DETERMINANTS OF TAX NONCOMPLIANCE AMONG SMALL AND MEDIUM ENTERPRISES IN KLANG VALLEY, MALAYSIA

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ABSTRACT

The aim of this study was to identify the determinant of tax noncompliance among the small and medium enterprises (SMEs). The study also examine the perception of SME taxpayers toward tax penalty, company size and level of income. Tax noncompliance is defined as when the taxpayers did not comply or follow the tax rule and tax regulation set by the tax authority. The increasing value of tax noncompliance will affect the value of tax revenue to the government. The sample consists of the small and medium enterprises (SME) operators in distributive trade, service providers; and food and beverages in Klang Valley, Malaysia. The selected of this sectors because among the highest numbers SMEs operators. 150 questionnaires were distributed to the SME operators, only 86 (55.42%) respondents' agreed to participate. Statistical Package for Social Sciences (SPSS) is using to test the reliability, normality, descriptive and correlation of the respondents. The results indicated that there is/was a number of significant relationship between company size and level of income towards tax noncompliance among the SMEs. The study recommends that Inland Revenue Board of Malaysia (IRBM) management can improve the level of tax compliance by ensuring the favorable and fair tax rates especially to SME operators

Keywords: *SMEs, Tax noncompliance, Tax penalty, Company size, Level of income*

1. Introduction

Taxation is one of the methods to finance government expenditures and the important components of government revenues to each country. It also as the main sources of a country to support the facilities and developments for all nations. Several studies stated that taxation is an amount payable required by the government to supply and provide any specific welfare or service to all citizens (Aghion, Akgigit, Cage and Ker, 2016; Spilker, Ayers, Robinson, Outslay, Worsham, Barrick and Weaver, 2013). In Malaysia, two types of taxes are imposed namely direct and indirect tax. Direct taxes included individual tax, company tax, real property tax and petroleum tax. For indirect taxes are good and services tax (GST), import duties, export duties and excise tax. The Inland Revenue Board of Malaysia (IRBM) administers direct tax and Royal Malaysia Customs and Excise Department handles indirect tax.

Based on the trend of tax collection for direct taxes between years 2010 until 2014 shows that the amount tax collection was slightly increasing year by year. However, in year 2015 and 2016, tax collection was slightly decrease (Annual Report, 2016). Given this trend, it shows that some of the taxpayers did not disclose all their total income and submitted accordingly. It called as tax noncompliance. Tax noncompliance is one of the several phenomena that have affected the global economy in developed and developing countries (Ross and McGee, 2012; Hindriks, Peralta and Weber, 2008).

Small and medium enterprises (SMEs) are the majority business taxpayers in most developing countries and impart direct impact on government revenue (Maseko, 2014). In Malaysia, National Small and Medium Enterprises Development Council (SMIDEC) categories SMEs into micro, small and medium enterprises based on the number of employees and annual turnover. In 2016, based on SMIDEC data, 76.5% (n=693,670) of the SMEs are microenterprises, 21.2% (n=192,783) are small and 2.3% (n=20,612) are medium categories of SMEs. According to Palil and Mustapha (2011) reported that SME taxpayers are lack knowledge about the level of taxable income, types of taxes of the business that supposed to pay. It also supported by Alink (2010), indicated that tax noncompliance behavior of SMEs includes non-registration for tax, non-filing of returns, none or poor payment record, underreporting of turnover and profit; and poor bookkeeping. Many SME taxpayers do not know the domain of tax professional because of lack the independence and have no tax competency (Nakiwala, 2010; European Commission, 2007). Besides that, the

difficulties within the tax system, some of SME taxpayers involved to avoid or evade tax payable (Muharremi, Madani, Pelari, 2014; Choong, Lai and Ng, 2009).

Thus, the objective of this study is to identify the determinants of tax noncompliance among small and medium enterprises in Klang Valley, Malaysia. This study highlights three main determinants of tax noncompliance, namely tax penalty, company size and level of income.

