TAXPAYER COMPLIANCE IN SERVICE TAX:

AN INDIRECT COMPLIANCE STUDY

SAW SOR TIN

A Thesis Submitted to Asia e University in
Fulfilment of the Requirements for the
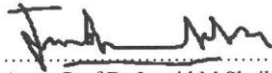Degree of Doctor of Philosophy
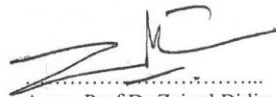
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# ABSTRACT

This study investigates the influence of tax audit variables on taxpayer compliance (TC) and the mediating effect of tax return filing (TRF) on taxable sales and TC. The study sample comprised 250 service tax (ST) licensees registered in Federal Territory of Kuala Lumpur. The ratio of taxpayer compliance in terms of 'declared service tax' to 'actual service tax' for the period year 2010 to 2012 is the basis for determining a compliance rate for the dependent variable in the analysis. Direct or interfaced data obtained from questionnaire, tax audit cases closed in year 2012 with supporting database are used for statistical analysis, validity or reliability measure. Six hypotheses are tested for their correlation relationship with TC factor. Multiple linear regression (MLR) analysis is performed to determine the set of significant continuous variables for ST noncompliance (n=150) and to test the adapted simplified Fischer et al. (1992) TC model. Descriptive statistics using frequency, percentage and *mean* analysis are used to evaluate compliance level for 250 audited taxpayers. ANOVA with post-hoc Tukey HSD and Kruskal-Wallis test are performed on five categorical variables to test for statistical significance difference between independent groups. The results obtained show that there is a significant negative correlation between the 'tax deficiency claim , proportional penalty' and TC; and a positive correlation between the 'taxable sales level, tax return filing' and TC. The new TC (MLR) model comprises variables: three noncompliance opportunity (NCO), two tax system/structure (TSS) and taxpayer compliance. There is a marginally significant mediating effect of TRF on the relationship between taxable sales and TC. The study contributes to the body of knowledge by uncovering the significant MLR model and the various significant tax audit variables of TC. The evidences reported on a new tax compliance model will help shed light on the influence of NCO and/or TSS variables on taxpayer compliance in the taxable services sector in Malaysia. The results also offer suggestions on public enforcement strategy of coercion versus cooperation approach for policy makers and tax authorities to enforce compliance, elicit voluntary compliance, plan and implement an effective tax policy and tax administration.
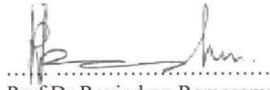
## APPROVAL PAGE

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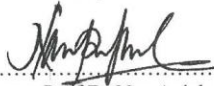
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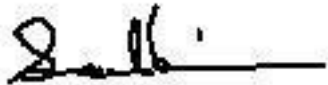
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# DECLARATION

I hereby declare that the thesis submitted in fulfilment of the PhD degree is my own work and that all contributions from any other persons or sources are properly and duly cited. I further declare that the material has not been submitted either in whole or in part, for a degree at this or any other university. In making this declaration, I understand and acknowledge any breaches in this declaration constitute academic misconduct, which may result in my expulsion from the programme and/or exclusion from the award of the degree.

Name of Candidate:  SAW SOR TIN

Signature of Candidate:                                    Date: 30 November 2016

