TAX SIMPLICITY AND SMALL BUSINESS IN MALAYSIA: 
PAST DEVELOPMENTS AND THE FUTURE

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ABSTRACT

Two major reforms occurred in Malaysia in the year 2000. These were the move from the preceding year to a current year assessment system (from 2000) and the introduction of the self-assessment system (implemented in stages commencing in 2001). More recently, a proposed Goods and Services Tax (GST) has been postponed indefinitely following feedback received from businesses and other considerations. This paper discusses the Malaysian issues of tax complexity, tax compliance costs, tax administration, policy and institutional issues, tax reform and simplification in the context of small and medium size businesses (SMEs). It draws upon both Malaysian and overseas experience and research, particularly work in Australia and the UK. It suggests that much needs to be done in order to simplify the taxation of Malaysian SMEs and minimise their compliance costs. The paper concludes by emphasising four major areas for policy consideration.
1 INTRODUCTION

A number of tax reforms have taken place in Malaysia from the mid 1980s to the present. The features of Malaysian tax reform follow the overall international trend that includes the introduction of self-assessment system (SAS), deduction in tax rates and a change in the tax mix, removal of tax expenditures, redistribution of the tax burden and broadening of the income tax base (Hasseldine and Li 1999; Sandford 1993). In 2000 two major income tax reforms took place in Malaysia, namely the move from the preceding year to a current year assessment system and the introduction of the self-assessment system (SAS). As for indirect taxes, major reform was announced in the 2005 budget to introduce a single broad based Goods and Services Tax (GST) to replace the existing sales and service taxes effective 1 January 2007. However, recognising the issues raised by businesses, in early 2006 the government announced that the implementation of the GST would be postponed indefinitely.

The SMEs in Malaysia 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, and 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). Sole proprietorship account for the highest percentage of SME business establishments (69 per cent), followed by private limited company (21 per cent) and partnership (10 per cent). In terms of size, micro businesses account for nearly 80 per cent of SMEs, as shown in Table 1.

<table>
<thead>
<tr>
<th>Business size</th>
<th>Number</th>
<th>Percentage</th>
</tr>
</thead>
<tbody>
<tr>
<td>Micro</td>
<td>411,849</td>
<td>79.4</td>
</tr>
<tr>
<td>Small</td>
<td>95,490</td>
<td>18.4</td>
</tr>
<tr>
<td>Medium</td>
<td>11,657</td>
<td>2.20</td>
</tr>
<tr>
<td><strong>Total SMEs</strong></td>
<td>518,996</td>
<td>100</td>
</tr>
</tbody>
</table>

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

As Malaysia aims to be a fully industrialised nation by the year 2020, SMEs will continue to play a vital supportive role in the nation’s growth. Further, SMEs are expected to complement the activities of the large enterprises through integration into the mainstream of industrial development process (BT Online 1996). Given the large number of SMEs and their contribution to the economy and employment, the sector have been continuously and increasingly supported by the government (Osman and Hashim 2003), particularly with regards to general business and financial management. Reducing the compliance burden of SMEs through the simplification of government regulations in general and tax requirements in particular needs to be given a much higher priority than hitherto.

Given this background, the paper discusses the issues of tax complexity and simplicity and the progress made since the implementation of SAS in Malaysia. A particular consideration suggests strategies that could minimize the tax compliance costs of SMEs, especially income tax.

The paper is organised as follows. The next section gives an overview of the Malaysian business tax system and also highlights some recent major changes.
Section 3 surveys prior literature as a basis for developing the theoretical framework with regards to tax complexity, simplification and compliance costs. Section 4 and 5 discussed problems and issues surrounding SMEs and some of the tax simplification measures that have taken place in Malaysia since the introduction of the SAS. Section 6 analyses simplification in a policy and institutional context, and Section 7 discusses specific proposals for future tax simplification and cost minimisation in Malaysia. Section 8 concludes and offers direction for further research.

2 TAXATION IN MALAYSIA

2.1 An Overview

The Malaysian government tax revenue comprises direct and indirect taxes. Direct taxes are under the administration of the Inland Revenue Board of Malaysia (IRB). On the other hand, indirect taxes are administered by the Royal Customs of Malaysia (RCM). Both tax authorities are under the responsibility of the Ministry of Finance. The IRB was established (as an agent of the federal government) in accordance with the Inland Revenue Board of Malaysia Act 1995, which gives autonomy in the administration and effectiveness of direct taxes. On the contrary, the RCM is a government agency. A summary of direct and indirect taxes in Malaysia is presented in Table 2.

