

Intention of Tax Non-Compliance-Examine the Gaps

Dr Oh Teik Hai

Senior Lecturer

Faculty of Business and Management, Open University of Malaysia,

50480 Kuala Lumpur, Malaysia

E-mail: teikhai@oum.edu.my

Lim Meng See

Centre of Graduate Studies, Open University of Malaysia,

50480 Kuala Lumpur, Malaysia

E-mail: lmsee55@gmail.com

Abstract

This paper is to provide a literature review on factors that affect the intention of tax non-compliance behaviour among the sole-proprietors. The review of literature is to examine the issues involved in the area of tax non-compliances and identify the gaps on tax non-compliance behaviour.

Keywords: Tax non-compliance, behavioural intention, sole-proprietors

1. Introduction

Academic scholars frequently make extensive research on tax compliance or non-compliance in the field of taxation in order to establish the relationship between economic and non-economic factors on tax non-compliance behaviour. The problem of tax non-compliance is as old as taxes themselves. It is generally accepted that tax non-compliance and tax evasion exists in every country and Malaysia is no exception. Tax evasion and tax non-compliance is a serious problem (**Jackson and Jones, 1985; Worsham, 1996**). Tax non-compliance by individual sole-proprietors is an expensive and pervasive problem (**Kasipillai, 1998**). In Malaysia, the problem of unintentional tax non-compliance became even more significant with the implementation of Self-Assessment System (SAS). A review of the tax compliance/non-compliance behaviour indicated previous researchers had studied extensively about the various factors influencing the tax non-compliance behaviours of sole-proprietors. Though there were extensive studies on these factors, the paper sought to examine whether there are factors that influencing the intention of tax non-compliance among the taxpayers or sole-proprietors that have not been studied i.e. the vacuum that presently exists.

2. Literature Review

Tax non-compliance is a complex issue. There has been a substantial amount of research undertaken in the area of tax compliance and tax non-compliance in United States of America (USA) and countries outside USA. The Inland Revenue Services of USA indicated that there are 64 factors that are related with tax non-compliance by taxpayers or companies (**Young, 1994**). **Cuccia (1994)** defined tax non-compliance as “illegal tax evasion”. Tax non-compliance occurs when there is a failure to perform a timely filing or submission by taxpayers of all required tax returns, when not accurately reporting the tax liability in accordance with the tax laws, when there is a non-payment or late payment on the tax due, an understatement of income, and overstatement of expenses (**Singh, 2003**). Tax non-compliance is difficult to measure because it involves individuals and firms concealing the true level of their assessable income whether intentionally or unintentionally. Based on the literature review, factors that are commonly used by previous researchers relating with tax non-compliance among the individual taxpayers and sole-proprietors are as follows;

Income: Income from self-employment or business would be subject to lower compliance as compared to those who have incomes from salaries (**Madeo, Schepanski and Uecker, 1987**). **Fledman and Slemrod (2005)** found that non-compliance is significant and that it varies with source of income. Taxpayers who are at high income bracket tend to be tax non-compliant when compared to those in the lower income bracket (**Harwood, Larkins & Vazques, 1993**). Different level of distribution of income may also affect tax non-compliance among the individual taxpayers. This may be because taxpayers may feel that it is acceptable to under-report small amount of income (**Worsham, 1996**). On the contrary, there were also researchers (**Spicer & Becker, 1980**) that argued that income appears to have no significant relation to tax non-compliance.

Tax rate: Most research supports the notion that high tax rates increases tax non-compliance (**Spicer & Becker, 1980; Milliron & Toy, 1988; Christian & Gupta, 1992 and Joulfanian & Rider, 1998, Sour 2001**). Tax payers who had been told that their tax rates were higher than the average tax rate paid by others have the highest percentage in terms of evading tax (**Spicer & Becker, 1980**). According to **Christian and Gupta, 1992**, most taxpayers are sensitive to and respond to even the small tax effects of the table of bracket.

