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TAX COMPLIANCE COSTS OF SMALL AND MEDIUM ENTERPRISES IN MALAYSIA: POLICY IMPLICATIONS

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Tax Compliance Costs of Small and Medium Enterprises in Malaysia: Policy Implications

Abstract

Tax compliance costs often fall heavily on small and medium enterprises (SMEs). The international tax literature exhibits a similar pattern of fixed costs effect whether measured for a specific tax or overall business taxes. In Malaysia, the government SME focus is often restricted to general business and finance-related issues. However, the issue of the tax compliance burden is yet to materialise explicitly. This paper discusses this SME tax compliance burden, relevant international and Malaysian compliance cost estimates and challenges for Malaysian SMEs. The paper concludes by indicating the tax policy challenges facing the government, particularly for SMEs.

INTRODUCTION

Government regulations, particularly taxation, are a major concern of the business sector throughout the world. International experience demonstrates that regulatory burdens appear to fall disproportionately on small and medium enterprises (SMEs). Businesses, in whatever form, size and/or sector are required by law to comply with all relevant legislation, including taxation. Over the last decade, an increasing recognition of the importance of SMEs was evident in Malaysia, particularly in 2005 through the establishment of the National SME Development Council (NSDC). The SMEs have played an important role in the economic growth of the nation. In 2005, there were 518,996 SMEs, comprising around 99 per cent of all enterprises in Malaysia, contributing almost 48 per cent of the total value added of the business establishments and around 65 per cent of total employment (National SME Development Council, 2006, pp. 19 - 23). The composition of SME by business size is shown in Table 1. Micro businesses account for around four-fifths of SME business establishments.

TABLE 1: SMEs IN MALAYSIA BY BUSINESS SIZE (2005)

Business size	Number	Percentage
Micro	411,849	79.4
Small	95,490	18.4
Medium	11,657	2.2
Total SMEs	518,996	100

Source: National SME Development Council (2006, p. 21).

In recognition of the their contribution to the economy and employment, the SMEs have been continuously and increasingly supported by the government (I Osman and Mohd-Khairuddin Hashim, 2003), particularly with regards to general business and financial management. The sector is expected to play a vital supportive role in sustained economic growth. The lack of explicit recognition of the regulatory burden in general and taxation in particular imposed on SMEs may affect them adversely.

Given this background, the paper discusses the issues, estimates and challenges of the tax compliance and administrative burden in the context of tax policy considerations in Malaysia. The paper is organised as follows. Section 2 highlights key recent income tax changes. Section 3 discusses the major tax compliance burden difficulties and issues for SMEs. Section 4 discuss estimates of tax compliance costs, both internationally and in Malaysia. The fifth section analyses Malaysian institutional and policy issues. Section 6 discusses Malaysian SME tax challenges, including proposals to simplify income tax. Section 7 concludes this paper.

RECENT MAJOR INCOME TAX CHANGES

In 2000, two major reforms took place in Malaysia, namely, the move from the preceding year (PY) to current year (CY) assessment and the introduction of the self-assessment system (SAS). Another major reform, namely a single tier company income tax system to

replace the corporate imputation system, was recently announced in the National 2008 Budget.

Prior to the year 2000, income tax assessments in Malaysia were made on a PY basis, with assessments made by the Inland Revenue Board (IRB) by way of an official assessment (OAS). Under this system, a taxpayer was required to submit his/her annual tax return by a stipulated period.¹ The IRB then issues a notice of assessment, payable within 30 days.

The SAS was implemented in stages, starting with companies from the year 2001 and consequently to other taxpayers (i.e. self-employed individuals, partnerships, co-operatives and employees) in 2004. The introduction of SAS involves a substantial shift of responsibility on to the taxpayers in terms of their compliance obligations. Generally, in the SAS, a taxpayer is required to compute and pay his/her income tax. Companies are required to observe additional requirements.² The SAS has been successfully implemented in 2005 and now covers all taxpayers. It is important to note that following the move to SAS, a number of significant amendments have been made throughout. A number of public rulings have also been issued since 2000. Arguably, the simplification of the business basis period, re-categorisation of capital expenditure for capital allowance purposes and the full capital allowance for small value assets are some of the major income tax simplifications that have been introduced since the implementation of the SAS.

