Tax Practitioners’ Perception on Tax Audit and Tax Evasion: Survey Evidence in Malaysia

Choong Kwai Fatt* and Lai Ming Ling**

Although the essence of tax audit is to promote voluntary compliance, tax practitioners’ need to understand its meaning and further eliminate intentional noncompliance. In this study, we explore the subject of tax audit and tax evasion in Malaysian taxation environment from the perception of tax practitioners. Using questionnaire method as a basis, we could investigate on the extent of taxpayers’ awareness toward their obligation under the self assessment system (SAS), draw out their experience in tax audits, discover a general method to effectively prevent tax evasion and assess taxpayers’ knowledge on identifying tax evasion transaction. Our study would have an implication for the Inland Revenue Board of Malaysia (IRBM) as it reflects the true phenomenon in Malaysia after the implementation of SAS through the responses gathered from business taxpayers and the tax paying public. It can serve as an indicator for future development of tax compliance in Malaysia.

Field of Research: Tax Audit, Tax Evasion, Tax Compliance

1.0 Introduction

Since the implementation of Self-Assessment System (SAS) in Malaysia in year of assessment (YA) 2001 for companies and YA 2004 for other taxpayers (individual, club and trade associations), tax audits act as the main control feature, to ensure taxpayers are paying tax in accordance to the Income Tax Act, 1967 (the Act) and Public Rulings (PR) issued by the Inland Revenue Board (the IRBM). To date, the IRBM has issued a total of 36 PR to guide taxpayers on the determination of basis period, taxability of employment income, deduction of legal expenses, treatment of entertainment expenses, loss of cash, key man insurance, bad and doubtful debts, pre-commencement expenses, withholding tax, double deduction of research and development, capital allowances, evasion, appeal procedures and record keepings. The objective of issuance of PR is to guide the taxpayers, to ensure that relevant tax treatments and concessions given by IRBM are complying by all taxpayers to achieve a higher level of consistency, certainty and transparency under the SAS.

*Assoc Prof. Dr. Choong Kwai Fatt, Faculty of Business and Accountancy, University of Malaya email: kwaifatt@um.edu.my

**Assoc Prof. Dr. Lai Ming Ling, Faculty of Accountancy, University Technology MARA email: laimingling@salam.uitm.edu.my

The IRBM carries out tax field audits at taxpayers' business premises to ensure appropriate amount of income has been reported by adopting correct tax treatments on business income and expenses in accordance to the Act and PR. Where in any instance the records of the taxpayer does not support the tax computation and the taxpayer cannot provide reasonable explanation on the discrepancy, a penalty for incorrect return between 15% to 60% will be imposed under Section 113(2) of the Act. Although under SAS, when filing tax returns, taxpayers are not required to submit documentary evidence, for tax audit purpose, they are obliged to keep business records and maintain sufficient documentations for 7 years.

The primary objective of tax audits is to detect non-compliance i.e., non submission of income tax returns or non payment of income tax by taxpayers. The method used by the IRBM during tax audit to detect non submission of tax returns are through street survey whereby a particular section of business premises will be visited by IRBM personnel floor by floor. When the taxpayer fails to submit its income tax returns for any particular year of assessment and detected by the IRBM during the field audits, a maximum penalty of 3 times of the tax payable will be imposed. Another means used by the IRBM in detecting non submission of income tax returns is through cross checking of sales and purchases among business enterprises. It is certain that business enterprises will record the full amount incurred on acquiring the trading stocks in the accounting books. The tax auditors will only need to cross reference these purchases to the suppliers' books to check whether the sales have been fully recorded. This is the most efficient method currently used. On the other hand, late payment penalties of 10% + 5% are imposed on the amount of taxes due to IRBM. This penalty is much lower as compared to the penalty imposed for non submission of income tax returns i.e. 3 times of the tax payable. Hence, tax audits also aim to detect non payment of income taxes as it is commonly used by taxpayers as illegitimate tax planning.