It should also be noted here that taxpayers' underreporting of income is positively correlated with tax rates (**Joulfian & Rider, 1998**). For example, **Feinstein (1991)** found that there is a positive relationship between tax rates and tax reporting compliance/non-compliance. However, **Clotfelter (1983)** found that there is a negative correlation between tax rates and tax reporting compliance / non-compliance.

Tax complexity: The impact of tax complexity on tax compliance is a bit more complicated because of the interaction of two factors i.e. perception of fairness and opportunity for non-compliance (**Milliron, 1985**). Under conditions of uncertainty (i.e. tax systems that are complex), taxpayers are more prone to tax non-compliance (**Beck, Davies & Jung, 1991**). Tax complexity also influences non-compliance by causing misinterpretation of rules, omissions and unintentional errors besides deliberate under-reporting (**Gupta, 2002**). Making tax system less complicated will lead to an increase perception of fairness on the tax system and subsequent a reduction of tax non-compliance (**Beck et al., 1991**). Also, in many countries, the occurrence of tax non compliance is more inclined towards small businesses (i.e. sole-proprietors) rather than towards large business (**Schuetze, 2002**). However, **Adam and Sheffrin (2002)** found that tax complexity may not necessarily be considered be unfair and simplifying the system may not effectively deter tax non-compliance.

Probability of audit: **Sour (2001)** found that increasing the probability of audit will increase tax compliance rate. Increase in the probability of audit was also found to have resulted in significantly higher levels of taxable income being reported (**Beck et al., 1991**). On the other hand, when an audit detection rate decreases, tax non-compliance will increase (**White, Harrison & Harrel, 1993; Lederman (2003) and Davis, Hecht and Perkins (2002)**). A small increase in detection risk may have a substantial impact on tax compliance (**Carnes & Englebrecht, 1995**) whilst an increase in audit rate will increase income reported (**Clotfelter, 1983; Dublin & Wilde, 1988**). The important finding by **Carnes and Englebrecht (1995)** revealed that perceptions of audit detection risk are more effective than actual detection risk in increasing tax compliance among the taxpayers.

Knowledge of Peer behavior: revealed that individual taxpayers do not live alone in this world and they have to interact with others in their daily life. Thus, influence of one person on another in their behaviour is an important part of their continuous existence in society. Peer influence usually comes from friends, relatives, colleagues and business acquaintances. Perceived confidentiality of another taxpayer's tax information may have a significant effect on tax non compliance (**Laury and Wallace, 2005**). When a taxpayer (say. Mr A) found that another taxpayer does not report the true amount of tax, the taxpayer (i.e. Mr A) will not report the true amount of tax to the tax authorities. Perception of peers not to comply with the tax laws resulted in the taxpayers' non-compliance action. However, **Hite (1988)** found that there is no significant correlation between taxpayer non-compliance and knowing non-compliant peers.

Perception of fairness of tax system: generally affects the taxpayers' tax/ non-compliance performance. When taxpayers perceive the exchange of tax payments for services received as unequal and in the tax authorities' favour, the taxpayers tend to be tax non-compliant. **Spicer and Becker (1980)** found that taxpayers significantly increase their tax non-compliance when they perceive themselves to be victims of tax inequity. Taxpayers' morale increases when tax officials treat them with respect. If tax officials solely rely on deterrence, taxpayers tend to avoid tax (**Frey & Feld, 2002**). Public service announcements are effective in improving taxpayers' perception of fairness of tax system (**Roberts, 1994**). Any increases in perception of fairness can lead to lower tax non-compliance (**Forest & Sheffrin, 2002**).