<table>
<thead>
<tr>
<th>Direct tax</th>
<th>Indirect Tax</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Income Tax</strong></td>
<td><strong>Sales Tax</strong></td>
</tr>
<tr>
<td>Charged on individuals, company and other entities (such as clubs and association) deriving income from businesses, employment, dividends, interests, rents, royalties, pensions, annuities and other periodical payments.</td>
<td>A single stage tax levied on certain imported and locally manufactured goods. The tax rate ranges from 0 – 25 per cent. The general rate of sales tax is 10 per cent.</td>
</tr>
<tr>
<td><strong>Petroleum Income Tax</strong></td>
<td><strong>Service Tax</strong></td>
</tr>
<tr>
<td>Charged on businesses deriving income from petroleum operations.</td>
<td>Imposed on certain goods and services provided in certain prescribed establishments. Service tax is charged and levied at the rate of 5 per cent.</td>
</tr>
<tr>
<td><strong>Real Property Gains Tax</strong></td>
<td><strong>Excise Duties</strong></td>
</tr>
<tr>
<td>A capital gains tax imposed on the disposal of real property and or shares in a real property company.</td>
<td>Levied on selected products manufactured in Malaysia. For example cigarettes, liquors and motor vehicles.</td>
</tr>
<tr>
<td><strong>Stamp Duty</strong></td>
<td><strong>Customs Duties</strong></td>
</tr>
<tr>
<td>A transaction based tax and is imposed on instruments, such as tenant agreement, purchase and transfer of property.</td>
<td>Comprise of export and import duties. The customs duties vary according to the type of goods imported or exported.</td>
</tr>
</tbody>
</table>

Source: Various tax legislations.
All taxes are administered under different Acts of Parliament. For example, income tax is governed by the *Income Tax Act (ITA) 1967*, real property gains tax is under the *Real Property Gains Tax Act (RPGTA) 1976*, whilst sales tax and service tax is covered by the *Sales Tax Act 1972* and *Service Tax Act 1975* respectively.

Direct taxes in Malaysia contribute significantly towards federal government revenue, either in terms of total federal revenue or tax revenue. For example, in 2005, direct taxes accounted for 46 per cent of federal government revenue or 64 per cent of overall tax revenue. The major source of direct taxes is income tax, which contributed between 94 to 96 per cent for the period between 2002 and 2006. A summary of direct and indirect taxes contribution towards federal tax revenue for the period between 2002 and 2006 is presented in Table 3.

<table>
<thead>
<tr>
<th>Year</th>
<th>Direct Taxes (%)</th>
<th>Indirect Taxes (%)</th>
</tr>
</thead>
<tbody>
<tr>
<td>2002</td>
<td>66</td>
<td>34</td>
</tr>
<tr>
<td>2003</td>
<td>66</td>
<td>34</td>
</tr>
<tr>
<td>2004</td>
<td>68</td>
<td>32</td>
</tr>
<tr>
<td>2005</td>
<td>64</td>
<td>36</td>
</tr>
<tr>
<td>2006</td>
<td>65</td>
<td>35</td>
</tr>
</tbody>
</table>


Considering the significance of tax revenue and the importance of businesses, particularly the SMEs, the next section gives some background on business taxation in Malaysia. Prior to discussing the major changes on direct and indirect taxes that have taken place since 2000.

### 2.2 Business and Taxation

Businesses in Malaysia are subject to income tax\(^1\), (mainly personal and corporate) on a yearly basis, depending on the type of establishment. SMEs in Malaysia takes a variety of legal forms, either incorporated (company) or unincorporated (sole-proprietor or partnership). The taxation of both incorporated and unincorporated businesses\(^2\) are governed by the *ITA 1967*, with almost similar tax provisions. Generally, unincorporated SMEs are treated as individuals, hence subject to progressive tax rates and eligible for personal reliefs and rebates. On the contrary, incorporated businesses, either SMEs or large enterprises, are treated in similar ways, with a few exceptions or incentives. For example, SME companies are given a deduction for pre-incorporated expenses. Table 4 summarises the major differences in income tax treatment for company and non-company cases (treated as individual). From a taxation viewpoint, a company is typically likely to require greater resources to handle its tax matters and is likely to pay higher tax compared to unincorporated businesses.

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\(^1\) It is important to note that a company in the petroleum operation is subject to a petroleum income tax under the *Petroleum Income Tax Act (PITA) 1967*.  

