

TAX PENALTIES AND TAX COMPLIANCE OF SMALL MEDIUM ENTERPRISES (SMEs) IN MALAYSIA

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ABSTRACT

Taxation has become an important source of revenue for the government all over the world. The collection of tax revenue is essential for the government to ensure its funding. Thus, any activities encourage tax noncompliance such as tax fraud has placed government under pressure to prevent revenue leakage. In 2014, it is estimated that the 'black' economy has reached 10% of GDP in an advanced country and can top to 70% in developing countries. Among various tax administration strategies and other global measures to combat tax noncompliance or tax fraud are the roles played by the penalties and sanctions. Prior studies found that tax penalty system in one's country influence tax compliance behaviour. In accordance with that, the objective of this study was to investigate the relationship between the tax penalties and tax compliance behaviour of the taxpayer in particular among the SMEs, since they are more prone to tax non-compliance as shown by previous studies. The elements of tax penalties for this study were rate and punishment, knowledge and education as well as psychological behaviour of taxpayers. This study attempts to see the effect of tax penalties according to each element with the tax compliance behaviour. This study applied quantitative research method where a survey has been conducted on selected sample of Small Medium Enterprise (SMEs) in Malaysia. The result shows that tax penalties do have a significant effect on tax compliance behaviour. Study results found all elements of tax penalties possess a significant relationship with tax compliance behaviour namely rate and punishment, education and knowledge of tax penalties as well as the psychological behaviour of taxpayers with tax compliance behaviour. This study thus described the roles of tax penalties in increasing the tax compliance behaviour in Malaysia to the tax administrator. The findings from this study also provide a platform for IRBM to evaluate their existing tax penalty system in the country.

Keywords: tax penalties, tax compliance, rate, education, psychological behaviour

INTRODUCTION

Tax has become an important source of revenue for the government all over the world. The collection of tax revenues is essential for a government to ensure its funding (Hartner et al., 2008). In Malaysia, Inland Revenue Board (IRBM) and Royal Malaysian Customs (RMC) are responsible for administration of the tax system and custom regime. These two bodies play significant roles in collecting tax revenue on behalf of the government. Within the last five years, federal revenue derived from tax revenue continuously increased. According to the data provided by the IRBM, there are significant increases in the amount of tax revenue collected by the tax authorities from 2010 to 2011. In fact, compared to 2010, the tax collection in 2011 increased to RM 109.6 billion. The amount continues to increase until recent year. Latest in 2013, the tax collection by IRBM continues to show a significant increase by 0.36 % from previous years. Out of RM213 billion of the Federal Revenue, RM129 billion is contributed by tax revenue.

Previously, income tax in Malaysia was assessed under the official assessment system (SOA). But since 2001, Malaysia has adopted the self-assessment system for corporate taxpayers. Under this system, the taxpayers are required to register, calculate, and pay the amount of tax liability by themselves (Nurlis & Islamiah Kamil, 2015). Thus, tax revenue collected from the self-working individuals is highly depended on the level of compliance of the taxpayers. Some of the taxpayers tend to avoid from paying taxes for some reasons, so it is the responsibility of the tax authority to ensure that the current tax system will capable to overcome the problem. Tax non-compliance has always been a problem to tax administrative system in any countries, either in developed countries, or in emerging countries. Most of the countries in the world, including developed and developing countries face major challenges in effectively collect their tax revenue (Ern, Evans & McKerchar, 2010).

According to The Economic Times (2014), it is estimated that the "black" economy has reached 10% of GDP in advanced countries and can top to 70% in developing countries. Among various tax administration strategies and other global measures to combat tax noncompliance or tax fraud is the roles played by the penalties and sanctions. These two enforcement strategies are the most discussed by the prior literature. According to Devos (2013), improving the level of tax compliance with tax laws has always been an important objective for the government. By having effective tax laws or system, the level of tax compliance can be increased. In Malaysia, the law governing income taxation is the Income Tax Act 1967 (Act 53/1967). This Act has been widely used in Malaysia as a guideline for any laws regarding income tax.

Previous researchers have reiterated the importance of tax penalties and sanctions in addressing the issues of tax compliance. To date, the study on tax penalties done by the previous researchers are by Ern, Evans and McKerchar 2010; Palil 2010; Mohd Yusof, Lai and Yap 2014; Sapiei and Kasipillai, 2013; Sheikh Obid, 2004 and Mohdali, Isa and Yusoff, 2014. Most of the prior

studies standardly focus on the issues related to the rate of tax penalties and severity of punishment that influence the tax compliance behaviour. Meanwhile, the studies carried out by Mahmood (2012) discuss the education on tax penalties. Based on the study conducted, Mahmood examined the issue from IRBM perspectives. On the other hand Palil (2010) investigate on knowledge and the role of penalties in determining tax compliance from the individual taxpayers perspective. Apart from that, Mohdali, Isa and Yusoff (2014) reviewed the impact of threat punishment on tax compliance and non-compliance attitudes in Malaysia.