Following simplification to the business basis period, all individual business taxpayers are required to close their accounting year to 31 December each year. By contrast, a basis period for a company will follow the financial year end. Sections 20 and 21 of the *Income Tax Act (ITA) 1967* have been amended and a new section 21A has been introduced. Additionally, three related public rulings³ were issued in 2000 and consequently superseded by the later version in 2001.

For capital allowances, the simplification is made by re-classifying 16 capital expenditures under the plant and machinery category to only three sub-categories, i.e. heavy machinery and motor vehicles; plant and machinery; and furniture and office equipment. Accordingly a large variety of capital allowance rates were reduced to three rates only. Another simplification of capital allowance took place in 2006, which allows small value assets (up to RM1,000 each) to be given a 100 per cent allowance. The total of such allowance is restricted to a maximum of RM10,000 per year.

The corporate tax imputation system is to be replaced by a single tier company income tax system, as announced in the National 2008 Budget (Ministry of Finance Malaysia,

¹ The submission deadline is within 30 days from the issuing date of notice of assessment or within six months after the business year-end respectively for individual and corporate taxpayer.

² These requirements include an estimation of the tax liability in advance and payment of monthly tax instalments (also in advance) as provided for in the new Section 107C of *ITA 1967*.

³ A public ruling is issued by the IRB to provide guidance to taxpayers and revenue officers as well with a view to minimise ambiguous interpretation of tax law.

2007). Under this single tier system, the corporate tax is imposed at the corporate level (i.e. final tax) and the dividends will be tax exempt to its shareholders. The one tier system certainly would simplify the procedures (section 108) for effecting dividend distributions and arguably would reduce both the administrative costs (to the tax authority) and tax compliance costs (to the taxpayer), that together comprise tax operating costs.

Specific to SME sectors (but confined to a company), two additional measures have been introduced. The first is dual corporate tax rates in 2003. Under this structure, SME companies, with paid-up capital of up to RM2.5 million are subject to a tax rate of 20 per cent for the first RM500,000 (from 1 January 2004; RM100,000 in 2003) of taxable income and the remaining income is subject to the normal corporate tax rate of 26 per cent (from 1 January 2008; 25 per cent from 1 January 2009; 27 per cent in 2007). The most recent amendment (announced in September 2007) relates to the estimation of tax payable and payment of a monthly tax instalment. SME companies are not required to furnish an estimate of tax payable or make instalment payments for their first two years of business commencement, in order to relieve the cash flow constraints faced by SMEs, in particular during the initial stages of operation.

MAJOR TAX DIFFICULTIES AND ISSUES FOR SMEs

Tax Compliance in Malaysia: An Overview

SMEs in Malaysia are subject to income tax, either as individual (unincorporated businesses) or as corporate taxpayers (incorporated businesses), depending on the business establishment. The taxation of both individual and corporate businesses is governed by the *ITA 1967*, with almost similar tax provisions. Business taxpayers regardless of their size are required by law, essentially, to file an annual tax return correctly and in full (Sections 77 and 77A), to keep sufficient records and documentations (Sections 82 & 82A) and to observe other tax-related requirements (e.g. Sections 107, 107B, 107C, 108). Additionally, businesses are required to implement the *Schedular Monthly Tax Deduction Scheme* (Section 107(1) and *Income Tax – Deduction from Remuneration Rules 1994*) and to furnish certain returns on behalf of their employees (Section 83). Businesses that are subject to indirect tax are further required to comply with all applicable provisions under the respective Acts. Besides direct and indirect taxes imposed by federal government, businesses are also required to comply with state and local government taxes, including property taxes (assessment tax and land tax), and various business permits and licensing.

Compliance to the above regulatory requirements is mandatory in nature, placing an enormous burden and costs upon the business sector. Largely, international experiences often indicate the difficulties faced by SMEs in managing government laws and regulations (Pracula Fernandez and Lynne Oats, 1998, p.162), particularly in maintaining proper records for management and taxation purposes (Chris Evans et al., 2005, p.289, Small Business Deregulation Task Force, 1996, p.2). The issues facing small businesses in relation to regulatory costs are worldwide phenomena and almost identical in the US,

UK, Australia and New Zealand. These include a lack of understanding of the regulatory requirements, frequent changes in regulations and high fixed costs (Francis Chittenden et al., 2003, p.110).

