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have found a positive association between complexity and non-compliance, whether intentional or unintentional,³⁹ while others found that the impact of complexity on compliance varied with the characteristics of individual taxpayers, which included education level, perceptions of fairness and the opportunity to evade.⁴⁰

Christensen et al⁴¹ found that increasing taxpayer education enhanced both the understanding and acceptance of tax law complexity. While some studies⁴² which have found a positive correlation between tax knowledge and compliance, others⁴³ have refuted the existence of any direct relationship between these variables. It appeared that reducing the complexity of tax laws might encourage compliance among taxpayers in that they may more easily understand the law, the tax structure, and the computation of their own tax liability.⁴⁴ However, it has been argued that, based on findings from a survey, simplifying the tax system might not be an effective deterrence to tax evasion as taxpayers may not necessarily consider a complex tax system to be unfair.⁴⁵

Both the economic and psychology literature have consistently revealed supportive evidence that correlations exist between compliance and demographic variables (such as age, gender and

³⁹ M McKerchar, 'The effects of complexity on unintentional non-compliance for personal taxpayers in Australia' (2002) 17 *Australian Tax Forum* 3; Clotfelter, above n 13; Ritsema et al, above n 37.

⁴⁰ Witte and Woodbury, above n 14.

⁴¹ AL Christensen, SG Wehrich and MDG Newman, 'The impact of education on perceptions of tax fairness' (1994) 6 *Advances in Taxation* 63.

⁴² CM Fischer, M Wartick and MM Mark, 'Detection probability and taxpayer compliance: a literature review' (1992) 11 *Journal of Accounting Literature* 1; Kasipillai et al, above n 34.

⁴³ Eriksen and Fallan, above n 34; Mottiakavandar et al, above n 2.

⁴⁴ JC Baldry, 'Self assessed taxation in Australia: definition, costs and benefits' *The Chartered Secretary Malaysia* (January/February 1999) 6-8; Somasundram, above n 5.

⁴⁵ A Forest and SM Sheffrin, 'Complexity and compliance: an empirical investigation' (2002) 55 *National Tax Journal* 75.

marital status, level of education and level of income). In terms of gender, Jackson and Milliron⁴⁶ found that males tended to be more non-compliant than females. Further, Glen⁴⁷ and Kasipillai et al⁴⁸ concluded that, among females, there was improvement in compliance attitudes after they were given lessons on tax. As for age as a determining factor, Clotfelter⁴⁹ noted a curvilinear relation with middle-aged taxpayers being the least compliant. However, other researchers⁵⁰ have noted a negative relationship between age and compliance. In terms of marital status, single taxpayers were found to be more intentionally non-compliant than were married taxpayers.⁵¹

In respect of the level of education and its influence on taxpayer compliance, there are mixed findings evident in the literature. For example, Beron et al⁵² found a positive relationship between education and non-compliance, which was consistent with the findings of Witte and Woodbury,⁵³ Kinsey et al,⁵⁴ and others,⁵⁵ but in

⁴⁶ BR Jackson and VC Milliron, 'Tax compliance research: findings, problems, and prospects' (1986) 5 *Journal of Accounting Literature* 125. This finding was also supported by KA Kinsey, H Grasmick and K Smith, 'Framing justice: taxpayer evaluations of personal tax burden' (1991) 25 *Law and Society Review* 845.

⁴⁷ W Glen, 'The influence of gender and education on tax avoidance and tax evasion' in C Evans and A. Greenbaum (eds), *Tax Administration: Facing the Challenges of the Future* (1998) 63-73.

⁴⁸ Above n 34.

⁴⁹ Above n 13.

⁵⁰ See Witte and Woodbury, above n 14; Dubin and Wilde, above n 14.

⁵¹ See Clotfelter, above n 13; JC Young, 'Factors associated with non-compliance: evidence from the Michigan tax amnesty program' (1994) 16 *Journal of American Taxation Association* 82.

⁵² Above n 17.

⁵³ Above n 14.

⁵⁴ Above n 46.