Having looked at the prior literature on tax penalties, instead of looking at the elements of the tax penalties separately, the focus of this study is to look at the thorough elements of tax penalties by extending the prior literatures on tax penalties that have been discussed previously. Firstly, this study will look at the rate and punishment on tax penalties; secondly the knowledge and the education of the taxpayers on tax penalties, and lastly the psychological behaviour of taxpayers towards the tax penalties. So, further study is required in order to test the tax penalties variables simultaneously, in terms of deciding on which variable of tax penalties are significant in addressing the tax compliance behaviour. This study will only focuses on the review of the current Malaysian tax laws which dealing with the issues of tax penalties specifically on the SMEs as most of the previous studies on tax penalties were undertaken on the individual taxpayers rather than companies or corporation (Mohd Yusof, Lai & Yap 2014). The objective of this study to investigate the relationship between tax penalties and tax compliance behaviour of SMEs in Malaysia by looking at the:

- i) rate and punishment of tax penalties
- ii) knowledge and education on tax penalties
- iii) psychological behaviour of taxpayers towards tax penalties

LITERATURE REVIEW

Definition of SME

Small and Medium Enterprises or known as SMEs is one of the contributors of tax revenue in Malaysia. The revised definition of SMEs has been introduced by NSDC which has been simplified under two categories, namely:

Table 1. The definitions of SMEs

Manufacturing	Sales turnover not exceeding RM50 million OR full-time employees not exceeding 200 workers
Services and others sectors	Sales turnover not exceeding RM20 million OR full-time employees not exceeding 75 workers.

Source: Central Bank 2014

Income Tax Act 1967

In Malaysia, the law governing income taxation is the Income Tax Act 1967 (Act 53/1967). The Income Tax Act was first enacted in 1967 and has been amended frequently to suit the rapid development of Malaysia Taxation System. Currently, the ITA consists of 13 Parts with 13 Schedules and 156 Sections.

Table 2. Summaries of Income Tax Offences

Offences	With Prosecution	Without prosecution
1. Failure to furnish return [S 77(1), 77A(1)] Failure to give notice of chargeability [s77(3)]	Penalty of three (3) times the amount of tax [s112(3)]	Fine between RM 200 to RM2000 or not exceeding six(6) months imprisonment or both [s 112(1)]
2. Incorrect return (a) Omitting or understating income (b) Provides incorrect information on income or chargeability [s 113(1) and (2)]	Penalty equal to the tax undercharged [s 113(2)]	Fine between RM 1,000 to RM 10,000 and (plus) penalty equal to twice the amount of tax undercharged [s 113(1)]
3. Willful evasion (s 114)	Not applicable	Fine between RM 1,000 to RM 20,000 or three (3) years imprisonment or both; plus penalty equal to three times the tax undercharged [s 114(1)]

4.	Understatement of tax liability [s 114(1A)]	Not applicable	Fine between RM 2,000 and RM 20,000 or not exceeding there (3) years imprisonment or both [s 114(1A)]
5.	Leaving Malaysia without payment of tax (s 115)	Not applicable	Fine between RM 200 to RM 2000 or not exceeding six (6) months imprisonment or both [s115(1)]

Source: Income Tax Act 1967

The concept of tax compliance

According to Mohdali (2013), the policy makers, tax administration as well as societies has a concern regarding the tax compliance. In fact, tax compliance has become a major concern for most of the country including developed and developing country. Many researchers have come out with definition of tax compliance. Sapiei and Kasipillai (2013), defines tax compliance as the accurate reporting of income and claiming of expenses in accordance with the stipulated tax laws. Tax compliance also can be defined as the degree to which a taxpayer complies or fails to comply with the tax rules of their countries (Mohamad, Ahmad & Deris, 2010). According to Franzoni (2000), tax compliance is defined by four characteristics namely a true reporting of the tax base, a correct computation of the liability, a timely filing of the return, and a timely payment of the amounts due. If taxpayers fail to meet any of the four characteristics, they can be categorised as non-compliance.

