CHAPTER 1

INTRODUCTION

1.1 Historical Background of the Malaysian Tax System

The current tax regime practised in Malaysia was introduced by the British colonial government in the Malay Peninsular in 1948, in Sabah dan Sarawak in 1957, and in 1961 respectively. Prior to 1967, the Malay Peninsular, Sabah and Sarawak each had its own tax laws which were administered by then known as Inland Revenue Department, IRD. (March 1, 1996 became historically significant for the IRD when it opened a new chapter towards the corporatisation of the organisation and is now known as Inland Revenue Board, IRB). In 1967, the income tax laws were consolidated and revised to create a unified federal income tax law which was enacted by the Parliament and became effective throughout Malaysia. The new legislation was called the Income Tax Act 1967.

When first introduced, the income tax laws were considerably simpler than it is today. The tax base too was narrower. In the 1950's the total Malaysian population was less than seven million, and the total number of taxpayers was not more than 100,000 (The Inland Revenue Department’s Annual Report [IRDAR] 1950 to 1954). As of 1995, the total population of Malaysia is about 20.7 million, (Treasury’s Economic Report [ER] 1996/1997) while the country’s tax population has grown to over 2.4 million (IRDAR, 1995). The nation’s constant economic growth encouraging activities for both the private and public sectors has contributed to an increase in the number of taxpayers coming into the tax system, including partnerships and corporations. These changes in the social and economic environment in recent years not only influence the tax-paying community and complexity of the tax laws but also the level of complexity of the tax cases filed.
1.2 Problem Statement

An efficient and effective tax administration involves an effort to achieve the maximum outputs, in terms of revenue, equity and the other goals of a tax system, with the limited human and material inputs (resources) available to the tax agency (Kelley & Oldman, 1973). This goal implies a constant attempt to develop new procedures, amend present practices or adjust existing procedures to new conditions in order to achieve greater efficiency.

The Inland Revenue Board, IRB is under the supervision of the Ministry of Finance where it functions amongst others is to act as on agent of the Government and to provide services in administering, assessing, collecting and enforcing payment of direct taxes which includes income tax, real property tax, estate duties, and stamp duties. The IRB is a highly decentralized organization, with considerable authority for determining service and enforcement actions vested in twenty-two branches in Peninsular Malaysia, three branches each in Sabah and Sarawak and a branch office in the Federal Territory of Labuan. There are three branches which are authorized to collect taxes, located in Kuala Lumpur, Kota Kinabalu (Sabah) and Kuching (Sarawak). The primary function of these division is to enforce and monitor the collection of tax and ensure that all taxes are paid in due time.

Basically, in an ‘Assessment Branch’, there are two core units. The division of the unit, is based on the type of tax return received. The Employment Unit is responsible for assessing returns of salaried taxpayers and the Business Unit for assessing self-employed and partnership returns. Returns from corporations and associations are assessed in the ‘Companies Branch’. The standard working norm of the technical officers (called ‘assessors’) is determined by the type of return he or she is responsible for. The production norm for assessors who work in the Employment Unit is 2,000 cases per assessor per year (Inland Revenue Department Director General Circular [IRDDGC], 1978 a). It means that each assessor is required to assess and determine tax liability for 2,000 salaried taxpayers in a year. The work norms of assessors in the self-employed unit and the Companies Branch is 1080 cases and 480 cases respectively (IRDDGC, 1978 a). However, sometimes due to the complexity of the cases and/or inexperience of the assessors, they are unable to achieve their production norms.
Under the present tax assessment system known as the formal or official assessment system, IRB determines the amount of a taxpayer’s liability. One significant problem of this traditional approach of formal assessment system is that every tax return received has to be examined and its tax liability determined by assessors. In addition, the system also requires both the mathematical computation of the tax (known as ‘assessment’) and the scrutiny of the accuracy (known as ‘audit’) of a taxpayer’s declaration and other documents especially the business accounts of self-employed taxpayers be performed simultaneously (dual functions).

