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# POTENTIAL FACTORS MOTIVATING TAX COMPLIANCE AMONG SMALL AND MEDIUM-SIZED ENTERPRISES (SMEs)

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### Abstract:

Tax compliance is a compliance of taxpayers with the tax law of the country in terms of declaring their income, filing a return and paying any taxes that are due on time. Tax compliance is essential for the government and tax authorities to achieve the revenue collection target as taxes are the main sources of income to the country. The Inland Revenue Board in Malaysia (IRBM) has recorded 17% increase of tax collection in 2021 compared to 2020. In 2021, more than RM140 billion was collected from three million people and more than 400,000 businesses. Small and medium-sized enterprises (SMEs) play an important role since they contribute a significant source of government's tax revenue to ensure sustainable economic growth and development. Recognising SMEs played a crucial role in contributing a large portion of income to the government, this study aimed to identify factors motivating tax compliance among SMEs. The attitude of taxpayers towards tax is influenced by the specific knowledge on taxation, in which the taxpayers have a good understanding of the basic tax system and laws. Thus, tax knowledge among SMEs increases tax compliance as they are more responsible to meet their tax duties. This study also found that high tax morale influencing tax compliance

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of SMEs. They believe that paying taxes is a sense of moral obligation for the benefits of society. Meanwhile, tax penalties have a significant impact on tax compliance by promoting a positive attitude towards the tax regulations system. In other aspects, tax simplicity has reduced the complexity of the tax system and led to increase of the tax compliance among SMEs. The findings have shown possible strategies for tax authorities to achieve higher level of tax compliance among SMEs towards attaining targeted tax collection for the country.

**Keywords:**

Tax Compliance, SMEs, Tax System, Tax Evasion, Tax Authorities

**Introduction**

Taxes are the primary source of funding for the national budget and a crucial tool for regulating the macroeconomy, stimulating investment and controlling inflation (Huong & Phuong, 2021), meanwhile tax compliance is described as an action that encourages taxpayers to abide by the tax laws (Jalil et al., 2018). The government is concerned about tax compliance as it can raise tax revenue by strengthening tax compliance among taxpayers such as individual taxpayers, business owners as well as companies. As a result, higher taxes revenue is being collected by the government and tax authorities. On the other hand, it can be used to regulate economic growth and national development.

In order to build a good tax environment and enhance voluntary tax compliance in Malaysia, the Inland Revenue Board in Malaysia (IRBM) concentrates on tackling the issue by using three approaches such as awareness, education, and service. For instance, IRBM had advised 31,598 entities identified, including 23,751 individuals and 7847 enterprises and companies to voluntarily register their tax files and report their true income (The Malaysian Reserve, 2022). This is to prevent the direct tax leakage that could be curbed immediately as it could have a severe impact on the stability of the nation's economy. The implementation of the self-assessment system is the transformation process in the taxation system in Malaysia, whereby tax compliance is the main goal of IRBM and intensive efforts made by IRBM through providing better service to the taxpayers. Thus, a good tax environment can promote greater voluntary tax compliance and influence higher tax collection.

Small and medium-sized enterprises (SMEs) play a crucial role in economic development, especially for developing and emerging economies. In Malaysia, 98.5% of total businesses are SMEs as reported by the Malaysian Academy of Sciences (Hamid et al., 2022). Being a major player in Malaysia, SMEs contribute significantly to income tax revenue for the country. Recognizing the important role of SMEs and their contribution to the country's growth, the Malaysian government has announced during the 2023 Budget to reduce taxes on the first RM150,000 of revenue of micro, small and medium enterprises to 15 percent, from 17 per cent. This reduction allowed savings of up to RM3,000 for SMEs (Ikram, 2023) and reducing the tax rate is also the strategy to increase tax compliance. This shows the government continued support for the resilience and development of SMEs during the post-COVID19 pandemic as their contribution to national growth, particularly tax collection revenue.