In contrast with tax compliance, Jaffar et al. (2014) defines the tax con-compliance as the failure of incorporations or individuals to report or pay taxes are considered as tax non-compliance. According to Roth and Scholz (1989), non-compliance happens when taxpayers fail to submit their tax return, make an incorrect return by omitting and understating their income. For the purpose of this study, non-compliance happened if the taxpayers fail to obey the tax penalty laws that have been stated in Income Tax Act 1967 which are:

- i. Section 112: Fail to furnish return and give notice of chargeability
- ii. Section 113: Make an incorrect return by omitting and understating any income
- iii. Section 114: Willfully and with intent to evade tax

Determinants for tax penalties

According to Murphy (2008), there are two alternative approaches to enforcement which are deterrence and accommodative. The deterrence approach which consists of tax penalties and tax audits have been used to investigate the level of tax compliance. The researchers found out those regulatory enforcement strategies that depend on the deterrence principles can be used to deter people from breaking the law but does not guarantee them to comply with the law. Most of the prior literature believes that tax penalties and tax audit are the main government strategies to combat tax fraud as well as to increase the level of tax compliance (Devos, 2013; Mohdali, Isa & Yusoff, 2014; Sheikh Obid, 2004; Murphy, 2008). In Malaysia, provisions on tax penalties are included in the Income Tax Act 1967. Among the prior literature that discuss on the tax penalties are Sheikh Obid (2004), Marhaini (2012), Mohd Yusof, Lai & Yap (2014), Sapiei and Kasipillai (2013), Ern, Evans & Mc Kerchar (2010), Palil (2010) and Mohdali, Isa & Yusoff (2014).

i. Rate and punishment of tax penalties

Sheikh Obid (2014) discuss on the influence of tax penalties on taxpayers' compliance. The finding of the study suggests that penalty rate as well as detection rate does have a significant effect on tax evasion. On the other hand, Mohd Yusof, Lai & Yap, (2014) finds the relationship between tax penalties rate and tax non-compliance is insignificant, this results consistent with Kamdar (1997). The study done by Sapiei and Kasipillai (2013) on tax penalties and tax compliance also reported that there is no relationship between perceived tax deterrence sanctions and non-compliance of corporate taxpayers. The reason for the difference in the result obtain is because taxpayers tend to be risk-taker in making compliance decisions, as the penalties and fines imposed by IRBM are not too high, it will lead taxpayers to ignore their compliance decision. On the other hand, the study conducted by Mohdali, Isa & Yusoff (2014) looks at the impact of threat punishment on tax compliance and non-compliance attitudes in Malaysia suggest that the threat of punishment has encouraged taxpayers to become less compliant which might indicate their rebellious act towards the government.

ii. Knowledge and education on tax penalties

Most of the prior study on tax education mainly focuses on the education on tax system as a whole without specifically mentions on tax penalties education. However, only study done by Marhaini (2012) looks at the tax penalties education from the perspectives of the IRBM officer and find that taxpayer's education on tax penalties plays significant roles in influencing the level of tax compliance and it is suggested that IRBM should conduct more programs especially in educating the tax payers on the laws mainly on the tax penalty system. Thus, the current study is extending on the prior research by looking on tax penalties education from the taxpayers perspective, as taxpayers are those who directly related to tax law specifically on tax penalties as the laws are applied to them. By having taxpayers as the respondent in the study, it helps to provide accurate data for analysis on the education of tax penalties, as the taxpayers are the main subjects that influence the compliance behaviour. There are a number of studies that record positive relationship between tax knowledge and tax compliance behaviour (Kasipillai & Jabbar, 2003 and Loo, 2006). Kirchler, Boris and Friedrich (2001) hypothesized a correlation between tax knowledge and tax

compliance. The study found that tax knowledge positively correlated with the attitudes towards legal tax avoidance and negatively correlated with the attitudes towards illegal tax evasion. Meaning that, with knowledge of taxation, the taxpayers perceived tax avoidance more positively than tax evasion. In contrast, taxpayers with lack of tax knowledge are found to imply the opposite, which is to perceive tax evasion more positively than tax avoidance.