\(^2\) Section 4(a) of the *Income Tax Act 1967* stipulated that profits from businesses are subject to income tax. The legal entities are of no relevance in determining chargeability of income tax.
### Table 4: A Summary of the Differences in the Tax Treatment between Company and Non-Company

<table>
<thead>
<tr>
<th></th>
<th>Company</th>
<th>Sole proprietor/ partnership</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Tax rates</strong></td>
<td>Corporate tax rate is 28 per cent.(^3) A reduced or dual rate applies for SME companies since 2003.</td>
<td>Progressive tax rate of between 0 and 28 percent applies for resident individuals. Non-residents are subject to a flat rate of 28 per cent.</td>
</tr>
<tr>
<td><strong>Basis of assessment</strong></td>
<td>Financial year-end</td>
<td>Calendar year</td>
</tr>
<tr>
<td><strong>Availability of reliefs and rebates in ascertaining taxable income</strong></td>
<td>Not eligible</td>
<td>Eligible</td>
</tr>
<tr>
<td><strong>Availability of certain tax deductions, including a double deduction under the ITA 1967.</strong></td>
<td>Available to some SME companies</td>
<td>Not applicable</td>
</tr>
<tr>
<td><strong>Requirement relating to the imputation system.(^4)</strong></td>
<td>Yes</td>
<td>Not applicable</td>
</tr>
<tr>
<td><strong>Requirements with regards to SAS, specifically:</strong></td>
<td>Yes</td>
<td>Not applicable</td>
</tr>
<tr>
<td>• to estimate tax liability</td>
<td>Yes</td>
<td>Not applicable</td>
</tr>
<tr>
<td>• to make monthly payment</td>
<td>Yes</td>
<td>Not applicable</td>
</tr>
<tr>
<td>• to submit a tax return</td>
<td>Yes</td>
<td>Yes</td>
</tr>
<tr>
<td><strong>Availability of tax incentives, such as pioneer status and investment tax allowance under the Promotion of Investment Act (PIA), 1986.</strong></td>
<td>Available for certain sectors, mainly to manufacturing, agricultural, tourism and high-technology companies.</td>
<td>Not available, except for agricultural sectors</td>
</tr>
</tbody>
</table>


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\(^3\) In the latest Malaysian Budget (for 2007), the government proposed a reduction in the corporate tax rate to 27 per cent for the year of assessment 2007 and 26 per cent for 2008.

\(^4\) A resident company in Malaysia is subject to the imputation system. Relevant provisions provided in Section 108(1) to 108(16) of the ITA 1967.
Additionally, businesses are required to comply with the state and local government taxes, which include property taxes (assessment tax and land tax) and various business permits and licensing.

As for a third party tax, businesses have to deduct an income tax on behalf of their employees under the Schedular Monthly Tax Deduction (STD) Scheme.\(^5\) Under this scheme, employers are required to deduct monthly tax on behalf of their employees and remit the amounts to the IRB by the 10\(^{th}\) of the month following the month when the tax deduction is made. The deduction largely depends on the personal circumstances of employees. Thus it requires businesses to keep their employees’ records up-to-date. Penalties are imposed on those failing to comply with the requirements.

On top of the existing burden and constraints faced by the SMEs in meeting their regulatory requirements, the regular amendment to the various tax laws, the introduction of the SAS and increasing complexities of the tax system may have an adverse impact on the SMEs. The introduction of the proposed GST may even increase the unease of the SMEs, as discussed later.

2.3 Major Changes on Income Tax

In 2000, two major reforms took place in Malaysia, namely, the move from the preceding year (PY) to a current year (CY) assessment and the introduction of the SAS. The CY assessment was effective from 2000. Prior to the year 2000, the income tax assessments in Malaysia were made on a PY basis. For example, an income tax assessment issued in 1999 is related to the taxable income for the year 1998. Prior to the year 2000, an assessment was made by the IRB by way of an official assessment (OAS). Under this system, a taxpayer was required to submit his/her annual tax return by the stipulated period. The IRB then issued 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\(^6\) 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\(^7\). 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 (discussed later in the paper) have been made throughout. For example, record keeping requirements and changes on business basis period. A number of public rulings have also been issued since 2000.

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\(^5\) The system had been in place since 1995 and is almost similar to Pay As You Earn (PAYE) in UK and Pay As You Go (PAYG) in Australia.

\(^6\) Other taxpayers include self-employed individuals, partnerships, co-operatives and employees.