Gender: is a sociological factor that influences the non compliance behaviour of sole-proprietors (**Schuetze, 2002**). There is evidence that there is a significant relationship between tax non-compliance and gender. Majority of studies tested that compliance level of male and female. **Spicer and Becker (1980)** found that gender appears to have a significant impact on tax non-compliance and noted that male had greater percentage than female in terms of tax non-compliances. This was further supported by **Young (1994)** who found that males are less tax compliance than female. **Mottiakavandar, Haron and Kasipillai (2004)** also found that gender had a significant impact on tax non-compliance. However, **Hasseldine and Hite (2003)** noted there is no significant difference between men and women in tax non-compliance.

Age: is another sociological factor that influences the tax non compliance behaviour of sole-proprietors. Most of studies in USA indicate that age is an important factor to explain the level of tax non-compliance. For example, **Clotfelter (1983)** found that there is a close relationship between age and tax non compliance. **Christian and Gupta (1992)** found that older taxpayers are less likely to be at the top of the table brackets, less knowledgeable about tax or may be more conservative and hence less likely to search for additional deductions to lower their taxable income i.e. older people are less likely to be tax non compliance as compared with younger taxpayer. **Mottiakavandar et al., (2004)** found that among the small business entrepreneurs, sociological factors such as gender and age have a significant effect on taxpayers' attitude toward own tax non-compliance.

The tax compliance of sole-proprietors is also different when compared to the tax non compliance of wage earners (**Clotfelter, 1983**). **Feinstein (1991)** found that sole-proprietors are less likely to be tax compliant when compared to other taxpayers. **Erard (1993)** stated that it is easier for sole proprietors to manipulate their source of business income and as such, are less likely to be tax compliances (see, for example, **Tedds, 2005**). **Giles (2000)** found that relative small business is more likely to evade taxes more than large business. It is commonly believed that self-employed exhibit higher rate of voluntary tax non-compliance than wage and salaried income (**Klepper & Nagin, 1989; Joulfanian & Rider, 1998**).

Tax preparers: have an important role to play on taxpayers' non compliance decision. Prior studies have indicated that the role of tax preparers (e.g. Certified Public Accountants [CPA]) is related with either tax non-compliance (aggressive approach) or tax compliance (conservative approach). Tax preparers are not entirely at the mercy of taxpayers' demands. As a member of an elite profession, tax preparers are in a position to set standards (**Gordon, 1988**). However, it should be noted that not all tax preparers are willing to compromise their personal ethics to be successful (**Marshal, Armstrong and Smith, 1998**). Tax preparers can exert influence on taxpayers. The role of tax preparers can create an impact on taxpayers' non-compliance decision. Tax preparers are able to manipulate the taxpayers into a non-compliance decision. Tax preparers play a critical role in how small business owners approach tax planning opportunities (**Plamondon, 1996**). Most of previous studies on tax preparers have centered on approved tax preparers. The objective of using approved tax preparer and unapproved tax preparer are the same i.e. assisting and advising the taxpayers to fulfill their tax obligations. The only difference is the level of education, tax knowledge and training. Approved tax preparers are better educated than unapproved tax preparers because of professional certification requirements (**Ayers, Jackson & Hite, 1989**). As such, unapproved tax preparers may not be able to provide sound advise, thus, resulting in sole proprietors being more tax non compliant.

Other Factors: There are many other factors besides those above-mentioned factors that also affect tax non compliances. These factors includes tax penalty (**Davis et al., 2002**), opportunity to evade tax (**Collins, Milliron and Toy, 1992**), social responsibility (**Fortin, Lacroix & Villeval, 2007**), ethics (**Bobek & Radkte, 2007**), enforcement (**Frey & Fled, 2002**), moral reasoning (**Singh, 2003**), tax deduction (**Singh, 2003**) and sanctions (**Tittle, 1977**).