Recognising that all SMEs in Malaysia are subject to business income tax, the income tax-related-difficulties are of primary interest of this paper. Record keeping and documentation, tax compliance costs, tax complexity and legal entities are among major tax difficulties faced by SMEs in Malaysia (Jeff Pope and Hijattulah Abdul-Jabbar, 2007).

Record Keeping and Documentation

Similar to international experience, the difficulties of Malaysian SMEs in managing business laws (Jeyapalan Kasipillai and Raymond Liew, 2004) and specifically in maintaining appropriate records for business and taxation purposes (Mustafa Hanefah and Abdul-Latif Al-Mureshi, 1991) is evident in Malaysia. More than 15 years ago, Hanefah and Al-Mureshi (1991) observed that the predominant services provided by accounting firms to small business clients are book-keeping and taxation. The lack of proper records led small businesses to fail to comply with business taxation requirements (Abdul-Jabbar, 1996). On the contrary, Hanefah and Al-Mureshi (1991) hypothesized that the medium-scale enterprises may not have as much problem in this area, but to what extent this remains true in the SAS environment is not known.

Prior to the implementation of SAS to individual taxpayers i.e. before 2005, a number of studies had been conducted which included self-employed taxpayers (Kasipillai et al., 1999, Mohd-Rizal Palil, 2005, Mottiakavander Ramasamy et al., 2003), and small businesses (Hanefah and Al-Mureshi, 1991). Overall, these studies show that the issues relating to book-keeping and documentation for tax purposes are still relevant. Even a salary earner with a simple tax situation may have difficulties (Ern Chen Loo and Juan Keng Ho, 2005, Palil, 2005), and particularly self-employed business persons (small business) need to consider obtaining external advice. The same may also apply to medium scale enterprises. Thus it is anticipated that additional record keeping requirements (Section 82A) that were introduced since the implementation of the SAS could add to the existing problems of the SMEs.

Tax Complexity

Some degree of tax complexity for individual taxpayers in Malaysia was found by Hanefah (1996). Hanefah et al., (2001, p.96) observed that the Malaysian business tax system appears to be becoming increasingly more complex, either due to major amendments being made to existing law or new assessments systems being introduced. The trouble-free way to minimize such SME tax compliance problems is by outsourcing to tax professionals, but this generally increases tax compliance costs. Chittenden et al., (2003, p. 110) in their review of the tax compliance cost studies within small businesses in the USA, UK, Australia and New Zealand noted that the incompetency of small

business in dealing with complex tax regulation has affected them more severely than large firms.

Tax complexity could be best measured via tax compliance costs (Simon James et al., 1998, p.32, Pope, 1993b, p.70, Joel Slemrod, 1992, p.53). High costs of compliance are the product of a complex tax system and vice-versa (Pope, 1993b, p.70). A number of taxes imposed on business may also increase the tax complexity and compliance costs (Cedric Sandford, et al., 1989, pp. 215 - 216). They suggest a minimum number of broader base taxes with minimal exemptions and reliefs to be considered in lowering compliance costs.

Tax Compliance Costs

Businesses incur costs to comply with tax requirements, which are additional to their tax liability. Tax compliance costs include three major components, namely monetary costs, time costs and psychological costs to the taxpayers (e.g. Pope et al., 1991, p.7, Sandford et al., 1989, pp.11-12). Monetary costs include sums spent on tax professionals (i.e. tax agents and accountants) and expenses relating to taxation guides, books, communication and other incidental costs. Time costs are incurred by the taxpayer, mainly on record keeping for tax purposes, completing the tax return and/or in preparing tax details for the tax professionals as well as time spent on dealing with the tax authorities. Psychological costs comprise costs such as the anxiety of handling complex tax matters. Additionally, Sandford et al., (1989, pp. 13-14) recognised cash flow benefits and managerial benefits as offsets to compliance costs.