Tax compliance is a compliance of taxpayers with the tax law of the country in terms of declaring their income, filing a return, and paying any taxes that are due on time. IRBM has recorded 17% increase of tax collection in 2021 compared to 2020. In 2021, more than RM140

billion collected from three million taxpayers and more than 400,000 businesses (Alias, 2023). The collection of direct taxes contributed to more than 50% of the country's total income. This shows that approximately half of the country's income is generated from the collection of direct taxes, and it is used to finance the government's expenditure and returned to the public in the form of subsidies, infrastructure and assistance packages.

SMEs play an important role since they contribute a significant source of government's tax revenue to ensure sustainable economic growth and development. Small business owners are high-risk taxpayers due to the high possibility that they may engage in tax evasion as they need to self-assess, report the income and pay their own income tax (Kamleitner, Korunka & Kirchler, 2012). Recognising SMEs played a crucial role in contributing large portion of income to the government, therefore the objective of this conceptual paper is to identify the possible factors motivating tax compliance among SMEs. This study is significant as it adds to the body of knowledge in the context of SMEs taxation. For tax authorities, the findings could be used to improve tax compliance of SMEs, thus increase taxes collection to the nation.

## Literature Review

### *Definition of SMEs*

The previous researchers commonly used the measurement of total assets, total employees, volume, and value of turnover to define SMEs (Agyei-Mensah, 2011). According to SME Corp Malaysia, two criteria used to determine the SMEs are sales turnover and number of full-time employees and it has classified SMEs into manufacturing and services and other sectors. For the manufacturing sector, SMEs are defined as firms with sales turnover not exceeding RM50 million or number of full-time employees not exceeding 200. Meanwhile, for the services and other sectors, SMEs are defined as firms with sales turnover not exceeding RM20 million or number of full-time employees not exceeding 75. The majority of large companies in Malaysia were founded from SMEs, which they used as the foundation for growing into larger companies (Ali, Zahari & Harizan, 2020).

### *The Concept and Definition of Tax Compliance*

Tax compliance has been defined in various ways in the previous empirical studies. Tax compliance is defined as the preparation, submission and payment of taxes due within the specified time periods (Naicker & Rajaram, 2018). In line with Naicker & Rajaram (2018), Le, Bui and Nguyen (2021) viewed that tax compliance means paying taxes properly and on time and this is an undeniable obligation for anyone in society. Another definition of tax compliance is the taxpayers' willingness to abide by tax regulations, report their income accurately, claim the appropriate deductions, relief, and rebates, and timely pay all of their taxes (Palil & Mustapha, 2011). Furthermore, tax compliance has been categorised into compliance of administration and filling out tax returns accurately (Kon@Sapawi, Abd Hamid, Shamsuddin & Norizan, 2022). Some authors state that tax compliance represents the taxpayers' willingness to pay taxes that leads to the honest payment of taxes either be voluntary or enforced by authorities (Kirchler & Wahl, 2010; Batool, Hassan & Kous, 2022). The taxpayers incurred common costs to obey with tax law such as time taken to complete tax returns, costs of hiring tax accountants, psychological costs such as stress that may affect them (Machago & Amayi, 2013). Pope and Jabbar (2008) state that the compliance to the regulatory requirements is mandatory in nature, imposed the costs and burden on the business sectors. The tax authority is also facing difficulties in collecting taxes due to most SMEs also operating in the informal sector and some do not even register their businesses with the government. This is supported

by Ahmad et al. (2018) where most SMEs do not have specific expertise including in managing their tax compliance, which lead to tax non-compliance behaviour. In order to reduce non-compliance with tax legislation, tax administration should put in place methods and structures of the matter so as to avoid tax losses to the government. By this, public confidence on tax system could be increased.