2. Literature review

Tax compliance and tax noncompliance has been discussing in a major research topic in economic psychology. It is a combination between economic and psychology or non-economic determinants. Economic determinants are measured the taxpayers perception in terms of tax rate, tax audit, penalty, total income and other monetary variables. In terms of non-economic determinants are measured by the willingness of taxpayers to pay tax and to explain the behavior of tax compliance (Yong and Hooper, 2011; Hyun, Park and Ya, 2002). Some researchers have viewed tax compliance and tax noncompliance from a different perspective. For example, Allingham and Sandmo (1972) described tax compliance as reporting an actual income and claimed that tax compliance behavior influenced by a situation of taxpayers' decision. According to Alm (1991) and Jackson and Milliron (1986) defined tax compliance as the reporting of all incomes and payments of all taxes by fulfilling the tax laws, regulations and court judgment that classified as an economic approach.

On the other side, Jackson and Milliron (1986) and Alm (1999), behavior can be interpreted by the social and psychological approach. Social and psychological approach includes personal factor and social influences to measure the tax noncompliance. Tax noncompliance consists of two elements, namely tax avoidance and tax evasion (Cussia, 2010). Tax avoidance is legal activities to minimise tax payable, and tax evasion is illegal activities such as fraud or manipulated the tax payable. Tax noncompliance is defined as taxpayers' failure to remit a proper amount of tax, contradictions in the tax legislation or tax administration procedure (Kasipillai and Jabbar, 2003; Kesselman, 1994; Jackson and Milliron, 1986). Several studies reported, the choices to omit income tax are taxpayers rational decision and formulated under the policy tools, such as penalty rates, tax rate and audit rate that lead to high tax non-compliance and contribute to hidden economy (Schneider, 2012; Schneider and Savasan, 2007; Dell'Anno, 2007; Savasan, 2003).

Tax penalty is imposed to taxpayers if they failure to perform well as required by the tax authorities such as failure to timely file return or filling wrong or underreporting income (Oladipupo and Obazee, 2016). The author finding reported that tax penalty did not have significant effect on tax compliance at 5% level of significance. In Malaysia, if taxpayers involved such as underreporting or misstatement the total income that discovered during the audit process, a penalty will be imposed under subsection 113(2) of the Income Tax Act (ITA) 1967. If the firms involved in fraud or manipulate activities, tax investigation will start by the tax inspector of IRB. Based on the Annual Report 2016, reported the increasing numbers of cases audited for SME taxpayers in 2016 than the year before which are 541,798 cases compared to 529,010 cases for 2015, respectively. It is consistent with previous studies reported that the higher tax burdens to the taxpayers especially SME taxpayers have negative impact on compliance (Bello and Danjuma, 2014; Barbuta-Misu, 2011).

Company size variable also one of the determinants to measure the level of tax noncompliance. Juahir, Norsiah and Norman (2010) and Zainal Abidin, Hasseldine and Paton (2010) emphasized that the bigger the firms are, the more the firm is complaint with the tax law due to proper internal control, need a good accounting system and greater tax knowledge as compared to small firms. In a study done by Hanlon, Mills and Slemrod (2007) and Slemrod (2007), they found a positive relationship between company size and tax noncompliance. From the findings, it concluded that tax noncompliance increases as the size of the business increases. Besides that, Olorunshola (2003) explained that the ownership style has led small and medium enterprises to have a simple management structure. It is due to few numbers of employees and the owners' have a low level of education.

Besides that, the level of income also influenced the tax noncompliance. For example, once the taxpayers have decided to evade taxes, the degree of underreporting depends on the relative risk aversion. Allingham and Sandom (1972) have concluded 'that when actual income varies, the fraction of income declared increases, stays constant or decreases accordingly as relative aversion is an increasing, constant or decreasing function of income'. Alm, McClelland and Schulze (1992), also successfully proved a positive relation of income and tax compliance. In a study done by Chau and Leung (2009) also reported that the respondents in the lower-income group tend to have a lower proportion of tax compliance by underreporting income and by over claiming expenses than their counterparts in the higher-income group. Therefore, the following hypotheses are constructed:

H₁: Tax penalty is significantly correlated to tax non-compliance

H₂: Company size is significantly correlated to tax non-compliance

H₃: Level of income is significantly correlated to tax non-compliance

3. Method

This study used survey design to analyse the perception of SME taxpayers toward tax noncompliance. Data of this study was gathered from fieldwork using questionnaire with Likert scale to determine agreement on the statements given (5 points Likert scale, 1 = strongly disagree, 2 = disagree, 3 = not sure, 4 = agree and 5 = strongly agree). The questionnaire consists of two parts. The part A of the questionnaire is on the demographic characteristics of the respondents while part B of the questionnaire is on the research questions on the research variables namely, tax penalty, company size, level of income and tax non-compliance. The dependent variable of this study is level of tax noncompliance. Questions were adapted from previous studies that are Abdullah, Harry, Sazali, Qaiser and Thurai (2014) and Abdul Jabbar (2009).