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## ACKNOWLEDGMENTS

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# LIST OF ABBREVIATIONS

| | |
|---|---|
| ANOVA | Analysis of Variance |
| BOD | Bill of Demand |
| CIS | Customs Information System |
| DV | Dependent Variable |
| EUT | Expected Utility Theory |
| FGR | Federal Government Revenue |
| FTR | Federal Tax Revenue |
| FTKL | Federal Territory Kuala Lumpur |
| GDP | Gross Domestic Product |
| GST | Goods and Service Tax |
| HMRC | Her Majesty's Revenues and Customs |
| HSD | Honest Significance Difference |
| IRB | Inland Revenue Board of Malaysia |
| IRAS | Internal Revenue Audit of Singapore |
| IRS | Internal Revenue Services (Federal Agency in the US) |
| IV | Independent Variable |
| LE | Licensing Experience |
| MLR | Multiple Linear Regression |
| MRA | Multiple Regression Analysis |
| NCO | Noncompliance Opportunity |
| OECD | Organization for Economic Cooperation and Development |
| OLS | Ordinary Least Squares |
| RM | Ringgit Malaysia (Malaysian Currency) |
| RMC | Royal Malaysian Customs Department |
| RTD | Round Table Discussion |
| *SD* | Standard Deviation |
| SEM | Structural Equation Modeling |
| SOP | Standard Operating Procedure |
| SPSS | Statistical Package for the Social Sciences |
| SST | Sales and Service Tax |
| ST | Service Tax |
| STA | Service Tax Act, 1975 |
| STC | Service Tax Compliance |
| STLH | Service Tax Licence Holder |
| Taxpayer | Taxable business firms, companies and persons |
| TC | Taxpayer Compliance |
| TDC | Tax Deficiency Claim |
| TR | Total Revenue |
| TRF | Tax Return Filing |
| TRS | Tax Return Submission |
| TSL | Taxable Sales Level |
| TSS | Tax System/Structure |
| UK | United Kingdom |
| US | United States |
| VAT | Value Added Tax |

# LIST OF APPENDICES

# CHAPTER ONE

# INTRODUCTION

Taxes are important to the country's economic growth and citizens' well-being. Taxes provide revenue for the government to fund national defence, justice, health, police, education, sports, transportation, housing, social welfare and other public services; for benefits of all citizens. In order to stimulate the economy, the government would introduce a higher tax rate during boom periods to reduce public deficit, increase tax revenue and public expenditure, as GDP and asset price rises while unemployment rate decreases. Conversely, in recession periods, the government may announce a tax rate cut that may increase public deficit, reduce tax revenue and public expenditure. Nonetheless, in a business cycle, taxes may stabilise or destabilise the changes in GDP, tax base or overall tax revenue.

In general, taxes will reduce the business revenue or personal income of taxpayers. A higher tax rate may reduce the business profit, expenditure and reserve; and the households' disposable income, consumption and saving. Therefore, a business firm or taxpayer will endeavour to make a cost-benefit analysis to decide on how much tax to pay; while large or multinational corporations will conduct a cost-benefit analysis to put tax avoidance into perspective. Nevertheless, the government should set rules and policies that encourage good compliance with the tax system.

In Malaysia, the two main types of tax are the direct and indirect tax which is administered by two different agencies under the Ministry Of Finance (IRB and RMC). Direct taxes are collected directly from the taxpayer and, have to be paid by the liable person whom tax is imposed. Indirect taxes fall on different persons and are recovered from customers or clients by the business entity and paid by the taxable person who collects it. The indirect tax revenue has contributed between

49.4% (RM78, 375 million in 2009) to 57.4% (RM126, 743 million in 2014) of the country's total revenue during the years 2008 to 2014. Apparently, service tax revenue showed a minimal growth by contributing about 2.1% (2008) to 2.8% (2014) of the total tax revenue from 2008 to 2014. (Annual Economic Reports, 2010 - 2016). The 0.4% increase in service tax collected in 2010 was mainly the result of the 5% service tax imposed on all professional taxable service fees regardless of the turnover threshold with effect from 1 January 2008. (Table 1)