In principle, another objective of tax audits is to educate taxpayers on their responsibility on income reporting and payment of taxes for nation building. However, majority of the taxpayers generally perceived that tax audits aim to penalize taxpayers instead of educating them. Generally, Malaysian taxpayers seemed unable to comprehend the objectives of tax audits despite various tax seminars and discussion forums had been organized by IRBM to educate the taxpayers and tax agents.

Fundamentally, tax audits are also conducted to ensure that the essence of SAS for a fair tax system is being implemented; and not aimed to detect tax evasion. As tax audits are carried out at the taxpayer's business premises, and with the street survey, there may be instances that serious fraud schemes are discovered where taxpayer substantially reduces its income tax by suppressing the revenue and overstating its costs and purchases. In such instances, specialized tax investigation teams will be sent in to carry out tax investigation to detect tax evasion. Consequentially, in January 2007, the IRBM issued "Tax Audit Framework" and "Tax Investigation Framework" to answer the call from tax paying public for a more transparent tax audit and investigation processes. The ‘Tax Audit Framework” among others outlined the objectives of tax audit, and describes the rights and responsibilities of the tax auditors, taxpayers and the tax agents in tax audit.

2.0 The Research Objectives

This study aims:-

(i) to investigate the awareness of taxpayers in relation to their tax obligations under the SAS;
(ii) to elicit the taxpayers’ experience in tax audits;
(iii) to canvas taxpayers’ opinions as to the most effective method to prevent tax evasion; and
(iv) to assess the taxpayers’ knowledge on tax evasion transactions.

3.0 Research Methodology

A questionnaire was purposefully designed to collect data. The questionnaire was administered on the survey respondents in a public tax seminar on “Tax Issues and Tax planning Schemes for Business Enterprises”, organized by Nanyang Siang Pau in Petaling Jaya and Johore Bahru in June 2007. Before the seminars start, the organizer distributed 400 questionnaires to the seminar participants. A total of 222 usable responses were collected.

3.1 Data Analysis

3.1.1 The Respondents’ Profiles

The respondents’ profiles show that 36% of the seminar participants who responded to survey were from the service sector, 35% from trading sector, 11% from manufacturing sector and 18% from other business sectors. About 76% of the respondents indicated that their business’ annual turnover was less than RM300,000, 9% of them earned between RM300,001 to RM500,000. Merely 6% were generating an annual turnover between RM500,001 to RM1,000,000, 3% has turnover of RM1,000,001 to RM2 million and remainder 6% earned more than RM2 million per annum.

3.1.2 Awareness of Taxpayers' Obligations

Five questions were designed to assess if the respondents were fully aware of the tax obligations when running a business. The findings as presented in Table 1 shows that only 30.2% of the respondents knew that business taxpayers are obliged to record business transaction within 60 days from the date the transaction took place. Only 44% were aware that employers need to inform the IRBM about the commencement and cessation of employment of their staff.

Table 1: Are you aware of the following obligations/responsibilities?

	Description	Yes (%)	No (%)
1	To record business transaction within 60 days from the date the transaction took place	30.2	69.8
2	To keep business records for 7 years.	89.2	10.8
3	To pay final tax payment upon submission of tax return form	79.7	20.3
4	To inform the IRBM about the commencement and cessation of staff	43.7	56.3
5	Employees are subject to monthly tax deduction.	86.9	13.1

It suffices to say that the campaigns organized by the IRBM on the importance of book keeping and taxpayer obligations have created tax awareness to a greater extent. However, the survey found 69.8% of the respondents were unaware that the business transactions must be recorded within 60 days from the date the transactions took place. This finding is alarming as SAS has been implemented since YA 2001. The plausible explanation is taxpayers; especially the sole proprietor and businessmen of small medium enterprise placed least importance on record keeping, as they may be preoccupied with more important business matters such as issuance of invoices and cheques collection/payment. Out of convenience, some small businessmen employed part- time book keepers to do record keeping and accounting.