iii. Psychological behaviour of taxpayers towards tax penalties

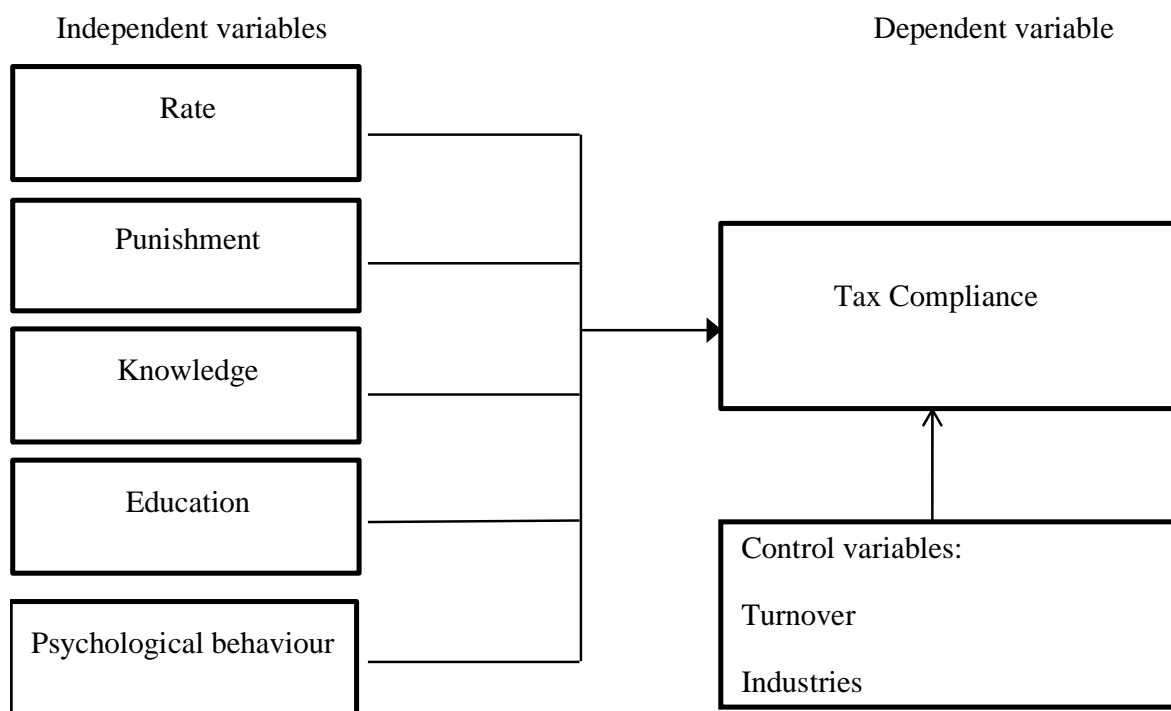
According to Schmolders (1970) in his study of tax attitudes in European countries, the citizens are likely to be extremely resentful of tax systems where extensive enforcement is used. This resentment can further lead to tax non-compliance. This study has been supported by the study done by Ern, Evans and McKerchar (2010), it is stated that the penalties remain a widely used enforcement strategy in Malaysia in the SAS system and it has resulting much concern, dissatisfaction and stress among taxpayers. According to Falkinger and Walther (1991), the pure penalty system used in practice is suboptimal. The tax authorities should consider implementing the mixed penalty-reward system whereby a taxpayer who fail to comply with tax law will pay penalty and those paid tax will gets rewards as this will help to improve the tax compliance without lowering the tax revenue of the government. Cummings, Vazquez and McKee (2005) also had stated that in order to reduce the level of tax non-compliance, the act is not simply by imposing higher tax penalties or increasing the frequency of audits. Tax penalties that are considered too high or punishment that is too extreme could cause backfire such as bribery and corruption, yet could lead to the increasing numbers of tax non-compliance. In order to come out with effective policies in reducing tax evasion, the tax authorities need to understand the behavioural aspects of tax compliance's decision.

Responsive Regulation Theory

Ian Ayres's and John Braithwaite developed this theory in 1992. Responsive regulation relies on the premises that the individual actions are motivated by different factors and in order to success, regulatory agency needs to have a range of enforcement options available to enable it to deal with those who are subject to those different motivational factors. For instances, business those who are motivated by a sense of social responsibility could be regulated effectively by a regime that relies on persuasion or self-regulation. On the other hand, a regime based on punishment would be required only to regulate those who are influenced solely by economic consideration. A driving motivation of this approach is to reduce the 'psychology of resentment,' the prospect that firms and individuals confronted with inflexible commands and harsh punishments adopt a critical, non-cooperative posture toward compliance goals and enforcement personnel.

The theory applied the compliance pyramid to select an enforcement strategy that reflects the behaviour of the taxpayers. According to the theory, the successful regulation can achieve when regulators use a suitable strategy, have access to a hierarchical range of sanctions and punitiveness of the most severe sanctions are sufficiently high. Ayres and Braithwaite (1992) state that the general principle of the theory is to tailor the regulator intervention style to the propensity and capacity of regulating to comply. This means that any new regulation made by the regulators need to consider the interest of the public. This theory stresses on the importance of the elements of persuasive and punitive to enhance the compliance behaviour which reflected in this study.