The rapid growth in the taxpayer population has brought on a corresponding increase in work load which has not been matched by a commensurate increase in the number of personnel of the tax agency. As an example, Table 1 illustrates the lack of technical personnel to match 1993’s returns received. The recruitment of Malaysian federal government employees is a slow and time-consuming process which is subject to approval by Public Services Commission (PSC) under the Public Services Department. The PSC takes between one to two years to complete the process of staff recruitment. The IRB takes at least another eighteen months to two years to train newly recruited staff before they become productive employees (Inland Revenue Department Staff Training Procedure [IRDSTP], 1982).

Another problem encountered in this system of formal assessment is that the assessment function is often divided into providing ‘quality’ production of work and services as well as ‘quantity’ of the assessment that an assessor should be able to finalise in a period of time. As the number of complicated tax cases increases especially for those working in the Business Units, the Companies Branch and Investigation Centres, more working hours are required to finalise each case. However, the assessors become more obsessed with the production and quantity of work in order to satisfy their production norms rather than quality of assessments raised.
### Table 1
Number of Technical Personnel Needed Based on Type of Returns for 1993

<table>
<thead>
<tr>
<th>Type of Returns</th>
<th>Total Returns</th>
<th>Working Norm</th>
<th>Technical Needed</th>
<th>Available</th>
<th>Required</th>
</tr>
</thead>
<tbody>
<tr>
<td>Corporation</td>
<td>166,808</td>
<td>480</td>
<td>347</td>
<td>237</td>
<td>110(32%)</td>
</tr>
<tr>
<td>Partnership</td>
<td>79,079</td>
<td>720</td>
<td>71</td>
<td>51</td>
<td>20(28%)</td>
</tr>
<tr>
<td>Business</td>
<td>688,169</td>
<td>1,080</td>
<td>677</td>
<td>556</td>
<td>121(18%)</td>
</tr>
<tr>
<td>Employment</td>
<td>1,168,025</td>
<td>2,000</td>
<td>583</td>
<td>466</td>
<td>117(20%)</td>
</tr>
</tbody>
</table>

Source: IRD’s Working Paper, 1993 c ;
A proposal to change the existing tax assessment system in IRD to a self-assessment system.

Another limitation of the formal or official assessment system is that the issue of the notice of assessment or tax liability is spread over the tax year, which can sometime occur even later. Based on the present practice, the due date for submission of individual returns is between 3 to 7 months after the year ends, and 3 to 5 months for business returns. The liability of taxpayers to pay tax officially exists only after the issuance of the notice of assessment by the Board. Even if taxpayers pay through a compulsory deduction scheme as in the Schedular Tax Deduction for employees and Bimonthly Tax Deduction for self-employed taxpayers, only tax of the preceding year’s income is deducted from the current year salary or business income respectively.

All these result in more than a year’s gap between the time that income is earned by the taxpayer and the time when a portion of the income is returned to the government coffers as tax revenue. In addition, some of the tax due is never collected due in part to late recognition of tax liability on income earned. This delayed collection gives taxpayers an opportunity to use their income for reasons other than tax purposes. This is especially true for contract-based and cash-receipt taxpayers, when often by the time the Board issues the notice of assessment, the business has already gone bankrupt, or the taxpayers cannot be traced or are having a cash flow problem.
The robust economic growth and social and political changes together have led to an increase in the number of registered taxpayers, a growing complexity in the tax laws and more complicated business and corporate tax cases filed. Thus, it becomes increasingly more difficult to scrutinize in detail every return received under the present tax administration. In order to assess all the return forms filed, IRB has to increase its technical officers in proportion to the increase in tax returns. However, the current centralization of recruitment procedures make it impossible for the Board to respond immediately to the demand for additional officers. This situation has created a problem of delayed finalisation of tax cases, creating a back-log of unresolved cases because IRB, like many tax agencies in developing countries has limited financial and human resources to conduct both audit and assessment simultaneously as has been the case in 1948. The forty-nine-year old tax administration is failing to keep pace with the country’s rapid economic growth, expanding tax population, and increasing complexity in the business environment. (Inland Revenue Department’s Management Report [IRDMR], 1981, Inland Revenue Department’s Working Paper [IRDWP], 1993 c). A reform or overhaul of the present tax administrative structure is required in a 1990's economic, social and political environment for greater efficiency to raise revenue for the government.