3.1.3 Awareness about Public Rulings

As mentioned earlier, from time to time, the IRBM would issue PR to guide the taxpayers in preparing and filling of income tax returns. The individual taxpayers are required to indicate if he or she had complied with PR in assessing the income tax liability when filling up tax return form. The survey found that only 30% of the respondents were aware of the issuance of PR, and of these, just 7% knew that as of 30 June 2007, the IRBM has issued about 30 to 40 PR. Whilst the substantial majority (93%) has no idea of the number of PR which has been issued thus far, let alone reading any of them.

3.1.4 Objective of Tax Audits

When asked about the main objective of the IRBM in conducting tax audits, the findings are presented in Table 2.

Table 2: Objective of Tax Audit

	Objective of Tax Audit	Frequency	Percentage (%)
1	To ensure voluntary compliance	90	40.5
2	To educate taxpayers on Malaysian tax system	48	21.6
3	To collect tax penalties	4	1.8
4	To detect tax evasion as well as to recover more tax and to penalize non-compliance	71	32.0
5	Not sure	9	4.1
	Total	222	100

Despite the IRBM's efforts to emphasize that the objectives of tax audits are to educate the taxpayers and encourage voluntary submission of income tax returns during the past 5 years, the survey found that more than 50% of the participants seem to have a misconception that tax audits are either aimed to detect tax, to recover more tax or to penalize non compliance. The findings indicate that more educational tax campaigns in the mass media are needed to educate the Malaysian tax paying public on the primary objectives of tax audits.

3.1.5 Approach to Tax Audits

Out of the 222 respondents, 69 (31%) of the survey respondents indicated that their firms or businesses had been subjected to tax audits. Of these, we elicited their opinions on the professionalism of tax officers in the course of tax audit, anchored on a scale of 1 (not professional) to 5 (very professional). The finding shows a mean score of 2.05 on a 5-point scale (significant at $p<.001$), thus indicates that the respondents found tax auditors were *somewhat not very* professional in the course of tax audit. This finding lends support to the report lodged by tax representatives at the "Tax Audit dialogue" between members of professional bodies and the IRBM on 14 December 2006 (see The IRBM Minutes of Meeting, issued on 7 April 2007, available at http://www.mit.org.my). Notably, the professional bodies had reflected several complains and concerns from their corporate clients related to approach to tax audit in the above mentioned dialogue with the IRBM officers.

To further probe the issue on approach to tax audits, we asked the survey respondents to evaluate and rank the eight most common approaches to tax audits that are seen to be deemed undesirable or ‘not so professional’ on a scale of 1 (most undesirable or most unprofessional) to 8 (least undesirable/not so unprofessional). The results are presented in Table 3.

Table 3: Eight Common Approaches to Tax Audit that Are Seen to be ‘Most Undesirable” or ‘Not so professional’

Rank	Approach to Tax Audit
1	Tax auditors have a preconceived mindset that taxpayer is guilty and the visit is to confirm the ‘offence’
2	Do not show rational or basis to the taxpayers on tax adjustment made
3	Do not understand the nature of the taxpayers’ businesses
4	Threaten to impose penalties
5	Limited accounting knowledge
6	Collect income tax payment upfront
7	IRBM reversed their past confirmation and verbal promises made during the course of tax audit
8	Threaten jail imprisonment

As expected, ‘Tax auditors have a preconceived mindset that taxpayer is guilty and the visit is to confirm the offence’ ranked as the top most undesirable or ‘most unprofessional’ approach to tax audit.

Overall, the findings show that when conducting tax audits, the respondents found tax auditors appear to adopt a hidden approach, which is “In god we trust, in taxpayers we suspect”, kind of mindset, and most of the time, the basis for tax audit adjustments lack of transparency and consistency. The survey findings also suggested that the tax auditors were very goal orientated in conducting their work; tax auditors seem to be very result based and more interested to find out irregularities in the tax computations rather than educating the taxpayers, as outlined in the Tax audit Framework (IRBM, 2007), one of the key objectives of tax audit is to educate taxpayer on tax compliance matters. The survey found respondents have the perceptions that tax auditors lack business and accounting knowledge, thus incompetence and slow in finalizing the tax audit. In business setting, even though two businesses may have the same nature of business, the taxpayers nonetheless might carry out the transactions in different modus operandi. It appears that tax auditors failed to acknowledge this distinction, hence did not give the benefit of doubt to the taxpayers. In essence, unless taxpayers have acted mala fide or there exists clear evidence of tax evasion embarked by taxpayers, then only additional tax can be raised with objective evidence and justification. However, tax auditors seem to overlook this, some failed to provide justification for tax adjustment and some asked for additional tax payment upfront.