Figure 1. Research Framework



Population, Sampling Frame, Data collection method and Sample Size

This study applied quantitative research method. This is because quantitative approach is the most suitable method to make generalization for a population. The population of the study comprises Small Medium Enterprise in Malaysia. The primary data were collected from the respondents and the analysis is used to determine the relationship between tax penalties variables (rate and punishment, education and knowledge, and psychological behaviour) with the tax compliance behaviour of the taxpayers. According to SME Corporation Malaysia (2011), the total populations of the SME in Malaysia are 644 136 companies. This consists of five sectors, which are manufacturing, services, agriculture, construction and mining and quarrying. The focus of this study is on the manufacturing and service as well as construction sectors as these sectors contribute significantly to the overall performance of SMEs that represent the total population of 638 129 companies (SME Corporation Malaysia, 2015). The SME corporation directory was used as the sampling frame. The companies were identified using the stratified random sampling method. Stratified random sampling is a better method to be used in this study as it involves different subgroups in the population. Stratified random sampling divides a population into strata or subgroups, and random samples are taken from each strata of the population. The members in each stratum share similar characteristics and attributes (Fowler, 1993). This method is widely used and very useful when the target population is heterogeneous or different. Apart from that, this can help in minimizing sample selection bias and ensuring that certain segments of the population are not overrepresented or underrepresented. In this study, the populations have been divided into three subgroups from industrial bases, which are manufacturing, construction and services. Mail questionnaire was used in the survey. Out of 500 questionnaires that were sent out, only 110 was returned. Five questionnaires have been dropped out as it failed to meet the requirement for further analysis. Thus, it left only with 105 respondents represent 22 % of response rate for analysis. According to Kerlinger and Pedhazur (1973), the response rate via post is around 20% to 40% is acceptable for the analysis. In this study, the low response rate is due to the fact that the research in the area of taxation is the sensitive issues that make taxpayers reluctant to answer the questionnaires (Sapiei, Kassipilai & Uchenna, 2014).

Questionnaire Design and testing

This research adopts self-monitored survey involving a set of questionnaires. A questionnaire survey is a formulated written set of questions to which respondent’s record their answers, usually within rather closely defined alternatives (Sekaran, 2003). The questionnaire has three sections. Section A contains questions pertaining to demographic details. Section B has been divided into three parts represent each of the independent variables of the study that are rate and punishment, education and knowledge and psychological behaviour of taxpayers. Section C asked on the tax compliance behaviour among SMEs.

For Part 1 (rate and punishment of tax penalties), six statements were developed in which was adapted from previous study. The statements measuring the perception of taxpayers on the rate and punishment of tax penalties as well as the current rate of tax penalties that have been imposed by the tax authorities. Education and knowledge is measured in the Part 2 of the questionnaire and have been split into 2 parts, which are Part 2(A), and Part 2(B). Part 2(A) measured the knowledge of the taxpayers regarding tax penalties. The questions were extracted from the Income Tax Act 1967 (Section 112 to Section 119). The

statements measure the level of knowledge of the taxpayers of the provisions of tax penalties. On the other hand, Part 2 (B) was used to measure the education level/ programmed made by the tax authorities. Part 3 of the questionnaire measured the psychological behaviour of the taxpayers towards tax penalties. Four statements on the psychological behaviour of the taxpayers have been used to measure the relationship between psychological behaviour and tax compliance. The dependent variable is the tax compliance behaviour. Tax compliance behaviour is measured using the case scenario. Five scenarios have been adapted based on the prior research. The questionnaires were measured using the 5 Likert-scale.

Pilot test has been conducted before the questionnaires are distributed to the respondents of the study to ensure the reliability and validity of the questionnaire design. Other than that, the pilot study is also conducted to estimates the time taken by respondents to answer the questionnaire. Thirty SMEs in Bandar Baru Bangi area have been selected to participate in the pilot study. Based on the responses received, some adjustment had been made to the questionnaire to encourage responses as well as to make it easier and simple for the respondents to understand. In addition, some of the questionnaire has been cut-off especially questionnaire involving cases as it takes much time to read and answer.

RESULTS AND DISCUSSION

Table 4. Respondent's Profile

Items	Frequency	Percentage (%)
Legal structure of SMEs		
Individual Proprietorship	44	41.9
Partnership	19	18.1
Private limited companies	42	40.0
Total	105	100
SME primary business		
Manufacturing	25	23.8
Construction	23	21.9
Services and other sectors (eg: Food and beverages, trading, printing)	57	54.3
Total	105	100
Company turnover		
Services and other sectors		
< RM 300 000	50	47.6
RM 300 000 - < RM 3 000 000	33	31.4
RM 3 000 000 - < RM 20 000 000	5	4.8
Manufacturing		
< RM 300 000	7	6.7
RM 300 000 - < RM 15 000 000	6	5.7
RM 15 000 000 - < RM 50 000 000	4	3.8
Total	105	100
Number of employees		
Services and other sectors		
< 5 person	49	46.7
> 5 person - < 30 person	29	27.6
> 30 person - < 75 person	9	8.6
Manufacturing		
< 5 person	4	3.8
> 5 person - < 75 person	11	10.5
> 75 person - < 200 person	3	2.8
Total	105	100