**Table 1:** *Federal Tax & Non-Tax Revenue 2008-2014 (Million in Ringgit)*

|  | 2008 | 2009 | 2010 | 2011 | 2012 | 2013 | 2014 |
|---|---|---|---|---|---|---|---|
| Direct Tax | 82,138 | 78,375 | 79,009 | 102,242 | 116,937 | 120,523 | 126,743 |
|  | 51.4% | 49.4% | 49.5% | 55.1% | 56.2% | 56.5% | 57.4% |
| Indirect | 30,760 | 28,129 | 30,507 | 32,643 | 34,706 | 35,429 | 37,462 |
| Tax | 19.2% | 17.7% | 19.1% | 17.6% | 16.7% | 16.6% | 17.0% |
| Service | 3,345 | 3,344 | 3,926 | 4,982 | 5,583 | 5,944 | 6,278 |
| Tax | 2.1% | 2.1% | 2.5% | 2.7% | 2.7% | 2.8% | 2.8% |
| Non-Tax | 46,896 | 52,135 | 50,138 | 50,534 | 56,270 | 57,418 | 56,421 |
| Revenue | 29.3% | 32.9% | 31.4% | 27.3% | 27.1% | 26.9% | 25.7% |
| **Total** | **159,793** | **158,639** | **159,653** | **185,419** | **207,913** | **213,370** | **220,626** |
| **Revenue** | 100% | 100% | 100% | 100% | 100% | 100% | 100% |
| **% TR** | **40.07%** | **47.1%** | **37.99%** | **35.98%** | **33%** | **30%** | **30%** |

Source: *Economic Report, Petronas / Bank Negara Malaysia Report 2008-2014*
Note: % TR is Petronas' contribution to 'federal government revenue (FGR)'

In the non-tax revenue categories, dividend from Petroliam Nasional Berhad (Petronas) is the major contributor to total collection of non-tax revenue. The Malaysian government has relied heavily on revenue from oil and gas industries where the amount of collection reaches RM14,566 million in 2005 (Bloomberg News, 2006). There is no doubt a  higher revenue from Petronas 'dividend, royalty, taxes and export duty' will help government to increase development spending and reduce taxes. On the average, Petronas contributed between 35% - 40% of FGR from 2008 to 2011. In 2012, oil and gas prices keep falling and Petronas contribution to FGR also went down to about 30% in 2014. This contribution is expected to be

gradually reduced to 21.5% (2015), 18.5% (2016) and 15.5% (2020) under the 11th Malaysian Plan (MP) in which the main objective is to reduce its heavy dependence on petroleum-related revenue and increase future contribution from other sectors such as the services sector, financial, tourism and manufacturing sectors. This includes an increase dependency on indirect tax revenue particularly service tax, hence a study on understanding taxpayer compliance in service tax (an indirect tax) so as to improve voluntary compliance will contribute to the consolidation of public finance or federal tax revenue.

## 1.0    Background of the Study

Tax compliance is basic in the realization by government of its economic and social goals. In recent times, due to the global economic crisis and high fiscal deficits, indirect taxes have become an increasingly prominent source of tax revenue. In United Kingdom (UK) about 21% in 2012-2013 of total tax revenue is derived from VAT/ GST and taxes on specific goods and services.[1]

With reference to the OECD Revenue Statistics for year 2010, the average tax revenue as percentage of GDP  is calculated at 32.8%;  in which the tax revenue as percentage of GDP  for United States is 23.2, Australia is 25.6, Japan is 27.6, New Zealand is 30.6, United Kingdom is 32.8, Sweden is 43.2 and Denmark is 45.3. Based on Malaysia Economic Report 2010 figures with total revenue at RM159.653 billion, indirect tax revenue at RM30.507 billion and GDP at RM676.7 billion, the tax revenue as a percentage of GDP is estimated at 23.6% while indirect tax revenue is estimated at 4.5% for year 2010.

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[1] Revenue statistics in this paragraph come from HMRC-National Statistics: HM Revenue & Customs. (2013). *HMRC Tax & NIC Receipts, Monthly and Annual historical record - The Economy.* HMRC Press Office. Released 20th September 2013. Retrieved from http://www.hmrc.gov.uk/statistics/receipts/info-analysis.pdf.

Therefore, since Malaysian total tax revenue collection as a percentage of GDP has yet to achieve the OECD average of 32.8% that takes into account all taxes; hence the issue of compliance with tax laws and regulations and the administrative requirements of the tax authority need to be addressed and investigated in order to improve the tax collection system, particularly on indirect taxes. This has invariably put more pressure on tax administration to enforce improved compliance and the cautious taxpayers to strengthen their company's compliance or to avoid or mitigate tax risks. Indeed, improvement in a country's federal budget is due in some degree to an improvement in the level of compliance. Therefore, an indirect compliance study on taxpayer compliance in service tax would be beneficial to tax authorities as it will address the issue of under-declaration or under-payment of the actual amount of service tax which affects the indirect tax revenue collection and percentage contribution to the federal government revenue.