3. Gaps

There are various areas that, however, have not been covered by previous researchers on issues pertaining to tax non compliances. These areas are discussed below:

a. Unapproved tax preparer

Most of previous research conducted in the area of tax non-compliance were approved or qualified tax preparers such as CPAs. To best of the author knowledge, no research had been conducted on the impact of unapproved tax preparer on the taxpayers' tax non-compliance. Many taxpayers or companies are still using the services of persons or commercial/management service firms e.g. non-CPAs. Most small business firms do not understand the tax laws of authorising an approved tax preparer i.e. CPAs and they have an impression that commercial/management firm can act for them. Small business firms cannot differentiate which are approved tax preparers and which are unapproved tax preparers. Moreover, unapproved tax preparers fees are cheaper when compared to the fees of approved tax preparers. Many small business entities are still using the services of unapproved tax preparers (**Liew, 2004**). **Collin et al, (1992)** in the Journal of the American Taxation Association recommended the study of the impact of unapproved tax preparer on tax non-compliance.

b. Unapproved account preparer

Previous research conducted centered on approved account preparer. To the best of the authors' knowledge, no research has been conducted on the impact of unapproved account preparer on tax non compliances. There are several reasons why unapproved account preparers are employed by taxpayers (see, for example, **Liew, 2004**). For example, aggressive financial reporting will lead to aggressive tax reporting i.e. tax non-compliance (**Frank, Lynch, & Rego, 2009**). Usually these unapproved account preparers are located in small town or districts. Whatever accounting preparation or advise these unapproved account preparers provide are purely on their own, and that, they are likely to preparer the accounting work that suits their clients' expectation i.e. less profit results in low tax liability (i.e. being tax non-compliance). These unapproved account preparers need not have to follow the tax regulations and professional ethics set by approved accounting board. **Cuccia (1994)** in the Journal of the American Taxation Association recommended that investigation be carried out on the impact of unapproved account preparer on tax non-compliance.

c. Future expected tax costs

The anticipated benefits of being tax non-compliant had been researched by **Collins et al. (1992)**. The contrary meaning of anticipated benefits would be future expected tax cost.

Anticipated benefits revealed that a taxpayer presumes to gain when he performs intended tax non-compliance if not audited by tax authorities. On the other hand, if in future, the tax authorities audited the taxpayers, whatever additional tax and penalties would be the taxpayer's future expected tax costs. Therefore, if a taxpayer wishes to evade tax, the taxpayers must understand what the future expected tax costs likely to be. With the increase of tax audit activities by tax authorities, future expected tax costs for tax non-compliant will exist. This is why future expected tax costs need to research upon. **Jackson and Jones (1985)** in the Journal of the American Taxation Association had indicate that if expected cost of tax non-compliance is known to taxpayers, then, it is a factor that may change taxpayer's non-compliance decision-making.

4. Conclusion

The literature identified a broad range of tax compliance/non-compliance attributes. A summary of the major attributes of various studies used in the area of tax compliance/non-compliance were provided. The literature review had been examined and had help identify gaps for future research towards the behavioral tax non-compliance intention. These gaps are:

- Unapproved tax preparer,
- Unapproved account preparer and
- Future expected tax costs.