Table 4 shows the profile of 105 respondents. Respondents consist of individual proprietorship, partnership and private limited companies. The majority of respondents were sole proprietorship represents 41.9%, second is private limited companies with 40.0% and only 18.1% were partnership. The definitions of Small Medium Enterprise have been classified into two which separated between manufacturing and other sectors. Thus, for the purpose of this study the definition provided by the Central Bank was used. Based on the distribution of the data, most of the respondents involved in services and other sectors including construction and trading with the total of 80 companies (76.2%) meanwhile about 25 companies (23.8%) involved in manufacturing sector. The data on the annual turnover of the companies also have been separated into two. For services and other sectors, 50 companies (47.6%) record an annual turnover of less than RM300 000, 33 companies (31.4%) record the annual turnover of RM300000 to less than RM3000000 and lastly 5 (4.8%) companies record an annual turnover of RM3000000 to less than RM20000000. For manufacturing sector, 7 (6.7%) companies recorded the annual turnover less than RM300000, 6 (5.7%)

companies record annual turnover of RM300 000 to less than RM15000000 and 4 (3.8%) companies record the annual turnover of RM15000000 to RM50000000.

Data on the number of employees found that majority numbers of employees in the companies for services and other sectors are less than 5 people in 49 (46.7%) companies, followed by more than 5 and less than 30 people in 29 (27.6%) companies and more than 30 to less than 75 people only in 9 (8.6%) companies. Meanwhile for manufacturing sector, 11 (10.5%) companies have the number of employees of more than 5 and less than 75 people, 4 (3.8%) companies less than 5 people and only 3 (2.8%) companies with more than 75 to less than 200 people. In conclusion, majority of the respondents are sole proprietorship and private limited companies which specialized in services and other sectors such as trading, consultation, hospitality with the annual turnover of less than RM300000 and number of employees less than 5 people.

Correlation Analysis

Table 5. Correlation Analysis

	Rate	Punish	Knowledge	Education	Psycho	Compliance
Rate	1					
Punish	-0.074	1				
Knowledge	0.025	0.189	1			
Education	0.092	0.017	0.166	1		
Psycho	.353**	-.327**	-0.087	-0.014	1	
Compliance	.316**	-.365**	.226*	.244*	-.364**	1

** Correlation is significant at the 0.01 level (2tailed).

*Correlation is significant at the 0.05 level (2-tailed).

Multiple Regression Analysis

Regression analyses are a set of statistical technique that allows one to assess the relationship between relationship between one dependent variable (DV) and several independent variables (IVs) (Tabachnick & Fidell, 2013). The primary goal of regression analysis is to investigate the relationship between the DV and several IVs. Multiple regression can be used to address a variety of research questions. It can also tell how well a set of variables is able to predict a particular outcome (Pallant, 2010).

Table 6. Summary of regression

Model	R	R Square	Adjusted R Square	Std. Error of the Estimate
1	.599 ^a	0.359	0.290	0.67670

From the Table 6 above, one model and all independent variables are selected from this result. It shows that the independent variables (rate and punishment, knowledge and education and psychological behaviour) did have a relationship with the dependent variable. The value of R for model 1 is 0.599, it shows that there is a high correlation between a dependent variable (tax compliance) and independent variables (rate and punishment, knowledge and education and psychological behaviour).

Table 7. ANOVA

Model		Sum of Squares	Df	Mean Square	F	Sig.
	Regression	24.058	10	2.406	5.254	.000 ^b
1	Residual	43.045	94	0.458		
	Total	67.102	104			

F-statistic is a value resulting from ANOVA and it is to determine if the variance between the means of two models are significantly different. From the Table 7 it shows that there is relationship between five independent variables namely rate and punishment, knowledge and education and psychological behaviour) t with dependent variable (tax compliance) at significant level.