\(^7\) 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.
2.4 A Proposed Major Change in Indirect Tax

In the 2005 budget, a major proposal on indirect taxes was announced. A single broad based GST was proposed to replace the existing sales and service taxes effective 1 January 2007. Recognizing the need to ensure the taxation system is efficient, equitable and business friendly, the Malaysian government established a Taxation Review Panel (TRP). The TRP comprises representatives from the public and private sector and its main function is to review the tax system with a view to suggest amendments to improve clarity and transparency of (both direct and indirect) tax administration (Malaysian Budget 2005). One of the terms of reference (and probably its first task) was to formulate the concept, legislation, process and procedure for the Malaysian GST (Tax Review Panel 2005). In July 2005, the TRP had issued a discussion paper on the proposed GST for Malaysia. However, following feedback received from businesses, the government announced the postponement of the introduction of the GST in early 2006.

3 TAX COMPLEXITY, TAX SIMPLIFICATION AND TAX COMPLIANCE COSTS: A THEORETICAL OVERVIEW

A comprehensive review of prior major tax compliance studies is provided by Jackson and Milliron (1986) and Richardson and Sawyer (2001). They noted that tax complexity was one of the factors affecting taxpayers’ compliance behaviour. A number of studies on tax complexity, particularly regarding income tax returns, had been studied by various researchers (for example Long and Swingen 1987; Milliron 1985).

Tax regimes in a developing country are less complex compared to those of developed countries such as Australia, UK and the US (Ariff and Pope 2002, p. 6). The effect of tax complexity was studied by Hanefah (1996) and provides evidence on the presence of some degree of tax complexity in Malaysia. Tax complexity could be reduced by way of tax simplification, i.e. making the tax system to be as simple as possible. The Australian experience has demonstrated that small business wants simplicity in taxation matters (Small Business Deregulation Task Force 1996, p. 2).

Tax simplicity is a relative (McKerchar 2002, p. 25) and ‘a mirror image’ of tax complexity (Tran-Nam 1999). Tran-Nam 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. Tax simplification could improve the voluntary compliance behaviour and also increase tax revenue (Pope 1993a, p. 284). However, tax law simplification itself does not necessarily achieve the ultimate goal of simplification (James, Sawyer and Wallschutzky 1998, p. 31) and prevent tax evasion (Forest and Sheffrin 2002, p. 76). The success of simplification measures requires more than linguistic improvement to existing legislation (James, Sawyer and Wallschutzky 1998, p. 35).

Tax compliance costs is among measures of tax complexity (James, Sawyer and Wallschutzky 1998, p. 32; Pope 1993b, p. 70; Slemrod 1992, p 53). High costs of compliance are the product of a complex tax system and vice-versa (Pope 1993b, p.
70). In Australia, pioneering work on compliance costs of major federal taxes was conducted by Pope et al. (Pope, Fayle and Chen 1991; Pope, Fayle and Chen 1993a; Pope, Fayle and Chen 1993b; Pope, Fayle and Chen 1994; Pope, Fayle and Duncanson 1990). Pope’s studies indicate that tax compliance costs in Australia are significant, regressive and politically sensitive in nature. During the early stage of major tax changes, compliance costs are expected to increase substantially due to start-up and learning costs (Pope 1993b, p. 81). Studies suggest that start-up compliance costs represent a significant amount of recurrent compliance costs (Rametse and Pope 2005). Consequently, only the simple tax provisions will minimise the regular compliance costs (Pope 1993b, p. 81). Pope argued that tax features such as a single rate, a high threshold, and minimum exemptions shall be considered in the design of tax legislation. He recognised the conflicting policy objective of minimising tax compliance costs. Nonetheless, he agreed with the view of Sandford, Godwin and Hardwick (1989, p. 212) that reasonable consideration should be given to policy decisions on tax compliance costs. Another major study in Australia by Evans et al. (1997, p. viii), provides further evidence on the regressive nature of tax compliance costs, particularly for small business taxpayers.

Thus, a reduction in the level of tax complexity through tax simplicity measures should lower tax compliance costs and consequently should improve tax compliance and tax revenue accordingly. It is important to acknowledge that an attempt to improve the tax compliance successfully should take into account the level of tax complexity and tax compliance costs simultaneously. It is likely to be fruitful if a reasonable consideration were given to these at the policy level.

In Malaysia, it was publicly acknowledged that the introduction of the SAS was mainly to increase the collection rate, reduce the cost of collecting taxes and increase voluntary compliance (Kasipillai 2005, pp. 26 - 27). In this regime, tax advisers are expected to play a significant role in providing services to taxpayers in complying with the tax laws. Consequently the 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.