### ***Empirical Studies of SMEs and Tax Compliance in Developed and Developing Countries***

The growing body of literature on tax compliance among SMEs has received an interest in developed and developing countries. Abdellatif & Tran-Nam (2022) conducts a comparative analysis of the Australian and Egyptian experiences in taxing SMEs. The findings revealed that Australia and Egypt have adopted different approaches in providing specific tax treatment to SMEs and the simplicity of the tax treatment for SMEs. Their approaches gained significant interest from policy-makers in both countries. Other researchers (Mukhlis, Utomo & Soesetio, 2015; Fauziati et al., 2016) examined tax compliance on entrepreneurs in Indonesia and they found that tax knowledge has a significant and positive effect on tax compliance. Nguyen (2022) conducted the study on the impact of non-economic factors on voluntary tax compliance behaviour in Vietnam. The results showed that the tax inspection and audit, social norms, tax knowledge, personal norms, perception of the tax system's fairness, and tax service quality has a significant influence on the voluntary tax compliance behaviour of SMEs in Vietnam. In Jordan, Alshira'h et al. (2020) conducted a survey to the owner-managers of SMEs and they found that patriotism and public governance increase the level of tax compliance of SMEs. Another researcher, Aladejebi (2018) examined the level of tax compliance among owners of SMEs in Nigeria. The findings showed that female SME owners are more tax compliant than male and there is a need for tax education among SME owners. In Ghana, Twum et al. (2020) investigated the factors that affect SMEs' tax compliance. The results of the study revealed that knowledge of tax rights and responsibilities, knowledge of employment income, and awareness of sanctions were found to have a positive and significant relationship with tax compliance.

### ***SMEs and Tax Compliance in Malaysia Context***

Pope and Jabbar (2007) has reviewed the tax complexity of SMEs and the researchers found that record keeping and documentation, tax complexity and cost of compliance are the tax compliance issues in Malaysia. Yunus, Ramli and Hassan (2017) investigated the relationship between the tax penalties and tax compliance behaviour of the taxpayer and the researchers used a quantitative research method where a survey has been conducted on a selected sample of SMEs. The study found that tax penalties played a significant role in increasing tax compliance in Malaysia. Another study by Jalil et al. (2018) examined the determinants of tax knowledge, tax penalty and tax rate on the tax compliance behaviour of SMEs in Selangor. As a result, all variables have a significant relationship towards tax compliance among the SMEs. The researchers proposed that SMEs taxpayers should be levied lower amounts of taxes to ensure the growth and development of the business. Hamid et al. (2019) has interviewed six SMEs owners to examine factors affecting tax compliance among SMEs engaging in online business in Malaysia. The study found that higher tax knowledge and better attitude will increase tax awareness among the e-commerce SMEs in Malaysia. Ali et al. (2020) also examined the influence of tax penalties towards tax compliance among SMEs in Selangor, the questionnaires were distributed to 150 respondents, with 130 responses received in the study. The researchers found that tax penalties variables managed to influence the tax compliance among SMEs. Other researchers Kon@Sapawi et al. (2022) distributed an online questionnaire to micro-business owners using simple random sampling techniques. The researchers suggested that more effective tax education programmes should be created to convey tax



knowledge and awareness to business owners in Malaysia. Therefore, the growing interest of SMEs in developed and developing countries has shown the significant roles of SMEs to the global and the findings of the studies could help the tax authorities improve their policies and reform tax procedures to create favourable conditions for SMEs towards achieving higher tax compliance.

### ***Factors Motivating Tax Compliance of SMEs***

#### ***Tax Knowledge***

Tax knowledge refers to the level of awareness and understanding of the country's tax system (Twum et al., 2020) and a taxpayer's ability to understand the tax system, depending on the knowledge of the tax system and law (Hamid et al., 2019). Studies have shown that tax knowledge has a significant impact on tax compliance among SMEs in Malaysia (Kon@Sapawi et al., 2022; Hamid et al., 2019; Jalil et al., 2018). The findings of these studies indicated that tax knowledge is the motivating factor for tax compliance of SMEs. Therefore, the taxpayers become more positive towards compliance when they perceive more tax knowledge. This is supported by Batool et al. (2012), tax knowledge develops a sense of fairness of the tax system and tax compliance as a civic responsibility that influences them to comply with the tax law. The study of Mukhlis et al. (2015) implied that lack of tax knowledge can lead to negative attitudes of taxpayers as tax is highly related to the various tax rules. In the self-assessment system, a thorough understanding of tax policy and other tax related information is crucial to ensure higher tax compliance (Kon@Sapawi et al., 2022). Therefore, tax knowledge possessed by taxpayers influenced them to engage in tax compliance such as compute accurate tax liability and made them aware of their tax obligations. As a result, increasing tax knowledge creates a more responsive to the tax system that could increase tax compliance and reduce tax evasion among SMEs owners.