Reference

- Adam, F., & Sheffrin, S. M. (2002). Complexity and Compliance: An Empirical Investigation. *National Tax Journal*, LV (1), 75-88
- Ayers, F. L., Jackson, B. R., & Hite, P. S. (1989). The Economic Benefits Of Regulation : Evidence From Professional Tax Preparers. *The Accounting Review*, I (2), 300-312.
- Beck, P. J., Davis, J. S., & Jung, W. (1991). Experimental Evidence on Taxpayer Reporting Under Uncertainty. *The Accounting Review*, 66(3), 535-558.
- Bobek, D. D., & Radtke, R. R. (2007). An Experimental Investigation of Tax Professionals ' Ethical Environments. *Journal of the American Taxation Association*, 29(2), 63-84.
- Carnes, G. A., & Englebrecht, T.D. (1995, Spring). An Investigation of the Effect of Detection Risk Perceptions, Penalty Sanctions, and Income Visibility on Tax Compliance. *The Journal of the American Taxation Association*, 17(1), 26-41.
- Christian, C. W., & Gupta, S. (1992, December). New Evidence on Secondary Evasion. *The Journal of the American Taxation Association*, 72 – 93.
- Clotfelter, C. T. (1983, August). Tax Evasion and Tax Rates: An Analysis of Individual Returns. *Review of Economics and Statistics*, 65(3), 363-373.
- Collins, J. H., Millron, V. C., & Toy, R. D. (1992). Determinants of Tax Compliance: A Contingency Approach. *The Journal of the American Taxation Association*, 1-29.
- Clotfelter, C. T. (1983). Tax Evasion and Tax Rates : An Analysis of Individual Returns. *The Review of Economics and Statistics*, 363-373.
- Cuccia, A. D. (1994). The Effects Of Increased Sanctions On Paid Tax Preparers: Integrating Economic And Psychological Factors. *The Journal of the American Taxation Association*, 16(1), 41-66.
- Davis, J. S., Hecht, G., & Perkins, J. D. (2002). Social Behaviours: Enforcement and Tax Compliance Dynamics. *The Accounting Review*, 78(1), 39-69.
- Dublin, J. A., & Wilde, L. L. (March, 1988). An Empirical Analysis of Federal Income Tax Auditing and Compliance. *National Tax Journal*, 41(1). 61-74.
- Erard, B. (1993). Taxation with Representation : An Analysis of the Role of Tax Practitioners in Tax Compliance. *Journal of Public Economics*, 52(2), 163-197.
- Feinstein, J. S. (1991). An Econometric Analysis of Income Tax Evasion and Its Detection. *Rand* 22 (1), 14-35.
- Feldman, N. F., & Slemrod, J. (2005). Estimating Tax Non Compliance With Evidence From Unaudited Tax Return. Discussion Paper No. 05-15. Ben-Gurion University of the Negev, Israel.
- Forest, A., & Sheffrin, S. M. (2002). Complexity and Compliance : An Empirical Investigation. *National Tax Journal*, LV, 75 -88.
- Fortin, B., Lacroix, G., & Villeval, M. (2007). Tax Evasion and Social Interactions. *Journal of Public Economics*, 11(12), 1-31.
- Frank, M. M., Lynch, L. J. & Rego, S. O. (2009). Tax Reporting Aggressive and Its Relation to Aggressive Financial Reporting. *Accounting Review*, 84 (2), 467-496.
- Frey, B. S., & Feld, L. P. (2002). Deterrence and Morale in Taxation. University of Zurich, Switzerland.