A total of 150 questionnaires were distributed to the top three industries of SME taxpayers' in Klang Valley, Malaysia. The Klang Valley includes Kuala Lumpur and Selangor area. The top three industries selected are distributive trade, service providers; and food and beverages. Selected of these sectors because among the highest numbers SMEs operators. The total response rates for all three sectors are 55.42% (n = 86) is presented in Table 1. This response is acceptable according to Hair, Black, Balin and Anderson (2010).

Table 1: Response rate

Sector	Total distributed	Total completed	Response rate per sector
Distributive trade	113	64	56.64%
Service providers	23	17	73.91%
Food and beverages	14	5	35.71%
Total	150	86	55.42 %

To ensure the reliability of the instrument, the questionnaire was pre-tested using fifteen (15) respondents. The data obtained were analysed by using Statistical Package for Social Sciences (SPSS) to test the reliability, normality, descriptive and correlation of the respondents.

4. Results and discussion

Reliability analysis is used to measure the data is without bias or error free and ensures consistent measurement across time and all items in the instrument (Sekaran and Bougie, 2011). The finding shows that the Cronbach alpha coefficient obtained is an equal or above 0.70 which is acceptable. The result in Table 2 represents that all research questions in the questionnaire have internal consistency.

Table 2: Reliability analysis

Cronbach's alpha	Cronbach's alpha based on Standardised Items	No of Items
Tax penalty: 0.821	0.813	8
Company size: 0.770	0.770	8
Level of Income: 0.695	0.697	6
Level of Tax non-compliance:0.721	0.720	5

Normality test is used to determine whether a data set is well modeled by normal distribution or not normal distribution. The form of Kolmogorov-Smirnov (K-S) test compares the scores in the sample to a normally distributed set of scores with the same means and standard deviation. From the findings, it shows that all variables p value is more than 0.05 except the tax noncompliance variable, which is the p value is less than 0.05. From the findings, the ratio of 3 out of 4 variables the p value is more than 0.05; therefore the data collected is normally distributed. The results are represented in Table 3.

Table 3: Normality analysis

Kolmogorov – Smirnov ^a			
	Statistic	df	Sig.
Tax penalty	0.084	86	0.198

Company size	0.079	86	0.200
Level of income	0.088	86	0.097
Tax non-compliance	0.187	86	0.000

Descriptive analysis has been utilised to explain the profile of respondents regarding both demographic information of SME taxpayers, namely age, gender, position, numbers of employees and annual turnover. The analysis revealed that the majority of respondents were aged between 21 to 30 years (40.7%), while 25.6 percent of the respondents were between 31 to 40 years old. In respect of the gender, it is show an equal responses rate which is 50 percent for both male (n=43) and female (n=43), respectively. Then, in terms of SME taxpayers' position, the majority of the respondents were senior (43%), followed by junior (25.6%), manager (22.10%), partner (8.1%) and others (1.2%). Based on the number of employees, it has divided into SME categories, which are micro, small and medium. The highest percentage is small categories (53.5%), followed by medium categories (29.1%) and micro categories (17.4%). Lastly, in terms of annual turnover, the highest percentage of the respondents is below RM300,000 (41.9%), followed by annual turnover between RM300,001 to RM3,000,000 (40.7%) and annual turnover between RM3,000,001 to RM20,000,000 (17.4%).

Table 4 shows the level of SMEs perception on tax penalty. Some of the respondents agreed with the statement of *"cost to hire expertise to handle tax compliance is higher than the penalty rate imposed"*. Majority of the respondents are not sure with the current penalty rate imposed by the IRB to the noncompliance taxpayers. Besides that, they also are not sure either the higher tax penalty will result a good of tax compliance.