In Malaysia, the introduction of the SAS was mainly motivated by the aim of increasing the collection rate, to reduce the cost of collecting taxes and to increase voluntary compliance (Kasipillai, 2005, pp.26-27). The SAS environment involves a substantial shift of responsibility on to taxpayers in terms of their compliance obligations with tax professionals expected to play a significant role in providing services to taxpayers in complying with the tax laws. Consequently compliance costs are expected to increase significantly during the early years of SAS implementation. In the longer term, the relative level of compliance costs will depend upon a range of factors, particularly the complexity of the tax laws and frequency of tax changes. Prior literature indicates that to date there are only two published studies on the costs of compliance in Malaysia (Hanefah et al., 2001, Alfred Loh et al., 1997), both on companies, discussed later.

Legal Entities

For tax purposes, each legal entity may be subject to some different tax treatment. For example, an individual taxpayer is subjected to progressive tax rates and eligible for personal reliefs and rebates. On the other hand, depending on the size of the company, corporate taxpayers are subject to either a flat rate of 26 per cent (for large companies) or dual tax rates (for SMEs), without any personal reliefs and rebates. There are two main advantages of the company business structure compared to that of the non-company taxpayer, namely on tax rates and investment incentives. For tax rates, it is beneficial

particularly when the company's taxable profits exceed RM20,000. For example, on the one hand, the marginal tax rate of individuals carrying on business with taxable income⁴ of RM30,000 is 24 per cent; on the other hand, SME companies having taxable income up to RM500,000 are subject to a tax rate of 20 per cent. For investment incentives, corporate firms are entitled to various tax incentives.⁵ Most of the incentives are mutually exclusive, thus reasonable care should be exercised. For example a company enjoying pioneer status could not apply for other types of incentives. They need to consider a number of options that best suit their circumstances. Such a number of tax incentives probably increases the complexity of the tax laws and ensuing tax compliance costs.

Complicating factors in considering and designing tax provisions for small businesses have been discussed by Judith Freedman (2003, pp.19-20). It is claimed that a simple tax system is more important to small businesses instead of too many special provisions, which potentially leads to tax complexity (Freedman, 2003, p.15) and distort the choice of business form (Christian Valenduc and Steven Clark, 2007). The UK experience, for example, shows that economists and politicians tend to ignore unincorporated entities (Freedman, 2003, p.34). Thus the favourable tax treatment of incorporated bodies in Malaysia is not surprising. Arguably, such favourable tax treatment should be extended to include other SME establishments as well, subject to appropriate provisos.

COMPLIANCE COST ESTIMATES

International Findings on Compliance Costs

Compliance cost estimates in the modern era have been conducted internationally, mainly in the UK, USA and Australia for over 20 years, and now cover other countries e.g. Netherlands, Spain, Croatia, New Zealand, Singapore, Malaysia, Hong Kong and India. Currently, requiring a Tax Impact Statement (also known as Regulatory Impact Statement and Compliance Costs Assessment) for tax law changes is a normal practice in the Organisation for Economic Co-operation and Development (OECD) countries, including Australia, the European Union, New Zealand, UK and the US (Chris Evans and Mike Walpole, 1999, p.21). In the UK, the requirement to produce a Compliance Cost Assessment was introduced in 1985 and it is probably the first country to recognise compliance costs as a policy issue (Sandford, 1995, p.3). The historical development of tax compliance costs is not considered further; interested readers should refer Evans et al, (2001), Evans (2003) and Pope (2005).

Nearly all studies have found a markedly regressive pattern of tax compliance costs i.e. the burden falls heavily on smaller firms. The same trend hold true, either measured for a single type of tax or at a combined level, for all types of business taxes. The regressive

⁴ It is important to note the taxable income is derived after deductions of personal and other reliefs.

⁵ The incentives are provided under the *Promotion of Investment Act (PIA) 1986* (such as pioneer status and investment tax allowance) and *ITA 1967* (such as reinvestment allowance and a deduction for pre-incorporated expenses). The mechanism of incentive varies depending on a number of factors e.g. types of incentives, business sector and whether a small-scale company or not. Most of the incentives are not available for unincorporated businesses, except in the agricultural sectors.

nature of compliance costs for all types of business taxes and by legal form is illustrated by Australian data, as shown in Table 2. Tax compliance costs of small business, irrespective of entity, measured per AU\$1,000 of turnover, is at least nineteen times greater than for both medium and large business (Evans et al., 1997, pp.79-80).