Kasipillai (2005, p 26) suggests three reasons why tax law in Malaysia should be simplified, namely to lower both compliance costs and administrative costs, to reduce uncertainty faced by taxpayers; and to improve the levels of voluntary compliance.

In the Australian context, Boucher (1991) suggested the following nine main areas for tax simplification:

1. Rewriting the legislation in plain English
2. Reduced the length of the legislation
3. Eliminate discretions to increase the certainty
4. Removal of uncertainties
5. Reducing costs and record keeping requirements
6. Eliminate the special concessions
7. Review the use of tax system to achieve non-revenue objective
8. Streamlining administrative process
9. Certain taxpayers to be taken out of the system
Later in 1993, Pope (1993, p82) proposed four measures to reduce the compliance costs in Australia, namely to require PAYE employees to submit tax returns once in every five years, requiring banks and financial institutions to withhold tax on interest payment, increasing the tax-free threshold and modifying the tax rates.

Given the foregoing theoretical overview, it is important to fully understand the problem and issues faced by the SMEs before considering any tax simplification. The next section discusses some of the major problems facing SMEs.

4 MAJOR TAX DIFFICULTIES AND ISSUES FOR SMEs

4.1 Introduction

Small businesses often have difficulties in managing government laws and regulations (Fernandez and Oats 1998, p.162; Kasipillai and Liew 2004) and particularly in maintaining proper records for management and taxation purposes (Hanefah and Al-Mureshi 1991; Small Business Deregulation Task Force 1996, p.2). Apart from this major problem, this section highlights the issues concerning tax compliance costs, tax complexity, legal entities and finally the proposed GST.

4.2 Record Keeping and Documentation

Hanefah and Al-Mureshi (1991) noted that the predominant services provided by the 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, medium-scale enterprises may not have as much problem in this area (Hanefah and Al-Mureshi 1991).

Section 82 of the *ITA 1967* stipulated that every person carrying on business (regardless of legal entities) is required to keep sufficient records for seven years. The Act also requires businesses with annual turnover exceeding RM150,000 to issue a serially printed receipt and retain a duplicate copy of each receipt. In 2003, Section 82A extended the duty to keep documents to all taxpayers, specifically in ascertaining chargeable income and income tax payable. Demanding additional record keeping and documentation add to the existing problems of the SMEs, particularly small business. More interestingly, with a government plan to introduce the GST, maintaining additional records and documentation were absolutely essential. For the GST, even the existing accounting and computer systems may need to be upgraded to accommodate the implementation of the GST.

Prior to the implementation of SAS to individual taxpayers (i.e. before the year of assessment 2005), a number of studies had been conducted, which included self-employed taxpayers (Kasipillai et al. 1999; Palil 2005; Ramasamy et al. 2003), and small businesses as well Hanefah and Al-Mureshi (1991). Overall these studies show

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8 Section 82(9) defines records to include books of account recording receipts and payments or income and expenditure, invoices, vouchers, receipts and other relevant documents to verify the accounting entries.

9 Section 82A(6) defines documents as statement of income and expenditure, and invoices, vouchers, receipts and other relevant documents to verify the tax return.
that the issues relating to book-keeping and documentation for tax purpose are still relevant. Even a salary earner with a simple tax situation may have difficulties (Loo and 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.

### 4.3 Tax Compliance Costs

Following the two earlier compliance cost studies (Hanefah, Ariff and Kasipillai 2001; Loh et al. 1995), Ariff and Pope (2002, p. 9) noted that the average compliance costs for both large and small firms in Malaysia are the lowest when compared to Australia, Hong Kong and Singapore. A summary of both Malaysian studies is presented in Table 5.

<table>
<thead>
<tr>
<th>Costs</th>
<th>Public listed company*</th>
<th>SME company**</th>
</tr>
</thead>
<tbody>
<tr>
<td>Computational</td>
<td>RM41,906 (61%)</td>
<td>RM12,960 (59%)</td>
</tr>
<tr>
<td>Planning</td>
<td>RM26,930 (39%)</td>
<td>RM 9,005 (41%)</td>
</tr>
<tr>
<td>Total Compliance</td>
<td>RM68,836 (100%)</td>
<td>RM21,964 (100%)</td>
</tr>
</tbody>
</table>

Source: * Loh et al. (1995) and ** Hanefah, Ariff and Kasipillai (2001)

In terms of resources, 72 per cent of public listed companies rely on the use of paid external advisers (Loh et al. 1995). In contrast, 75 per cent of SMEs seems to rely on their internal resources to comply with the tax laws. Caution is necessary given that both compliance costs studies were carried out prior to the introduction of the self-assessment system. The compliance costs under the SAS regime could be higher. However, no study has been conducted in Malaysia since the implementation of SAS in Malaysia.