1.3 Objectives of the Study

Many researches and tax administrators believe that voluntary compliance is a prime element of an efficient tax system. It fosters citizens’ respect for the government and the tax administrative system (Goode, [1951] 1984; Rowen, 1969; World Bank 1991; Wallshutzky, 1991). Goode (1984, p 102) enumerated six conditions ‘necessary’ for the successful implementation of an income tax in a developing country. One of them is to achieve ‘a large degree of voluntary compliance on the part of taxpayers’. According to Wallshutzky (1989), developing countries such as Malaysia can increase the level of voluntary compliance on the part of their taxpayers. They can achieve high levels of voluntary compliance by learning from the experience of developed countries as well as by knowing more about their own taxpayers. Today it is not surprising to observe that improving voluntary compliance of taxpayers has become one of the main goals of tax administration in developed as well as
developing countries. In fact, among the Corporate (Operational) Objectives of IRB/IRD (IRD Annual Report, [IRDAR], 1992) its tax administration is to achieve the highest possible degree of tax compliance within the law and with minimum cost for tax collection. Ideally, this compliance should be of a voluntary nature.

The main goal of this study is to explore as an alternative to the current Malaysian officially based assessment framework the feasibility of developing a new tax administrative system based on voluntary compliance. The study would involve the establishment of the following from the perspectives of tax collectors and tax agents:

(i) General perceptions of the current tax administrative system;
(ii) The level of individual taxpayers compliance;
(iii) The literacy and ethics of individual taxpayers; and
(iv) The identification of alternative policy and programme responses that will help promote voluntary compliance from the individual.

1.4 Significance of the Study

Voluntary compliance is largely dependent on the taxpayer’s knowledge and overall ethics and attitude towards his fiscal obligations. Therefore, it becomes the responsibility of the tax agency to take all necessary and possible measures through policy and programme responses to lift the levels of voluntary compliance among the tax population. It is hoped that this study will make a contribution to the general knowledge of taxpayer compliance with the intent to reform the Malaysian income tax administration based on the taxpayer’s voluntary compliance and to detect and punish noncompliance.

1.5 Structure of the Study

This paper attempts to study tax administrative systems which are based on the concept of voluntary compliance. It involves a study of tax compliance and tax evasion, and the methods and practices of achieving high level of voluntary compliance.

For the purposes of this study, voluntary compliance is said to occur when taxpayers: (a) timely file in all required tax returns, (b) accurately report tax liability in accordance with the
tax laws, and (c) pay the tax due without the need for further encorncement by the tax agency. Noncompliance occurs: (a) when there is failure to file a tax return, (b) when there is late payment of taxes, (c) when there is understatement of gross incomes, and (d) when there is overstatement of deductions, exemptions, and credits or rebates. Tax evasion is the opposite of voluntary compliance. It is defined as the reduction of tax by illegal means, including the omission of taxable income or transactions from tax declarations by fraudulent means.

The organization of this research paper takes a five-step approach as follows:

1. This chapter provides a review of the literature of the Malaysian tax administration in theory and practice whereby procedures taken to administer and enforce the federal income tax law will be identified. Problems and issues facing IRB will also be highlighted.

2. What follows in Chapter Two is a review of the related literature of other countries on voluntary tax compliance and evasion which will lead to the identification of factors influencing voluntary compliance levels as well as an examination of policy and programme responses taken by tax agencies in promoting voluntary compliance.

3. Chapter Three describes the research methodology adopted for this study. A survey questionnaire was designed to obtain information, comments about the present Malaysian tax administrative framework and ideas about an alternative administrative model based on voluntary compliance.

4. Chapter Four discusses the finding of the study. Voluntary compliance determinants of Malaysian taxpayers and how to promote them from the perspectives of tax administrators and tax agents will be identified. The levels of tax ethics and literacy of the taxpayers (which are considered important determinants in promoting voluntary compliance) will be determined. The survey also identifies tax administrative functions of IRB that need to be modified and introduced.
5. Chapter Five concludes with a summary of the research finding, administrative implications as well as suggestions for future research. A brief discussion of the limitations of the study will also be given.