Table 8. Multiple Regression Analysis

Variables	Coefficients	t	Sig	Tolerance	VIF
(Constant)	2.584	3.602	0.001		
Rate	0.181	2.001	0.048**	0.842	1.187
Punishment	-0.291	-3.57	0.001***	0.781	1.280
Knowledge	0.162	1.734	0.086*	0.893	1.120
Education	0.315	2.815	0.006***	0.897	1.115
Psychological behaviour	-0.177	-1.695	0.093*	0.702	1.424
Control variables					
Industries	-0.069	-0.365	0.716		
Turnover1	0.103	0.687	0.494		
Turnover2	0.515	1.620	0.109		
Turnover3	0.333	1.031	0.305		
Turnover4	0.147	3.770	0.707		

*** Significant at level $p < 0.01$

** Significant at level $p < 0.05$

* Significant at level $p < 0.10$

According to Pallant (2010), the value column Sig tells whether the variable is making a statistically unique contribution to the equation. If the Sig value is less than 0.05 and 0.1 the variables is making a significant contribution to the prediction of dependent variables. In Table 5.18 we can see that based on Pallant (2010), education, punishment and rate of tax penalties highly influenced the tax compliance and making statistically unique contribution to the equation compared to knowledge and psychological behaviour. There are significant relationships between education as well as rate and punishment towards the tax compliance behaviour significant at the level of 0.05. Education on tax penalties recorded level of significance ($B=0.315$, $p=0.006$) which is the highest among all variables. Second is the punishment of tax penalties ($B= -0.291$, $p=0.001$) and for rate of tax penalties the level of significance is ($B=0.181$, $p=0.048$). On the other hand, the result for psychological behaviour and knowledge of taxpayers the results are also significant but at a level of 0.1. The knowledge of tax penalties recorded the level of significance of ($B=0.086$, $p=0.162$) for knowledge and for the psychological behaviour of taxpayers the relationship is significant at the level of 0.1 where ($B=-0.177$, $p= 0.093$).

It can also be seen in Table 6, the relationship between all the independent variables and dependent variable are positive except for punishment and psychological behaviour towards tax compliance which is negative. Besides looking at the sig result, another indicator that we look is the value of Beta. According to Leech et al. (2005), higher beta coefficient means that the variables make the strongest unique contribution to explaining the dependent variables, when the variance explained by all other variables in the model is controlled for. Thus, based on the Beta values (B), it shows that the education of tax penalties that makes a strong unique contribution to explain the dependent variables compare to the other variables.

Discussion

The result of the study is important to achieve the objectives of the study. The discussion will be focusing on the main elements of tax penalties towards tax compliance. From the result of the study, we can see that all elements of tax penalties have a relationship with the tax compliance. This can be proved through the correlation analysis that has been done. On the other hand, the multiple regression analysis shows that the three variables did have a significant effect on the tax compliance behaviour. According to the responsive regulation theory, the elements of punitive as well as persuasive are important for the tax administrators to come out with a new regulation. In this study, the elements of punitive represent by the rate and punishment of the tax penalties said to have a significant effect on the tax compliance behaviour.

The relationship between the rate of tax penalties and tax compliance behavior

The elements of the rate of tax penalties have been divided into two which are rate and punishment. Based on the result of correlation analysis, there is a moderate positive relationship between the rate and tax compliance behaviour. Meaning that, the higher the rate of tax penalties the higher the tax compliance behaviour. For multiple regressions, rate has a significant effect on tax compliance behaviour significant at level 0.05 ($p=0.048$). The result of this study consistent with the majority of previous studies done by previous researchers that stated the rate of tax penalties has a positive effect on the tax compliance behaviour

(Andreoni, Erard & Feinstein, 1998; Slemrod & Yitzhaki, 2002). The study found that the higher the fines, the lower is tax evasion or the higher is the intensity of control, the lower is tax evasion.

On the other hand, punishment of tax penalties has moderate negative relationship with tax compliance behaviour. The result for the punishment also complements the previous study done by Mohdali, Isa and Yusoff (2014), which stated that the threat of punishment on tax compliance is positively significant to the tax avoidance attitudes. Meaning that, the higher the punishment, the more people will not comply. In this study, it shows the same result whereby people will only comply when punishment is low. Murphy (2008) also argues the severity of punishment do shape people behaviour to comply or not comply with the tax laws. Jackson and Milliron's mid-1980s pioneering study also indicated that the social cost of sanctions could outweigh the benefits. For example, taxpayers as a group may become disaffected if sanctions are perceived as too severe resulting in general antagonism and disrespect for the law.

Apart from that, the result of this study also supports the responsive regulation theory that explained the roles of the rate of tax penalties on the tax compliance behaviour. According to the responsive regulation theory, harsh punishment can discourage the bottom group of taxpayers which is voluntary taxpayers from paying tax. From this, we can see that the negative relationship between the punishment of tax penalties shows that the harsh punishment is negatively affecting their compliance behaviour as the majority of the taxpayers in this study is a voluntary taxpayers.

The relationship between education and knowledge of tax penalties and tax compliance behaviour

The second elements of tax penalties investigate in this study are knowledge and education of the taxpayers on tax penalties. From the correlation result, it shows that both knowledge and education of the taxpayers have a moderate positive relationship with the tax compliance. The result from the multiple regression analysis also shows both elements have a significant effect on tax compliance behaviour with education significant at level 0.05 and knowledge significant at level 0.1.