### 4.4 Tax Complexity

Evidence suggests that the Malaysian 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 (Hanefah, Ariff and Kasipillai 2001, p. 96). But the level of tax complexity in Malaysia could be considered very low compared to developed countries, such as UK, US and Australia (Ariff and Pope 2002, p. 9). Ariff and Pope noted that tax simplification measures implemented towards the end of 1990s and early 2000 had been received well by the Malaysian taxpayers.

A number of taxes imposed on business may also increase the tax complexity and compliance costs (Sandford, Godwin and Hardwick 1989, pp. 215 - 216). They suggest a minimum number of broader base taxes with minimal exemptions and reliefs to be considered in lowering the compliance costs.

In Malaysia, since the implementation of the SAS, Kasipillai (2005, p. 26) noted that there is a growing list of deductions available for resident individuals qualifying for various reliefs. Some of the deductions (such as deduction for reading materials and a relief for education, serious disease and parent medical expenses) are designed to
achieve social objectives. He cautioned the tax authority not to overly use the tax system as a means to achieve too many social and economic goals. Additionally he highlighted the difficulties faced by taxpayers in interpreting and taking advantage of the amendments. The expectation that the IRB would devise a simple tax return for individual taxpayers in 2005 (Kasipillai 2005, p. 26) unfortunately did not materialise.

4.5 Legal Entities

For tax purposes, each legal entity may be subject to some different tax treatment (see Table 4). Recently, the government introduced a dual corporate tax rates for SME companies. Under this structure, SME companies with ordinary paid-up capital of up to RM2.5 million are subject to a tax rate of 20 per cent for the first RM100,000 of taxable income. The remaining chargeable income is subject to a normal corporate tax rate. A year later, in 2004, the threshold of RM100,000 was increased to RM500,000.

It seems that there are two advantages to the company business structure compared to that of the non-company taxpayer i.e. 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 one hand, the marginal tax rate of individuals carrying on business with taxable income\(^{10}\) 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\(^ {11}\). 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 tax incentives increase the complexity of the tax laws.

Complicating factors in considering and designing tax provisions for small businesses have been discussed by Freedman (2003, pp 19-20). She argued that a simple tax system is more important to small businesses instead of too many special provisions, which potentially lead to tax complexity (p.15). The UK experience 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 SME establishments as well, subject to appropriate provisos.

5 SELF ASSESSMENT AND INCOME TAX SIMPLIFICATION

The main objectives of the IRB in promoting the SAS are to accelerate the rate of tax collection, reduce the cost of collecting taxes and increase the voluntary compliance (Kasipillai 2005, pp. 26-27). Arguably, the simplification of the business basis period

\(^{10}\) It is important to note the taxable income is derived after deductions of personal and other reliefs.

\(^{11}\) The incentives are provided under the 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 the number of factors (e.g. types of incentives, business sector and whether small-scale company or not). Most of the incentives are not available for unincorporated businesses, except in the agricultural sectors.
(in 2002), 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 *ITA 1967* have been amended and a new section 21A has been introduced. Additionally, three related public rulings were issued in 2000 and consequently superseded by the later version in 2001.

As 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. (1) heavy machinery and motor vehicles; (2) plant and machinery; and (3) furniture and office equipment. Accordingly a large variety in the capital allowance rates were also 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. But the total of such allowance is restricted to a maximum of RM10,000 per year.

As for other major simplification, anticipated personal income tax simplification, particularly for a salary earner, such as in UK, first mooted in 2005, is still awaited. It is hoped that the establishment of the TRP will promote tax simplification measures in future years.

6 THE INSTITUTIONAL AND POLICY CONTEXT OF TAX SIMPLIFICATION IN MALAYSIA

An increasing recognition on the importance of SMEs was evident in Malaysia since a decade ago. It has been further acknowledged with the establishment of the National SME Development Council (NSDC) and, most importantly, the Council is chaired by the Prime Minister. The NSDC will focus its efforts on three broad strategic areas towards promoting an enabling environment to foster and support the development of SMEs (National SME Development Council 2006, p.53). The first is to strengthen the infrastructure for SME development. The second is to build the capacity and capability of SMEs. The third is to enhance access to SMEs financing. It is clear that the NSDC was established in due recognition of the SME sectors. But the recognition of compliance burden issues, particularly the tax burden surrounding SMEs, and even large businesses is still yet to be realized. Surprisingly, the functioning of the NSDC seems to ignore issues surrounding regulations and/or compliance burden of the SME sectors.