⁵⁵ N Madi, *Tax Literacy Among Sole Proprietors and Partners at Tabuan Jaya and King Centre Kuching, Sarawak* (Dissertation submitted in partial fulfilment for the Master of Accounting, Curtin University of Technology, 1999); N Saad, M Mansor, and I Ibrahim, 'Self-assessment and its compliance costs' (Paper presented at

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conflict with the finding of a negative relationship between these two variables by Dubin and Wilde.⁵⁶ As for income level and its influence on taxpayer compliance, research findings also reveal mixed and inconsistent evidence.⁵⁷ However, it does appear that with higher levels of education, taxpayers might improve their tax knowledge as well as income level, and that together they may improve attitudes towards compliance.⁵⁸

Based on the review of the literature, it is clear that there is scope for more research to be undertaken into taxpayer compliance, particularly using different research methods, and across jurisdictions and assessment systems. At the time of introducing self assessment in Malaysia, there were concerns that the IRB's traditional reliance on the deterrence effect of penalties and enforcement activities, including the undertaking of criminal proceedings against errant taxpayers, may no longer be appropriate⁵⁹ given that there are many factors that can influence compliance behaviour and that non-compliance may not always be intentional. It was considered that the IRB, in introducing self assessment, may not have focused sufficiently on the necessity to identify, evaluate and take cognition of the breadth of factors that influenced compliance behaviour. Accordingly, it was felt that research was needed to identify the factors that may influence compliance behaviour associated with the

SEMAAC 2003 Research Proceedings: Issues and Challenges Confronting The Accounting Profession Today, 8-10 December 2003, Kangar, Malaysia).

⁵⁶ Above n 14.

⁵⁷ For example see J Alm, BR Jackson and M McKee, 'Estimating the determinants of taxpayer compliance with experimental data' (1992) 45 *National Tax Journal* 107; J Alm, BR Jackson and M McKee, 'Deterrence and beyond: toward a kinder, gentler IRS' in J Slemrod (ed), *Why People Pay Taxes: Tax Compliance and Enforcement*, (1992) 311-329; Clotfelter, above n 13; Young, above n 51.

⁵⁸ PA Hite, 'Identifying and mitigating taxpayer non-compliance' (1997) 13 *Australian Tax Forum* 155.

⁵⁹ S Shanmugam, 'Enforcing tax compliance - relevant issues for criminal prosecution' *Tax Nasional* (1st Quarter 2004) 17-19; Singh and Bhupalan, above n 5.

introduction of SA in Malaysia; and to identify problems associated with filing of tax returns under SA.

3. RESEARCH METHOD

At the outset, it was theorised that the introduction of SA did influence the compliance behaviour of personal income taxpayers. It was presumed that the method of assessment together with other factors might result in a certain level of intentional or unintentional error when individual taxpayers [both salary and wage earners (SW) and the self-employed (SE)] filed their tax returns. Given the desire to gain a deeper understanding of compliance behaviour and the processes by which taxpayers made decisions, a qualitative research paradigm was adopted.

Consistent with this paradigm, a case study was chosen as the strategy of inquiry to identify the impact or influence of SA on compliance behaviour. Given the objectives of the research, a case study was selected as the most appropriate strategy as it could provide indications of the influence of SA based on actual behaviour as close as possible to the time of occurrence, judged objectively based on a wider range of information obtained (i.e. the examination of the actual tax returns, taxpayers' records and documents as well as the opportunities to systematically interview the taxpayers). The case study design adopted was that of Yin⁶⁰ which has been successfully used previously in the compliance literature, but on a significantly smaller scale.⁶¹ A single unit case study was conducted, bounded by activity and time (i.e. respectively by the preparation of tax returns on income earned for the year ended 31 December 2004 and the deadline for filing tax returns). The deadline for submission of tax returns by the SW was 30 April 2005 while for the SE, it was

⁶⁰ RK Yin, *Case Study Research-Design and Methods* (3rd ed, 2003) Applied Social Research Methods Series, Volume 5.

⁶¹ See M McKerchar, *The Impact of Complexity Upon Taxpayer Compliance* (ATRF Research Study 39, Sydney, 2003).

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30 June 2005. A diagrammatic representation of a single unit case study is shown in Appendix 1.⁶²

Data collection involved multiple sources and chains of evidence (to strengthen the construct validity) and multiple replications of the case study protocol (to strengthen external validity). Documentation (a protocol) was prepared which contained a set of substantive questions reflecting the actual inquiry that allowed data collection to follow a general plan with some consistency, allowing for inferences to be as unbiased as possible. All the observations, examinations, inspections and interviews in relation to each subject were conducted independently without any interaction among the subjects.

The subjects were recruited in Malaysia via convenience sampling through invitations to the faculty staff of University of Technology MARA, Malacca campus and main campus in Shah Alam,⁶³ as well as to local communities. At the outset, it was anticipated to undertake only about 20 repetitions or observations. Surprisingly however, a total of 74 subjects (64 SW and 10 SE) from both rural and urban localities voluntarily participated in the research.