TABLE 2: COMPLIANCE COSTS* OF COMMONWEALTH BUSINESS TAXES IN AUSTRALIA PER AU\$1,000 OF TURNOVER IN ATAX STUDY – 1994/1995

Business Structure/size	Small	Medium	Large
Sole traders	27.72	1.28	n/a
Partnerships	31.74	1.54	0.72
Trusts	65.44	1.55	0.32
Superannuation Funds	32.08	1.78	1.49
Companies	36.68	1.98	1.93
Overall (all entities)	34.13	1.74	1.84

*Note: Tax compliance cost refers to gross tax compliance cost or social compliance costs as used in the ATAX study. The regressivity is even greater after the off setting benefits of tax deductibility and cash flow.

Source: Evans et al., (1997, Table 5.11 p.79).

As for a single tax e.g. corporate income tax, the regressive nature of compliance costs is best illustrated by Pope et al's (1994) comparative analysis of compliance costs in Australia, New Zealand and the UK. Note that different categories of turnover were used in those studies and turnover categories have not been converted to a common currency by Pope, as shown in Table 3.

TABLE 3: COMPLIANCE COSTS FOR COMPANIES INCOME TAX AS A PERCENTAGE OF TURNOVER IN AUSTRALIA, NEW ZEALAND AND THE UK

Australia 1990/1991		New Zealand 1990/1991		UK 1986/1987	
Turnover (AU\$ Million)	Compliance costs as a % turnover	Turnover (NZ\$ Million)	Compliance costs as a % turnover	Turnover (£ Million)	Compliance costs as a % turnover
Less than 0.5	3.0	Less than 0.03	13.15	Less than 0.05	0.77
		0.03 – 0.1	4.31	0.05 – 0.1	0.20
		0.1 – 0.25	2.12	0.1 – 0.5	0.17
		0.25 – 0.5	1.35		
0.5 – 1	0.8	0.5 – 1	0.78	0.5 – 1	0.07
1- 2	0.8	1- 2	0.79	1- 10	0.03
2 – 5	0.2	2 – 10	0.28		
5 – 10	0.1				
10 - 20	0.02	10 - 50	0.04	10 and over	0.01
20 – 50	0.01				
50 and over	0.02	50 and over	0.03		

Source: Pope et al., (1994, Table 7.2 p.87).

In the Asian countries, a number of compliance cost studies have been conducted in Singapore, Malaysia and Hong Kong solely for the corporate sector. The regressive nature of these tax compliance costs is clearly shown in Table 4.

TABLE 4: COMPLIANCE COSTS OF CORPORATE INCOME TAX PER \$1,000 OF TURNOVER IN ASIAN COUNTRIES

Turnover Level/year (in HK\$ / S\$/ RM)	Hong Kong^a 1995/1996	Singapore^b 1994	Singapore^c 1995	Malaysia^d 1995
Less than 100 million	5.41	0.55	0.40	0.36
100 – 550 million	1.17	0.39	0.29	0.17*
More than 550 million	0.21	0.19	0.08	0.11*

*Note: the turnover level for Malaysia differs slightly, i.e. between RM100 – RM500 million, and greater than RM500 respectively.

Sources: ^a Chan et al. (1999, p.55), ^b Ariff, et al., (1995, p.81), ^c Ariff et al., (1997, p.1260), ^d Loh et al. (1997).

Malaysian SME Compliance Costs

As stated earlier, to date there are only two published costs of compliance studies in Malaysia (Hanefah et al., 2001, Loh et al., 1997), both on corporate income tax. A comparative analysis of both studies indicates that, in absolute dollars, the average compliance cost of an SME companies is almost one-third of the public listed companies. Importantly, the average compliance costs for both large and small firms in Malaysia are considered the lowest when compared to other Asia Pacific countries such as Australia, Singapore and Hong Kong (Ariff and Pope, 2002, p.9). A summary of the main findings of both Malaysian studies is presented in Table 5.