#### ***Tax Morale***

Several researchers (Kon@Sapawi et al., 2022; Hamid et al., 2018) have identified tax morale as a significant factor that influenced the taxpayers' willingness to comply with the tax laws. Tax morale is described as intrinsic motivation that can lead taxpayers to pay taxes and it is also related to honesty and fulfilment of civic obligations to others, which could result the taxpayer's willingness to contribute to the public through the tax system (Luttmer & Singhal, 2014). Tax morale is also associated with the concept of personal and social norms as well as trust in authorities that contributed to more tax compliance (Hamid et al., 2018). In addition, Kondelaji et al. (2016) state that the trust in others has a significant effect on tax morale, as tax morale will increase if an individual taxpayer believes others to be honest. In the SME context, Kon@Sapawi et al. (2022) found that tax morale has a positive and significant impact on tax compliance of micro-business owners in Malaysia, as they believe that by paying tax could bring benefits to the society. Therefore, they are more likely to comply with the law. Consequently, tax morale is the factor motivating the tax compliance of taxpayers and reluctance to pay taxes is perceived as a violation of their morals.

#### ***Tax Penalties***

Tax penalties are defined as negative punishment to those who break the law by paying money (Savitri & Musfiadly, 2015). In the self-assessment system, a tax audit is performed on a regular basis to ensure tax is collected based on the tax return submitted by the taxpayers and tax penalties are imposed for any non-compliance of the tax law. Kamil (2015) in the study found that tax penalties have a positive and significant relationship to the individual taxpayer

compliance. Thus, the more effective application of tax penalties, the tax compliance rate will be higher. Previous studies documented tax penalties influenced tax compliance among SMEs in Malaysia (Yunus et al., 2017; Jalil et al., 2018; Ali et al., 2020). According to Yunus et. al (2017) elements of tax penalties namely rate and punishment have a significant effect on tax compliance behaviour. This is consistent with the findings by Ali et al. (2020) revealed tax penalty in terms of rate of penalty, knowledge of penalty and education on penalty and psychological behaviour of taxpayers toward tax penalty significantly influencing tax compliance between SMEs in Malaysia. Therefore, tax penalties can be seen as a preventive mechanism to ensure taxpayers do not violate the tax laws.

### ***Tax Simplicity***

A simpler tax administration and system could enhance the tax compliance among taxpayers, in return it could increase tax collection to the country. This is supported by Kon@Sapawi et al. (2022) that there is a positive relationship between tax simplicity and tax compliance among Malaysian micro-business owners. The authors suggested that the tax laws should be simple and easy to understand, consequently taxpayers comply with it. According to Hayat et al. (2022), tax authorities need to reduce tax complexity to increase the taxpayers' confidence in the system, as a result taxpayers start paying the correct and timely tax liabilities. Pope & Jabbar (2007), SMEs in Malaysia faced tax difficulties in record keeping and documentation, tax complexity, business legal form and tax compliance costs. Kamil (2015) further agreed that tax complexity represents the difficulty perceived by the taxpayers toward the tax system that encourages tax non-compliance. This is in line with the recent findings that tax evasion behaviour among SMEs is influenced by tax complexity (Al-Rahamneh & Bidin, 2022) and most SMEs agreed that complexity of the tax system might influence their tax non-compliance behaviour since they have to spend more time in furnishing their tax returns. Therefore, a simpler tax system could have the advantages, in terms of making better understanding of the SMEs owners and reducing the tax burden especially in the adoption of the self-assessment system in Malaysia. Hence, the taxpayers are willing to adhere to the tax obligation in determining the taxable income, compute the tax liability and submit their tax return based on the tax laws.