The findings of this study did complement the previous study done by the previous researcher that is Marhaini (2012) stated that the government should provide more education programme to the citizens to educate them on tax system including the knowledge on tax penalties. It is true that the tax authorities have done many programme on tax education but most of them only focusing on the tax education as a whole without zooming to the tax penalties education which also one of the most important element to improve the tax compliance.

The relationship between education and tax compliance also have been discussed by Nurlis and Islamiah Kamil (2015) that stated the effective implementation of tax penalties and the higher the understanding of the tax penalties, the higher the level of tax compliance meaning that, if the taxpayers has an understanding on tax penalties, the level of tax compliance will increase. The taxpayers will be more understood and familiar with the tax penalty system through the education provided by the tax authorities.

For knowledge of tax penalties, the result of this study did complement the previous study done by Palil (2010) that found the knowledge of tax penalties has a positive relationship with the tax compliance behaviour. In this study, the result also found that the knowledge on taxpayers positively affects the tax compliance behaviour but the relationship is not as crucial as the education on tax penalties. The knowledge of tax penalties did play significant roles in addressing the tax compliance behaviour but there are other elements that seem to be more important which is education and punishment. With the proper education on tax penalties, the taxpayers can gain more knowledge of tax penalties itself, thus it shows that the important roles that education plays in improving the tax compliance.

Apart from that, the result of the study also found that the knowledge of taxpayers of the tax penalties is on average. This is due to lack of education given by tax authorities on education of tax penalties alone. This also proves that the tax authorities should provide more education programmes which focusing solely on the tax penalties education to increase the level of knowledge among the taxpayers in Malaysia. As the education tax penalties play a crucial role in improving the tax compliance behaviour, thus the tax authorities should increase the education programmes to educate taxpayers about tax penalties.

The relationship between the psychological behaviour of the taxpayers towards tax penalties and tax compliance behaviour

According to Cummings, Vazquez and McKee (2005), in order to come out with effective policies in reducing tax evasion, the tax authorities need to understand the behavioural aspects of tax compliance decision. The result of this study found that the psychological behaviour of taxpayers towards tax penalties does affect the tax compliance behaviour negatively as the implementation of the tax penalties itself resulting much concern, stress and disappointment to the taxpayers. Thus, the feeling of stress and concern make them less likely to comply with the tax laws.

Schmolders (1970) stated that citizens are likely to be extremely resentful of tax systems where extensive enforcement is used. This resentment can further lead to tax non-compliance behaviour. Tax penalties that are considered too high or extreme can cause backfire such as bribery and corruption and resulting in the increasing numbers of tax non-compliance. On the other hand, fines those are too high, would lead to a perception of retributive justice and encourage the taxpayers to try even harder to escape paying taxes (Misu, 2011). Thus, the tax authorities need to choose the correct enforcement strategy to encourage the tax compliance behaviour.

Most of the respondents in this study agree that instead of punishing the taxpayers, the tax authorities should give rewards to the taxpayers that comply with the tax laws as this can become an incentive for the other taxpayers to comply with the tax laws. This

argument also have been supported by the prior study done by Feld and Frey (2002), that state in order to encouraged the tax compliance behaviour, the tax authorities should consider rewarding the voluntary taxpayers for their action on complying the tax laws. In a nutshell, the result from this study provides guidelines for the tax authorities on the better enforcement strategy for them to take to encourage the tax compliance behaviour.

CONCLUSION

As a conclusion, this study explains on the relationship between tax penalties and tax compliance of SMEs in Malaysia. Five variables on tax penalties namely rates and punishment, education and knowledge as well as the psychological behaviour of taxpayers have been used to measure the relationship. According to the findings, all variables did play significant roles in influencing the tax compliance behaviour of the taxpayers. But still, there are some limitations of the research such as this study only focusing on the provision of tax penalties on the Income Tax Act 1967 only and the sample of the study involving only the SMEs in the big cities. Thus, for future research it is advisable to explore provisions of the tax penalties on other Acts and also considering using a larger sample of the studies. The finding arising from this study has provide a valuable information on the tax penalties' variables that manage to influence the compliance behaviour which are very beneficial for policy makers in the area of taxation. The information gathered has provides guidelines and suggestion to the tax authority in a way to improve the effectiveness of tax penalties system in Malaysia as been suggested by Abdul Mohani (2001) and Phan (2013) which recommends a better tax penalty system that should complement the self-assessment system. The penalty system should also be equitable, proportionate, clearly defined, and even-handedly administered to encourage voluntary tax compliance and to deter the tax offenders from repeating the same mistakes.

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