TABLE 5: TAX COMPLIANCE COSTS IN MALAYSIA

	Public-listed company^a	SME company^b
Year of study	1995	1999
Tax Compliance Cost Average per firm	RM68,836	RM21,964
Component of costs (%)		
- Computational	61%	59%
- Planning	39%	41%
Sources of costs (%)		
- Internal	28%	75%
- External	72%	25%

Source: ^a Loh et al., (1997) and ^b Hanefah et al., (2001).

In terms of resources, 72 per cent of public listed companies rely on the use of paid external advisers (Loh et al., 1997). In contrast, 75 per cent of SMEs seem to rely on their internal resources to comply with the tax laws. The findings need to be treated cautiously because both studies were carried out prior to the introduction of the self-assessment system. A third study specifically on Malaysian SME compliance costs is currently being conducted by Abdul-Jabbar (2006). Initial findings suggest that Malaysian SME

compliance costs may have fallen, perhaps as much as 50 per cent. Final results are expected in the beginning of 2009.

MALAYSIAN INSTITUTIONAL AND POLICY PERSPECTIVES

The importance of SMEs has been evident in Malaysia over the last decade. Unfortunately, the issues of compliance burden, particularly the tax burden surrounding SMEs and even large businesses, are yet to be recognised. Further, the recent establishment of the Tax Review Panel (TRP) (Ministry of Finance Malaysia, 2004) seems mainly directed towards the proposed GST. The absence of NSDC participation in the TRP is noteworthy. Arguably, the IRB recognition may be considered substantially low. The IRB mission is to collect taxes with fairness, efficiency and integrity, at a justifiable cost and at the same time provide excellent service to its clients (Inland Revenue Board, n.d.). The establishment of the Small Traders' Support Service Unit provides some sort of recognition of the extent of the small business compliance burden. The Unit provides assistance and advice on taxation issues to small traders who are not represented by tax agents.

Moving to the operational aspects, collecting taxes without imposing excessive burden (compliance costs) on the public with a minimal cost to the government is one of the IRB objectives. Average tax administrative costs (known as management costs in Malaysia) per year just exceed one per cent of the direct tax collection, as shown in Table 6. The ratio is comparable to those of Australia and UK, but more than two times higher than US (OECD, 2004, p.65).⁶ As for private sector costs, such yearly estimates of tax compliance costs are practically impossible.⁷

TABLE 6: TAX MANAGEMENT COSTS OF THE INLAND REVENUE BOARD, 2000 – 2005

Year	Tax management costs (RM million)	Tax management costs as a percentage of tax collected
2000	328	1.13
2001	359	0.86
2002	544	1.23
2003	532	1.18
2004	565	1.16
2005	640	1.02

Source: Inland Revenue Board (2002, 2003, 2004, 2005).

Although there is some recognition of the burden upon the private sector, particularly small business, more needs to be acknowledged to fully recognised the 'real' compliance burden of the business sector, particularly the SMEs. Nothing is known of the extent to

⁶ The ratios need to be interpreted with caution due to significant differences between countries. For example, differences in tax rates, tax structure and nature of taxes administered by tax authorities.

⁷ No other country estimates yearly tax compliance costs. The practice of tax authorities elsewhere (such as in Australia, UK, US) indicates that they normally require a Tax Impact Statement prior to any major tax changes.

which relevant parties, particularly the IRB, TRP, NSDC, professional accountants, as well as SME related organizations, have acknowledged the compliance burden of the SMEs. A survey carried out by the Central Bank of Malaysia in 2001 largely highlights general business issues, such as financing problems of SME operations, staff training, usage of technology and problems in business operations (National SME Development Council, 2006, pp.33-34). Taxation only arises as a minor issue in the report and the SMEs urged the government to provide more tax incentives in order for them to remain competitive in the market. There needs to be a much greater specific focus on taxation issues and ensuring that the SME compliance burden is minimised.

Theoretically, Sandford et al. (1989, p.209) stressed the importance of compliance costs for government in four areas: to recognise the importance of compliance costs explicitly; not reduce the administrative costs at the expense of compliance costs; to minimise compliance costs, especially for small business; and finally, to compensate for compliance costs. Pope (1993b, pp.71-73) identified six stages in the development of the compliance costs of taxation as a policy area: non-recognition or lack of interest in the subject area; qualitative recognition by the professionals; estimation and evaluation; policy recognition; effective policy measures; and continual monitoring of compliance costs. Probably, Malaysia is still in stage one with some development in stages two and three having taken place during the mid 1990s to early 2000.