12 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.

13 In UK, most employees under the PAYE system are required to submit tax returns only once in every five years.

14 The Ministry of Finance conducts an annual pre-budget dialogue among the business community a few months before the yearly budget is tabled in the parliament. However, the dialogue seems to be short term in nature.
Further, the establishment of the TRP seems mainly directed towards the proposed GST. The absence of NSDC participation in the TRP is noteworthy. Even the IRB recognition was substantially low. The IRB mission is to collect taxes with fairness, efficiency and integrity, at a justifiable cost and at the same time providing excellent service to its clients (Inland Revenue Board n.d.). The establishment of the Small Traders’ Support Service Unit at IRB branches to assist taxpayers provides a kind of recognition of the extent of small business compliance burden. The unit provides assistance and advice on taxation issues to small traders who are not represented by tax agents. Its main objective is to provide personal service to small traders in order to systematically guide them in a more conducive environment.

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 their objectives. The IRB publish its tax management costs (see Table 6 for details) in administering and collecting direct taxes in Malaysia, but no such estimates of tax compliance costs are available for taxpayers. Taking into account the IRB mission, arguably they should also estimate and publish the tax compliance costs of the private sector.

<table>
<thead>
<tr>
<th>Year</th>
<th>Tax management costs (RM million)</th>
<th>Tax management costs as a percentage of tax collected</th>
</tr>
</thead>
<tbody>
<tr>
<td>2000</td>
<td>328</td>
<td>1.13</td>
</tr>
<tr>
<td>2001</td>
<td>359</td>
<td>0.86</td>
</tr>
<tr>
<td>2002</td>
<td>544</td>
<td>1.23</td>
</tr>
<tr>
<td>2003</td>
<td>532</td>
<td>1.18</td>
</tr>
<tr>
<td>2004</td>
<td>565</td>
<td>1.16</td>
</tr>
</tbody>
</table>

Table 6: Tax Management Costs of the IRB, 2000 - 2004


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 business sector, particularly the SMEs.

Focusing on tax compliance costs, prior studies in Malaysia are conducted by Hanefah, Ariff and Kasipillai (2001) and Loh et al. (1995). Nothing is known to what extent relevant parties, such as the IRB, RCM, TRP, NSDC, professional accountants, as well as SME related organizations had 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. 30 -34). The issue of taxation only arises as a small part in the report. The SMEs urged the government to provide more tax incentives to them so that they will be able to stay competitive in the market. There needs to be a much greater specific focus on taxation issues and ensuing SME compliance cost burden.

Theoretically, Sandford, Godwin and Hardwick (1989, p.209) stressed the importance of compliance costs as policy issues in four stages. They highlighted four criteria that governments should consider, namely, 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 6 stages in the
development of the compliance costs of taxation as a policy area: i.e. (1) non-
recognition or lack of interest in the subject area; (2) qualitative recognition by the
professionals; (3) estimation and evaluation; (4) policy recognition; (5) effective
policy measures; and (6) continual monitoring of compliance costs. Probably
Malaysia is still in stage one with some development in stages two and three taken
place during the mid 1990s to early 2000.

Having said that, academics and professionals may need to consider more study,
particularly in estimating tax compliance costs (stage 3). Consequently, they can
lobby the government to consider it more seriously in the policy decision (stage 4).
Moreover, the government, (particularly the IRB, RCM and the TRP) may move
forward to establish a specific committee, such as 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 1993a, p. 33). For example in
Australia, the Australian Taxation Office commissioned a research on the
methodology to be used in estimating the taxation compliance costs. Following
Australian experience, the next step is to introduce a Tax Impact Statement for future
tax law changes similar to that adopted in the Organisation for Economic Co-
operation and Development (OECD) countries (Evans and Walpole 1999). The
Taxation Impact Statements (also known as Regulatory Impact Statement and
Compliance Costs Assessment) have been used in a number of OECD countries,
including Australia, the European Union, New Zealand, UK and the US (Evans and
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).

Modernisation of tax administration (with a view to simplify the tax rules, reduced
compliance costs and taxpayer-friendly), with a particular focus on the small business
sector and to individuals, is among ten main lessons identified by Ariff and Pope
(2002, pp. 279 - 289) as a policy guide for developing countries. Streamlining the tax
administrative process, mainly by the IRB (in administering direct taxes) has taken
place for the past ten years and the trend is expected to continue throughout. On the
contrary, the RCM was somewhat behind in this area, and probably will move
towards it in the process of implementing the GST.