Table 4: Perception on tax penalty

Questions	Mean
The current penalty rates are fairly charged	2.6395
Higher penalty rate will result in betterment of tax compliance	2.6977
The current penalty rate imposed by the Inland Revenue Board (IRB) is efficient enough to ensure higher level of tax compliance	2.8488
If penalty rates are not imposed, there will be proper tax compliance practiced	2.9767
The penalty rate should be lowered if the tax payable is below certain amount	3.1860
Tax noncompliance should give a strict punishment to taxpayers	2.9070
Your firm rather choose to pay the penalty than to comply with the tax law	2.8488
Cost to hire expertise to handle tax compliance is higher than the penalty rate imposed	3.4535

Results in Table 5 shows the perception of SME taxpayers toward company size. Some of the respondents disagreed with the statement of *"smaller firms do not have sufficient expertise to handle tax compliance"*. On the other hand, majority of the respondents are not sure either the small firms are more likely to escape from tax noncompliance compared to larger firms.

Table 5: Perception on company size

Questions	Mean
Number of employees of the firm affects the efficiency of the tax compliance	3.4070
Capital structure of the firm affects the efficiency of tax compliance	3.2907
Smaller firms can option out, not to comply with tax requirements as IRB places less focus on these firms	3.3721

Larger firms can option out, not to comply with tax requirements	2.8837
Smaller firm's do not have sufficient expertise to handle tax compliance	2.5233
Organization culture in both large and small firms plays an important role in tax noncompliance	3.3372
Small management composition result in lower compliance to the tax requirement	3.2326
Small firms are more likely to escape from the tax noncompliance compared to larger firms	3.1628

Correlation analysis is used to investigate the correlate of all independent variables towards dependent variable. The Pearson correlation analysis is used to test hypothesis 1 (H_1), hypothesis 2 (H_2) and hypothesis 3 (H_3). The results in Table 6 revealed that the hypothesis 2 (H_2) and hypothesis 3 (H_3) are supported because the significant relationship is less than 0.05 at the level of significance. Firstly, in terms of tax penalty variable, the correlation value is 0.205 which represented that there is no significant relationship between the tax penalty and tax noncompliance. The p value is more than 0.05, which is 0.058. The finding is consistent with the previous studies, reported by Oladipupo and Obazee (2016). Therefore, hypothesis (H_1) is not supported.

Secondly, in term of company size, the finding shows that there is a significant relationship between company size and tax noncompliance. The correlation value is 0.227, which represented an average significant relationship with the p value is 0.035. This study is in line with the finding reported by Hanlon et. al., (2007) and Slemrod (2007). The finding proved that have positive relationship between company size and tax noncompliance. Therefore, hypothesis (H_2) is supported. Thirdly, in terms of level of income towards tax noncompliance, the result show that there is a significant relationship between level of income and tax noncompliance. It is represented the annual income have an effect toward tax noncompliance among the SME taxpayers. The correlations value is 0.216 with the significant value is less than 0.05, which is the p value of 0.46. The finding also consistent with the previous studies that verified a positive relation of income and tax compliance (Chau and Leung, 2009; Alm et al, 1992). Therefore, hypothesis (H_3) is supported.

Based on the classical author, which is Allingham and Sandmo (1972) stated that the decision to comply or not to comply is come from the taxpayers itself. Table 6 represented the level of overall tax noncompliance among SMEs respondents.

Table 6: Correlation Coefficients

	TNON	TAXPEN	SIZE	INCOME
TNON	1.000	0.205	0.227*	0.216*
TAXPEN	0.205	1.000	0.575**	0.536**
SIZE	0.227*	0.575**	1.000	0.420**
INCOME	0.216*	0.536*	0.420**	1.000

** Significant at 1% level

* Significant at 5% level

5. Conclusions

From the findings, it was shown that the various determinants that affect tax noncompliance were significant. As we know, tax noncompliance is a serious phenomenon to many tax authorities. In other word, it is not an easy work to persuade taxpayers followed or comply the tax law and regulations.

Based on the findings, company size and level of income have positively influenced the level of tax noncompliance. In terms of descriptive analysis, the overall finding on the perceptions of SME taxpayers towards tax penalty, company size and level of income is an average sensitivity. Some of SME taxpayers are agreed and not sure the tax system applied. For example, some of the respondents' are not sure the specific tax penalty rate entitled for those who are non-comply with tax rule and tax regulation.

Therefore, all parties are responsible to reduce the level of tax noncompliance. The increasing value of tax noncompliance will lead to reduce the tax collection every year. The tax authorities and tax firms need to organise and handle more training and education program especially to SME taxpayers. In other words, IRB should offer the favorable and fair tax rate to SME operators. However, this study cannot be generalized to all sectors and other area located in Malaysia.

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