It is timely that a relevant study is being carried out by Abdul-Jabbar (2006) (particularly in estimating tax compliance costs - stage 3), which consequently could be used in government policy decision-making (stage 4). Moreover, the government, (particularly the IRB and the TRP) may move forward to establish a specific committee, such as the Beddall Committee and the Small Business Deregulation Task Force in Australia, to look at compliance burden issues, particularly on SMEs, more systematically. The Beddall Report (1990) recognized the tax compliance burden of small business and had made various recommendations to simplify the tax systems for small business (Pope, 1993b, p.33). For example, the Australian Taxation Office commissioned research on the methodology to be used in estimating the taxation compliance costs. Following international experience, the later step is to introduce a Tax Impact Statement for future tax law changes similar to that adopted in the OECD countries (Evans and Walpole, 1999). As the feedback from businesses was the main reasons causing the GST postponement, therefore, the issue of compliance burden should be considered decisively for any major future tax changes, perhaps before the next date of GST implementation is announced.

MALAYSIAN SME TAX CHALLENGES

Administrative Arrangements and Simplification Policies

Modernisation of tax administration with a view to simplifying the tax rules and making them taxpayer-friendly, and reducing compliance costs, with a particular emphasis on the small business sector and individuals, is among the ten main lessons identified by Ariff and Pope (2002, pp.279-289) as a policy guide for developing countries. Tax simplicity

could improve the voluntary compliance behaviour and also increase tax revenue (Pope, 1993a, p. 284). Sandford (1993, pp 201-205) provides a comprehensive discussion on the advantages and disadvantages of an incremental and a package approach, but asserts that the success of tax reform is more likely to be achieved by way of a package approach (p.228).

The Australian experience has demonstrated that small business wants simplicity in taxation matters (Small Business Deregulation Task Force, 1996, p.2). It has been suggested that only simple tax provisions will minimise tax compliance costs (Pope, 1993b, p.81). Tran-Nam (1999) categorised tax simplicity into two types, namely, legal simplicity and effective simplicity. Legal simplicity refers to the readability and comprehensibility of the tax law. Effective simplicity refers to the ability to determine tax liability correctly. Arguably, tax law simplification itself does not necessarily achieve the ultimate goal of simplification (Simon James, Adrian Sawyer and Ian Wallschutzky, 1998, p. 31) and prevent tax evasion (Adam Forest and Steven Sheffrin, 2002, p.76). The success of simplification measures requires more than linguistic improvement to existing legislation (James, Sawyer and Wallschutzky, 1998, p.35). In the Australian context, Boucher (1991) suggested nine main areas for tax simplification, including a rewrite of the legislation in plain English, a reduction in the length of the legislation and record keeping requirements, elimination of discretions and the removal of uncertainties.

In the past, Malaysia seems to have adopted an incremental approach to tax simplification. Streamlining the tax administrative process, mainly by the IRB (in administering direct taxes) has taken place for the past ten years or so and the trend is expected to continue. A particular emphasis is needed for income tax simplification and tax compliance costs minimisation in a more comprehensive and systematic manner, preferably in a package approach.

Income Tax Simplification and Compliance Cost Minimization

Tax law should be simplified continuously, mainly for three reasons, namely to lower both compliance costs and administrative costs, to reduce uncertainty faced by taxpayers; and to improve the levels of voluntary compliance (Kasipillai, 2005, p.26). Various tax simplification measures have been introduced in Malaysia since 2000. The details of these simplifications were discussed in the major income tax changes section, above. Some of the considerations and areas for future Income Tax simplification, particularly for SMEs are as follows:

Uniform Definition for SMEs and Extension of Incentives

Prior to the establishment of the NSDC, there were various definitions of SMEs in Malaysia. In 2005, the NSDC introduced a uniform definition for SMEs in Malaysia. The definition is based on two criteria, either the number of employees or annual sales turnover depending on the sector (National SME Development Council, 2005). The NSDC also further distinguishes between micro, small and medium-sized enterprises. Table 7 summarizes the general SME definitions by sector.