### 1.0.1 Representative Sample

For this tax compliance study, the Federal Territory of Kuala Lumpur (FTKL) is chosen due to its high concentration of service tax providers in this country. There are approximately 45% of the total numbers of service tax licence holders[2] in Malaysia that are licensed in FTKL; and approximately 75% of the service tax revenue in Malaysia are collected by FTKL station. Besides, about 80% of the service tax audit cases are resolved in FTKL.

### 1.0.2 Theoretical Development

In the original standard economic tax compliance model (Allingham and Sandmo, 1972), financial incentives are determined by audit, penalty and tax rates. It was

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[2] There are a total of 17,161, 18,350, 19,564 service tax licence holders who are registered with the Royal Customs Department in the state of Federal Territory as at 31st December 2010, 2011 & 2012 respectively. Source: *RMCD Annual Report 2010*, *2011 & 2012.* Kuala Lumpur, FTKL: Malaysian Government Printing Office

established based on neoclassical paradigm that considered individuals as selfish, rational, self-interested rather than as influenced by other factors such as social norms, morality or fairness. It may be that there are better ways of achieving compliance than concentrating on the frequency and levels of auditing and penalties for those caught misbehaving (James & Edward, 2007). As a result, a behavioural approach to tax compliance was gradually developed to supplement and extend mainstream economic analysis. Some of these behavioural models include: Fishbein and Ajzen (1975); Jackson and Milliron (1986); Baldry (1986), "Some people never evade paying taxes"; Erard and Feinstein (1998), "Many people are honest taxpayers"; and Kirchler, Hoelzl and Wahl (2008).

According to Chan, Troutman and O'Brien (2000), most behavioural studies have adopted Fischer's 'Single Model'. Chau and Leung (2009) concluded that "the Fischer tax compliance model provides a sound framework for understanding the influence of those socio-economic and psychological components on tax payers' compliance decision" (p.034). From their findings, it is noted that some researchers have expanded Fischer's Model to incorporate other relevant factors to explain individual taxpayer compliance behaviour.

**1.0.2.1 The Proposed Model**

In this study, the Fischer 'Single Model' is chosen as the framework and basis for understanding the phenomenon of (a) what are the variables or factors influencing the service tax licence holders or taxpayers, business firms or companies compliance level; (b) why they do not comply; and (c) how to improve taxpayer compliance. This "Single Model' is simplified and adapted to include the tax audit variables of service tax compliance. The proposed model is examined using multiple regression (MR) analysis:

- To determine the relationship between the six independent variables and taxpayer compliance (dependent variable);

- To apply the ceteris paribus concept and establish a regression model or equation of taxpayer compliance and find the variables' order of importance;

- To assess the mediating effect of tax return filing (TRF) on taxable sales level (TSL) and taxpayer compliance (TC).


### 1.0.3 Goal and Purpose of the Study

The primary goal of the study is to conduct an in-depth analysis of taxpayer compliance on service tax, a form of indirect tax in Malaysia. This research concentrates mainly on analysing the influence of tax audit variables on taxpayer compliance , including mediating effect of tax return filing (TRF) on taxable sales level (TSL) and taxpayer compliance (TC). It covers: (a) correlation analysis on the relationship between the tax audit variables and taxpayer compliance; (b) multiple regression (MR) analysis to establish a taxpayer compliance model and a mediation model based on continuous data for a sample of 150 noncompliant taxpayers; (c) descriptive analysis (using frequency table and percentages) on the compliance level of 12 independent variables; (d) one-way analysis of variance (ANOVA) to test the differences between two or more independent variable (normal data) groups based on categorical data for a sample of 250 (comprises 150 noncompliant and 100 compliant) audited taxpayers; and (e) one-way ANOVA on ranks (Kruskal-Wallis H nonparametric test) to assess for significant differences on taxpayer compliance by a grouping independent variable ( with three or more group).