In turn, we elicit respondents’ opinions on tax auditors’ conduct in the course of audit. Figure 1 reports that 44% of those whose firms or businesses had been subjected to tax audits found tax auditors were hostile during the course of tax audit, and the remainder (56%) indicated otherwise. Figure 2 shows that only 35% of the respondents had asked the tax auditors to sign a letter of agreement on tax adjustments made and 65% did not do so. Although tax authorities had made numerous attempts to promise that the tax audit will be finalized in two weeks time and finalization letter be issued to taxpayer but this apparently has not been practiced in the course of audit.

Figure 1: Are tax auditors hostile during the course of tax audit

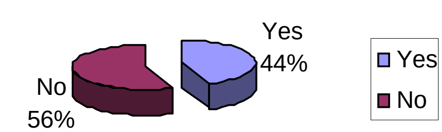
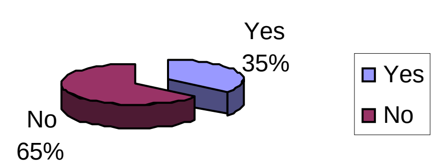


Figure 2: Did you ask the tax auditors to sign a letter of agreement on tax adjustments



3.1.6 Tax Evasion

Next, we outlined eight tax evasion transactions and the respondents were asked to indicate if in their opinion the 8 tax transactions outlined are considered to constitute tax evasion. Table 4 presents the findings.

Table 4: Does the following transactions constitute tax evasion?

		Yes (%)	No (%)
1	Did not report dividend income	37.4	62.4
2	Use taxpayer's father's name to report rental income, so that rental income is assessed at a lower tax rate	31.5	68.5
3	Did not report rental income	62.2	37.8
4	Used fictitious invoices to inflate expenses to reduce tax	74.3	25.7
5	Claim parents' maintenance expenses as salary paid to employees	49.5	50.5
6	Submitted tax return on time to the IRBM without tax payment	30.2	69.8
7	Did not report business income to the IRBM	65.8	34.2
8	Under reporting of business income	72.5	27.5

The survey revealed that taxpayers have a weak understanding between business and private and domestic expenses as well as the distinction of income reporting based on individual entities. Rental income generally must be reported based on ownership of properties. Hence, using another family member's name to report such rental income is not a legitimate tax planning scheme but indeed a tax evasion scheme. In addition, parents' maintenance expenses are not incurred in the production of business income and thus are not deductible under the

Income Tax Act; claiming of such expense as business expenses is tantamount to tax evasion. In fact, majority of the taxpayers were of the opinion that such practices were permissible and did not infringe the Act.

On top of this, it is quite alarming to note that a majority of the survey respondents seem to condone that submission of tax returns on time to the IRBM without tax payment is a legitimate tax planning and does not constitute tax evasion. To allow such practice to continue will prejudice honest taxpayers who made prompt payments to the IRBM. In this respect, the IRBM must expedite the collection of outstanding taxes. For long term and sustainable benefits, the findings suggest that it is imperative for the IRBM to intensify public tax and formal tax education in secondary and tertiary levels instead of using punitive system, as Malaysian businessmen and tax paying public seem genuinely lacking in adequate tax knowledge.