Qualitative data analysis techniques were utilised whereby data collected (from examinations of tax returns, inspections of relevant supporting document and in-depth interviews) was coded and formed the basis of a narrative description of the compliance behaviour observed. One of the most desirable techniques in qualitative research is pattern matching logic and where the results reveal the predicted pattern, the internal validity of a case study is strengthened.⁶⁴

⁶² This diagrammatic representation is from RK Yin, *Case Study Research-Design and Methods* (2nd edition, 1994) Applied Social Research Methods Series Vol 5, 49.

⁶³ Capital city of Selangor, a state of the Federation of Malaysia.

⁶⁴ Yin, above n 60.

4. FINDINGS

In presenting the findings of the research, the discussion focuses firstly on the problems encountered by the subjects in completing their tax returns, followed by the common errors detected from examination of the tax returns and the cause (or causes) of the errors. Drawing on pattern matching, judgements are then subsequently formed on the patterns of compliance behaviour of the subjects.

With the exception of four subjects, the remaining 70 subjects encountered problems in completing their respective tax returns. The main problems encountered were that the contents of the accompanying instruction booklet were too difficult to understand and that the instructions were too brief and inadequate in providing any proper and useful guidance to completing the tax returns. Generally, the subjects disclosed that the problems they encountered were resolved by means of seeking assistance from friends or colleagues, and in several cases, from family members. Several subjects left blank certain relevant parts of the tax returns, hoping that the IRB officers would make the necessary adjustments.

One particular aspect of the tax return required taxpayers to indicate whether or not he/she had complied with the relevant Public Rulings when filing their tax returns. This seemingly simple requirement of answering 'Yes' or 'No' was one of the problems commonly encountered by subjects. Regardless of their level of education, the subjects appeared to be totally at a loss as they had no knowledge as to the meaning of the term 'Public Rulings', let alone any knowledge of their relevance or contents.

Of the 64 SW subjects, 57 were employed in the public sector, were of various ages, all had tertiary qualifications and were able to communicate in either the Malay language or English. Three of these 57 subjects employed in the public sector did not have any previous experience in filing tax returns. The remaining seven of the SW subjects were employed in the private sector.

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Of the 57 subjects employed in the public sector, all except two had over declared their employment income. This was due to their lack of awareness or uncertainty on exemptions allowed in respect of housing, entertainment and civil service allowances that formed part of their remunerations package. The information pertaining to such exemptions was not incorporated in the accompanying instructions or tax guides but was only made available in a circular issued by the IRB to the respective finance departments in the public sector. As a result of erroneously reporting these exempted incomes, subjects had exercised unintentional non-compliance and as a consequence they had overstated their tax liability. No exemption was allowed on similar allowances paid to employees in the private sector and no reporting errors were found in relation to similar allowances in their tax returns. Therefore, these seven subjects had fully complied in the reporting of their employment income.

Of the seven subjects employed in the private sector, four had tertiary qualifications, two derived income only from employment, five also derived rental income and two were also in receipt of dividends. In relation to the rental income, two subjects attempted to evade tax by omitting the assessable rental income, as they felt that such income might not be traceable. One subject reported the gross rental income without realising that he/she could claim allowable deductions on expenses incurred in relation to the rented property, thus had unintentionally over complied. For the two subjects with dividend income, both had correctly reported their respective gross dividend but unintentionally failed to claim tax credit available to them, which again, was evidence of unintentional over compliance.

For the SE subjects, it was readily apparent that the tax returns⁶⁵ were too complicated. Of the ten SE subjects observed and interviewed; seven were unsure as to what details should be included in their respective tax returns, particularly the need to furnish

⁶⁵ SE and SW must fill in different tax returns.

information on specific items of income and expenses that had to be extracted for the business income statements.⁶⁶ To resolve the problems encountered, besides seeking the assistance from friends or family members, one subject had sought assistance from an IRB officer but the problems were still left unsolved, as the IRB officer himself /herself was not very certain about as what really needed to be reported and thus could not provide the appropriate solution. The 3 other subjects had apparently used the services of accountants to prepare their business accounts, and therefore found that furnishing similar required information in their tax returns was not a major problem.