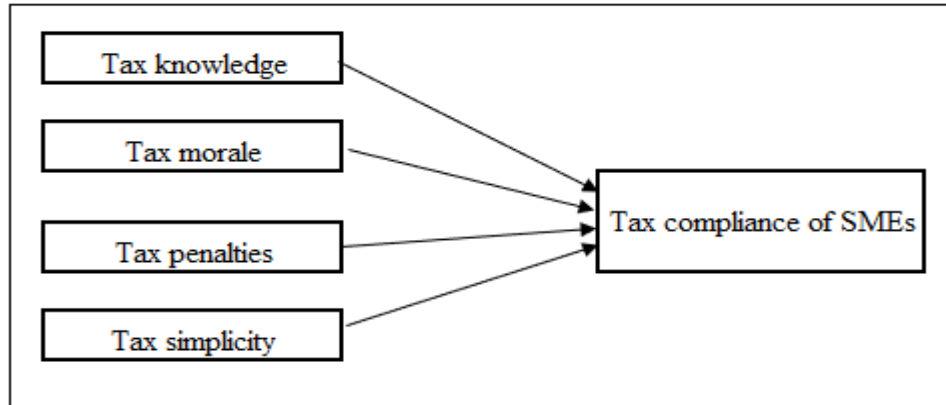
### **Methodology**

This study was conducted based on existing and prior literature review and this literature review was accessible via online databases. The researchers were engaged in a thorough literature review to understand the concepts and related research of tax compliance among SMEs.

### **Findings**

Building on previous research, the current study presents a model of factors motivating tax compliance of SMEs that conceptualises interactions between these selected variables. From the previous studies, this conceptual paper identifies tax knowledge, tax morale, tax penalties and tax simplicity are the factors motivating tax compliance among SMEs. This study found that tax knowledge is a factor for tax compliance of SMEs. Tax knowledge is necessary to enable SMEs to comply with tax laws as well as to increase their willingness to report the accurate income tax liability due to better understanding of the tax system. The finding also indicate that tax morale is the intrinsic motivation of SMEs that contributed to more tax compliance. This study also found that tax penalties influencing tax compliance among SMEs owners. The enforcement of tax penalties encourages the taxpayers to obey the tax rules, as they understand that they will be penalised by the tax authorities for any illegal acts to evade

tax. Tax simplicity also contributes to an increase in tax compliance of SMEs. Simpler tax system could reduce the burden of taxation system and it also helps SMEs to understand the tax law better, thus comply with it. Figure 1 depicts the model for the proposed study:



**Figure 1: Factors Motivating Tax Compliance of SMEs**

### Conclusion

The COVID-19 outbreak has severely impacted businesses and the global economy. In such an environment, SMEs need to remain resilient to face uncertainties and challenges for years to come. This conceptual study was conducted to identify the possible factors motivating tax compliance among SMEs. The findings from the previous studies indicate that tax knowledge, tax morale, tax penalties and tax simplicity are the factors motivating tax compliance of SMEs. This study summed up the findings of previous studies and contributed to the literature on tax compliance of SMEs. Future studies are recommended to conduct empirical research using the proposed conceptual model of this study. Finally, the tax authorities can benefit from this study by focusing on these factors so that the tax compliance among SMEs can be increased. Therefore, understanding these factors that influence tax compliance, it helps to reduce the opportunity of tax revenue loss in both developing and developed countries. As previous studies documented that tax knowledge plays a vital role in motivating tax compliance among SMEs, the tax authorities should continuously instil tax knowledge to educate the taxpayers on the tax laws and system. In the taxation context, tax morale is an intrinsic motivation to pay taxes and it is related positively to tax compliance. Tax compliance also could be improved by the enforcement of tax penalties for any tax evasion committed by taxpayers. In other aspects, having a tax system that is easy to understand and transparent is a way towards supporting SMEs in meeting their tax compliance obligations. The tax authorities should review and make the tax system simpler to encourage better understanding and reduce the burden of SMEs owners in terms of compliance with the requirement laws. As a result, it will overcome the opportunity of tax evasion among the taxpayers that can boost the tax revenue. In conclusion, the findings have shown possible strategies for tax authorities to achieve higher tax compliance among SMEs towards attaining targeted tax collection for the country.

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