- Giles, D. E.A. (2000). Modeling the Tax Compliance Profiles of New Zealand Firms. In *Taxation and the Limits of Government*, Boston: Kluwer Academic Publishers, 243-270.
- Gordon, R. W. (1988). The Independence of Lawyers. *Boston University Law Review*, 68, 1-83
- Gupta, A. D. (2002). The Economic Theory of Tax Compliance with special reference to Tax Compliance Costs . Paper presented at National Institute of Public Finance And Policy, India .
- Harwood, G. B., Larkins, E. R., & Vazques, J. M. (1993, April). Using a Randomized Response Methodology to Collect Data for Tax Compliance Research. *The Journal of the American Taxation Association*, 79 – 92.
- Hasseldine, J., & Hite, P.A.(2003).Framing, Gender and Tax Compliance. *The Journal of Economic Psychology* , 517 – 533.
- Hite, P. A. (1988, Spring). The Effect of Peer Reporting Behavior on Taxpayer Compliance. *The Journal of the American Taxation Association*, Spring, 47 – 64.
- Jackson, B.R., & Jones, S.M.(1985, Spring). Saliency of Tax Evasion Penalties Versus Detection Risk. *The Journal of the American Taxation Association*, 7 – 17.
- Joulfanian, D., & Rider, M. (1998, June). Tax Evasion By Small Business : Office Tax Analysis (OTA) Paper 77. Georgia State University, USA.
- Kasipillai, J. (1998, March). Overview of Malaysian Tax System : An Examination of Deliberate Non-Compliance. *Tax Nasional Journal*, 2-7.
- Klepper, S., & Nagin, D. (1989). The Anatomy of Tax Evasion. *Journal of Law, Economics and Organisation*, 5 (1), 1-24.
- Laury, S., & Wallace, S. (2005). Tax Confidentiality and Tax Compliance: An Experimental Analysis. Georgia State University, USA.
- Lederman, L. (2003). The Interplay Between Norms and Enforcement in Tax Compliance”, *Law and Economics. Working Paper*, George Mason University, USA.
- Liew, R. (2004, July). Turning The Tables On Bogus Accountants & Tax Consultants. *Accountants Today*, 24 -27.
- Madeo, S. A., Schepanski, A., & Uecker, V. W. (1987, April). Modeling Judgments of Taxpayer Compliance. *The Accounting Review*, 323 – 342.
- Marshall, R. L., Armstrong, R.W., & Smith, M. (1998). The Ethical Environment Of Tax Practitioners: Western Australia Evidence. *Journal of Business Ethics*, 17: 1265-1279.
- Milliron, V. C. (1985, Fall). An Analysis of the Relationship Between Tax Equity and Tax Complexity. *The Journal of the American Taxation Association*, 19 – 33.
- Milliron, V. C., & Toy, G. R.(1988, Spring). Tax Compliance: An Investigation of Key Features. *The Journal of the American Taxation Association*, 84 -103.
- Mottiakavandar R., Haron, H., & Kasipillai, J. (2004, March). Level of Tax Compliance Among Small Business Entrepreneurs. An Examination of Their Demographic Profile (Part One). *Accountants Today*, 34-37.
- Mottiakavandar, R., Haron, H., & Kasipillai, J. (2004, April). Level of Tax Compliance Among Small Business Entrepreneurs. An Examination of Their Demographic Profile (Part Two). *Accountants Today*, 36-39.
- Plamondon , A. I, (1996, Dec). Compliance Issues: Small Business and the Corporate Income Tax System. Working Paper 96-9 , Ottawa, Canada.
- Roberts, M. L. (1994, Spring). An Experimental Approach to Changing Taxpayers; Attitudes Toward Fairness and Compliance via Television. *The Journal of the American Taxation Association*, 16(1) , 67-86.
- Schuetze, H. J. (2002). Profiles of Tax Non compliance Among the Self-Employed in Canada 1969-1992, University of Victoria, Canada .
- Singh,V. (2003). Tax Compliance And Ethical Decision-Making. A Malaysian Perspective. 1st edn, Pearson Malaysia Sdn. Bhd.
- Sour, D. L. (2001). An Analysis of Tax Compliance For The Mexican Case : Experimental Evidence. Unpublished Doctoral’s Dissertation, University of Illinois.
- Spicer, M. W., & Becker, L. A. (1980). Fiscal Inequity and Tax Evasion: An Experimental Approach. *National Tax Journal*, 33, 171-175.
- Tedds, L.M. (2005). Keeping it off the Books : An Empirical Investigation Into The Characteristics Of Firms That Engage In Tax Non-Compliance. McMaster University, Canada.
- Tittle, C. R. (1977). Sanction Fear and The Maintenance of Social Order. *Social Forces*, 55(3), 579-596.
- White, R. A., Harrison, D. P., & Harrel, A. (1993, May). The Impact of Income Tax Withholding on Taxpayer Compliance: Further Empirical Evidence. *The Journal of the American Taxation Association*, 63 – 78.
- Worsham, J. R. G. (1996, Fall). The Effect of Tax Authority Behaviour on Taxpayer Compliance: A Procedural Justice Approach. *The Journal of the American Taxation Association*, 18(2), 19-
- Young, J. C. (1994, Fall). Factors Associated With Noncompliance: Evidence from Michigan Tax Amnesty Program. *The Journal of the American Taxation Association*, 16(2), 82 -105,