Common errors made by SE subjects included the tax treatment of salaries and remunerations drawn by the SE business proprietors, the expenses incurred partially for private purposes and the capital expenditure incurred on the acquisition of capital assets used for the purposes of their business activities. Two subjects who drew salaries or remunerations from their SE business had deducted the amount of salaries or remunerations so drawn against their business (as disclosed in their respective income statements), wrongly believing that such drawings were allowable deductions. Similarly, two other subjects had wrongly claimed full deductions for expenses that were partially incurred for private purposes.

In the case of capital expenditure incurred on the acquisition of capital assets used in the business, instead of calculating capital allowances, two subjects had deducted the total capital expenditure incurred. Four SE subjects were not aware of the capital allowances available to them in relation to capital expenditure acquired on the acquisition of capital assets. One subject, who was aware of the deductibility of capital allowances, had chosen not to claim them

⁶⁶ The format of income statement in the SE tax return differed to that used in general practice.

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because they were ‘troublesome and a hassle’ to compute, particularly in the event of subsequent disposals.

For subjects who had either under- or overstated their tax liability, there emerged a pattern of unintentional non-compliance. In the case of the one SE subject who choose not to claim capital allowances, there had been a deliberate decision to over comply. Another subject acknowledged that he/she had intentionally omitted an item of assessable income that could be traceable, but stated that he/she was not fearful of the likelihood of being audited. Such non-compliant behaviour is consistent with the rationale that the monetary benefit of evading is greater than the price to be paid in the event of being caught.

Further analysis of both categories of taxpayers revealed the commission of errors in relation to claiming reliefs and rebates in respect of premiums paid on life insurance; spouses; premiums paid on medical/ education insurance; expenses incurred on purchase of books or magazines; and medical expenses incurred on parents. Two subjects incorrectly claimed the premium paid on a child’s life insurance policy as a deduction, resulting in under payment of taxes. Such unintentional non-compliance could have been avoided if the subjects had carefully read the accompanying instructions. Another subject, due to uncertainty in matching, had wrongly claimed a deduction for a life insurance premium that was paid in January 2005 against income derived in 2004. Similarly, due to uncertainty of the deductibility of premium paid on medical or educational insurance policies, several subjects had over-deducted the relief available to them with the commission of such errors amounting to unintentional non-compliance.

As for expenses incurred on purchase of books or magazines, four subjects had deducted the total amount as printed in the receipts. Detailed inspection of the receipts revealed that some items purchased were general stationery items or newspapers, both of which were non-deductible. One subject was absolutely confident on

the accuracy of his/her claims for such deductions, acting on the belief that the so claimed was deductible simply because the receipt was issued by an established book vendor. Two other subjects intentionally deducted the maximum amount allowable as relief, acknowledging that they were taking the risk of being audited. Whilst the amount of taxes underpaid by these two subjects was minimal, their behaviour reflected intentional non-compliance.

In contrast, analysis revealed that several subjects had not claimed any deductions for books purchased or medical expenses paid for their parents because they did not keep the receipts and did not want to take the risk of being penalised should they be audited. In terms of reporting compliance, they had demonstrated reasonable commitment to compliance. However, at the same time, their failure to keep proper records was evidence of non-compliance, but could not be directly related to SA as these requirements existed under the previous assessment system.

Additional rebates may be allowable to taxpayers subject to certain thresholds. Ten subjects were eligible but did not claim such rebates, thus resulting in an overpayment of tax. Other less critical errors were in relation to rebates on purchase of personal computers,⁶⁷ child relief and spouse relief. Two subjects (who were husband and wife) both claimed for rebates on purchase of personal computers, wrongly thinking that such rebates were available to each individual taxpayer (rather than on a per household basis). Likewise, there were two married couples (i.e. four subjects) where both husband and wife had wrongly claimed full child relief on the same child. As for spouse relief, four subjects who had elected individual (rather than joint) assessments had wrongly claimed such relief. The confusion in relation to these erroneous claims appeared to be due to

⁶⁷ With effect from the year of assessment 2007, this rebate has been replaced by a relief or tax deduction.

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the ambiguity of the criteria contained in the tax return itself, and consequently gave rise to unintentional non-compliance among the subjects.

An individual taxpayer's income tax liability can be mitigated by way of contributing in a form of donation to any approved institution or/and in the case of a Muslim, by the payment of *zakat*.⁶⁸ Two subjects revealed their intentions to pay less income tax by giving donations to approved institutions and by claiming *zakat* payments. Both donations to approved institutions and *zakat* payments are allowable deductions, but an individual may choose not to claim them, thus no pattern of compliance or non-compliance is found. Some subjects had made donations, but did not understand the distinction between approved/unapproved donations and wanted to claim all donations. Some had made approved donations, but did not keep receipts. In respect of *zakat* payments, most subjects were aware of the rebate, but some did not keep receipts. One subject who had paid *zakat* intentionally did not wish to report it in the tax return, thus intentionally forgoing the deduction available and hence paying more income tax. The reason for such intentional non-compliance cited by this subject was that the payment of *zakat* was regarded as a moral and religious obligation.