3.1.7 Most Effective Methods to Combat Tax Evasion

We elicited the seminar participants' opinions on the most effective methods to combat tax evasion on a scale of 1 (not effective) to 5 (very effective). The results as presented in Table 5 showed that 'Creating an environment to facilitate tax compliance' ranked as the most effective method. The findings suggest that Malaysian public quest for a more tax friendly environment that would facilitate them to comply. In this respect, the IRBM ought to create a more tax friendly environment to encourage and facilitate voluntarily tax compliance to combat non-compliance and tax evasion. Pragmatically, the IRBM must organize more activities such as (i) free public tax seminars and forums to create public tax awareness, (ii) to uploading more up to date tax information onto the IRBM's website in multiple languages, (iii) to provide clear interpretations of the Act and PR, (iv) to train tax officers to be more approachable and friendly in helping the taxpayers to understand tax in layman terms.

Table 5: Most Effective Methods to Combat Tax Evasion

Most Effective Methods to Combat Tax Evasion	Mean	Standard Deviation	Rank
1. Create an environment to facilitate tax compliance	3.59	1.18	1
2. Fines and/or imprisonment	3.21	1.30	2
3. Provide amnesty period for tax evaders	3.04	1.23	3
4. Imprisonment	2.99	1.32	4
5. Monetary penalties	2.87	1.14	5
6. Public exposure of the tax offender's identity and nature of tax offence	2.72	1.31	6
7. Increase tax auditors	2.69	1.15	7

4.0 Conclusion

Overall, this survey found a majority of the respondents were not aware that the IRBM has issued PR to guide and assist them in tax compliance. Most of the respondents also had the misconception that the objectives of tax audits are to detect tax evasion and penalize non-compliance. The survey found Malaysian taxpayers and the tax paying public had difficulties in differentiating legitimate tax planning and tax evasion. The possible explanation is they lack formal tax education at primary, secondary and tertiary levels; coupled with inadequacy of public campaign on tax education and limited taxation books in layman terms to guide them. Unless and until all students (the future taxpayers) are exposed to formal tax education in schools, college or at tertiary levels, SAS and tax audit can never be successfully implemented. At the time of study, notably only undergraduates from the accountancy or some business disciplines are exposed to formal tax education at tertiary levels in Malaysia. As we are in the era of SAS, it is high time for all Malaysians to be exposed to formal tax education, so that they know how to report their income and expenses correctly in the accounts and tax returns.

This study provides a snap shot of real life phenomena in Malaysia from the perspective of business taxpayers and the Malaysian tax paying public. Future study should be conducted on a larger scale or a systematic nationwide study should be conducted to gain a better picture. Future studies should also be conducted to examine the perspective of tax officers and tax agents in respect of the implementation of SAS and tax audit.

Note

1. Tax representatives who attended the “Tax audit dialogue” on 14 December 2006 were from Malaysian Institute of Accountants, Malaysian Institute of Taxation, Malaysian Institute of Certified Public Accountants, Malaysian Institute of Chartered Secretaries and Administrators as well as Malaysian Association of Tax Accountants

References

Minutes of meeting of Tax Audit Dialogue Session 1/2006 between Inland Revenue Board of Malaysia and Professional Accounting Bodies date 14 December 2006.

The Star "Huge sum to be used for 9MP projects, says IRBM", 21 November 2006. Available at http://www.thestar.com.my/. Assessed on 1 September 2007.

The Star "IRBM committed to collecting taxes with fairness, efficiency and integrity", 27 March 2007. Available at http://www.thestar.com.my/. Assessed on 1 September 2007.

The Star "RM14bil in unpaid taxes, says Shahrir", 3 August 2007. Available at http://www.thestar.com.my/. Assessed on 1 September 2007.

Inland Revenue Board of Malaysia (2007). Tax Audit Framework. January, 1-17.

Inland Revenue Board of Malaysia (2007) Tax Investigation Framework, January, 1-18.

The Star "Former Pahang assemblyman fined for not submitting tax form", 7 February 2007. Available at http://www.thestar.com.my/. Assessed on 1 September 2007.

The Star "Datin claims trial in tax case", 8 November 2006. Assessed on 1 September 2007.

The Star "Fined for not submitting tax returns", 5 December 2006. Available at http://www.thestar.com.my/. Assessed on 1 September 2007.