TABLE 7: NATIONAL SMEs DEFINITION

Sectors/Criteria	Employees (not exceeding)	Annual turnover (not exceeding)
Manufacturing	150	RM25 million
Manufacturing-related services		
Primary Agriculture	50	RM 5 million
Services		

Source : National SME Development Council (2005, pp. 3-5).

As for income tax, currently there are at least three definitions that are in force for different purposes covering companies only. Three different proxies are used to measure the size of the company: paid-up capital, shareholder's fund and authorized capital, as shown in Table 8.

As a measure of standardization at the national level and tax simplification, a uniform definition of SMEs (to that of the NSDC) should be adopted for tax purposes as well. Moreover, a lower tax rate and various incentives eligible to certain SME companies could be extended to include all SMEs. However, from a Government and IRB viewpoint, the trade-off between losses of revenue and benefits of tax simplification would be of particular concern.

TABLE 8: DEFINITION OF SMEs FOR TAX PURPOSE

Types of incentives/ deductions*	Definition of small and/or medium enterprises
A dual corporate tax rates.	Company (resident in Malaysia) with an ordinary paid-up capital up to RM2.5 million at the beginning of the basis year. ^a
Deductions for pre-incorporation expenses.	Company (incorporated in Malaysia) and having authorized capital of not more than RM2.5 million. ^b
Pioneer status or investment tax allowance.	A small-scale company (incorporated in Malaysia) with a shareholder's funds not exceeding RM500,000. ^c

* Note: Other requirements may apply. For example, incentive for a small-scale company is confined to manufacturing sectors with at least 60 per cent Malaysian equity.

Sources:

^a Para 2A, Schedule 1, ITA 1967; ^b Para 2(1) Income Tax (Deduction for Incorporation Expenses) Rules 2003; ^c Guidelines and Procedure for Applying Tax Incentive for Small Scale Manufacturing Companies under the PIA 1986.

Reduce the Number of Personal Reliefs and Rebates and Increased the Tax Free-threshold

Currently, there are too many personal reliefs (such as self, wife, child, education, life insurance) and rebates (self, wife, personal computer, religious payment) available for individual taxpayers. The large number of reliefs and rebates could be reduced significantly e.g. classifying taxpayers into two or three categories (such as single, married, business) and providing them with an overall total deduction. Increasing the tax

free-threshold is one of the suggestions by Pope (1993b) in the Australian context. Such proposals may further simplify the income tax of small business, in particular the self-employed and partnership businesses.

Reduce the Issuance of Public Rulings and Encourage Private Rulings

Since the implementation of the SAS system, there is a growing list of Public Rulings issued, with an average of six per year. The fact that a growing list of Public Rulings may increase the tax complexity should be recognised. Perhaps the right to request a Private Ruling similar to Australia legislation can be considered (Nicholas Crist, 2004).

Simplify the Record Keeping Requirements and Encourage a Simplified Tax System (STS) for Small Businesses

Simplifying record keeping for small business would allow businesses to allocate more resources in doing business. At the same the relevant authorities should continuously and actively encourage small businesses to have good record keeping (Veerinderjeet Singh, 2002, p.277). The positive side of tax compliance, such as managerial benefits arising from tax compliance, needs to be further emphasised.

CONCLUSION

This paper has shown that the most important policy area that should be addressed is to recognise fully the compliance burden of the SMEs at the national level. Accordingly, establishment of relevant committees, similar to the Beddall Committee (1990) and the Small Business Deregulation Task Force (1996) in Australia, involving all relevant parties, including the NSDC, TRP, relevant SMEs organisations, tax professionals and academics, is recommended.

Secondly, simplification of the income tax system for SMEs in a more comprehensive manner is strongly supported. This should take account of Malaysian past experiences, taxpayer views, specific suggestions on legislative detail and the lessons learnt from other tax regimes. Findings from the current study by Abdul-Jabbar (2006) will give up-to-date data and reliable compliance cost estimates that, together with the data and findings discussed in this paper, should provide a sound basis for tax policy decision-making in Malaysia.

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