When discussing how the implementation of SA had affected their compliance behaviour, subjects indicated that they were more careful in completing their tax returns in order to avoid being penalised unnecessarily. For most subjects, they felt that it was important to ensure that their tax returns were correct and accurate. Several subjects agreed that the implementation of SA was a positive development as it would uplift the tax system to that of other tax systems globally, but they were also of view that taxpayers should be

⁶⁸ *Zakat* is a mandatory religious tithe payable annually by Muslims. Under Section 6A(3), Income Tax Act, only ‘...Islamic religious dues payment of which is obligatory...’ are available as rebates, which would effectively reduce an individual's tax payable.

well informed on the frequent changes to tax law. In addition, subjects felt that more tax education programs should have been conducted before implementing SA.

With the introduction of SA, most subjects (70) reported being more fearful of being audited. However, no subject had any idea as to how a tax audit would be conducted or any idea of the types of penalty that may be imposed for non-compliance. Subjects did feel that it would be unfair to penalise taxpayers for the commission of unintentional errors.

With regards to tax rates, two subjects (who were in the top income tax bracket) and one other subject (who was in the lowest tax bracket) were particularly unhappy with the tax rates imposed on them. Reasons cited included that taxes imposed did not correspond with the rising cost of living, such as the increase in fuel and electricity prices. Other subjects considered that the tax rates applicable to them were reasonable.

One of the main features of other SA regimes (such as Australia) was the prompt refund of overpaid taxes by the tax authority. This critical issue was raised by most subjects, particularly those who were subject to withholding tax. Under the SA regime, the tax law requires and the IRB expects taxpayers to assess their own tax liabilities and then to file their returns and to pay the taxes due before the stipulated due date. Similarly, on the part of the taxpayers, they expect the IRB to refund their excess tax payments within a certain stipulated time frame.⁶⁹

⁶⁹ According to the tax law, there is no time frame for refund. However, a two-month period was mentioned in the IRB's Clients' Charter.

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5. CONCLUSION

Based on this research conducted using a case study strategy of inquiry and in the context of the introduction of SA in Malaysia in respect of individual taxpayers, there is considerable evidence to indicate that the complexity, ambiguity, uncertainty and lack of knowledge of tax law were the main causes of either unintentional non-compliance or over-compliance. Other causes (tax audit, penalty and attitude towards tax) were also evident in affecting compliance behaviour.

The findings demonstrated the usefulness and importance for the IRB to be aware of and understand taxpayers' compliance behaviour and the need to provide tax education services to taxpayers in order to enable them to exercise appropriate compliance. Although the IRB does have some general minimal tax education programmes focusing on selected groups of taxpayers, there is the need to further develop its programmes to enhance taxpayers' level of tax knowledge. These education programmes need to reach out to all categories of taxpayers residing in all geographical locations of Malaysia, instead of the current practice of concentrating on taxpayers in the vicinity of the urban areas. In addition, clear and consistent application of tax law and public rulings is needed so as to not confuse taxpayers.

This research also found that individual taxpayers in Malaysia, in general, were willing to comply⁷⁰ and that taxpayers' attitudes towards the tax administration and experience encountered with the tax officers, rather than tax audits, were the determinants of their compliance behaviour. Based on this evidence, the IRB should review its tax audit and public relation strategies. Perhaps in relation

⁷⁰ This is supported in a study in which it was found that Malaysia was ranked 8th in the world after Singapore, New Zealand, Australia, UK, Hong Kong, Switzerland and US in term of tax compliance. See A Riahi-Belkaoui, 'Relationship between tax compliance internationally and selected determinants of tax morale' (2004) 13 *Journal of Accounting, Auditing and Taxation* 135.

to individual taxpayers, the IRB should de-emphasise tax audits and instead draw up strategies to enhance public relations. These policy implications are not limited to Malaysia, the findings of this study could also serve an important reference to other tax jurisdictions looking to implement self assessment particularly other developing countries where literacy levels among taxpayers are marginally lower compared to developed countries.

Appendix 1: Single Unit Case Study