A number of tax authorities worldwide have already made the move to simplify their
respective tax regimes. Sandford (1993, p201- 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 (p228). In the past, Malaysia seems to have adopted an
incremental approach to tax simplification 15.

The postponement of the GST provides an opportunity for reform in other areas. A
particular emphasis shall be put in place upon tax simplification and compliance costs

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15 Perhaps without a pre-determined goal, that has to be operationalised in a number of years. See
Sandford 1993, pp. 201-202.
minimisation (of both direct and indirect taxes) in a more comprehensive and systematic manner (following a package approach). A number of tax simplification proposals have already been made (see for example Boucher 1991; Crist 2004; Freedman 2003; James, Sawyer and Wallschutzky 1998; Kasipillai and Baldry 2004; Kasipillai and Liew 2004; 2005; Pope 1993b; 2001). Additional emphasis should be directed ‘legal simplicity’ in the first stage and ‘effective simplicity’ in the later stage (Tran-Nam 1999) as well.

Another administrative area worth considering as suggested by Kasipillai and Baldry (2004) is that both direct taxes and indirect taxes (particularly GST) be administered by the same agency. The TRP could lead the initial move towards a single tax authority in Malaysia. Probably, a working committee or a specific national committee under the TRP should conduct a detailed study and make some recommendations to the government. Relevant parties such as the IRB, RMC, and representatives from business sectors and professional (such as accountants and lawyers) as well as other national bodies, such as the NSDC, should take part in the process.

7 MAJOR SIMPLIFICATION PROPOSALS

7.1 Uniform Definition for SMEs and Extension of Incentives

Prior to the establishment of the NSDC, there are numerous definitions of SMEs existed in Malaysia, including for tax purpose\textsuperscript{16}. The definition varies even within an income tax purpose, as shown in Table 7. For example, three different proxies, namely paid-up capital, shareholder’s fund and authorized capital, are used to measure the size of the company.

<table>
<thead>
<tr>
<th>Types of incentives/ deductions\textsuperscript{17}</th>
<th>Definition of SMEs</th>
</tr>
</thead>
<tbody>
<tr>
<td>A dual corporate tax rates.</td>
<td>Company (resident in Malaysia) with an ordinary paid-up capital up to RM2.5 million at the beginning of the basis year.&quot;</td>
</tr>
<tr>
<td>Deductions for pre-incorporation expenses.</td>
<td>Company (incorporated in Malaysia) and having authorized capital of not more than RM2.5 million.\textsuperscript{b}</td>
</tr>
<tr>
<td>Pioneer status or investment tax allowance.</td>
<td>A small-scale company (incorporated in Malaysia) with a shareholder’s funds not exceeding RM500,000.\textsuperscript{c}</td>
</tr>
</tbody>
</table>

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

\textsuperscript{16} The definitions are stipulated in the ITA 1967 or PIA 1986 accordingly and still in force.  
\textsuperscript{17} 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.
In 2005, the NSDC adopted 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 8 summarizes the general SME definitions by sector.

<table>
<thead>
<tr>
<th>Sectors</th>
<th>Employees (not exceeding)</th>
<th>Annual turnover (not exceeding)</th>
</tr>
</thead>
<tbody>
<tr>
<td>Manufacturing</td>
<td>150</td>
<td>RM25 million</td>
</tr>
<tr>
<td>Manufacturing-related services</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Primary Agriculture</td>
<td>50</td>
<td>RM 5 million</td>
</tr>
<tr>
<td>Services</td>
<td></td>
<td></td>
</tr>
</tbody>
</table>

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

As a measure of simplification, a similar definition of SMEs (by the NSDC) should be adopted for tax purposes as well. Moreover, a lower tax rate and various incentives eligible to certain SME companies should be extended to include all SMEs. Consequently, the simplification of the relevant requirements and criteria should take place simultaneously.

### 7.2 Specific Areas for Income Tax Simplification

Some of the considerations and areas for Income Tax simplification, particularly for SMEs are presented in the following section:

- 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. Perhaps, 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 forwarded by Pope (1993b) in the Australian context. In the Malaysian context, it is worth considering both the reduction in the number of reliefs and the increases in the tax-free threshold in a package.

- Reduce the issuance of too many 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. Additionally, the right to request a Private Ruling similar to Australia legislation can be considered (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 (Singh 2002, p.277). The positive side of tax compliance, such as managerial benefits arising from tax compliance, needs to be emphasised.

7.3 Simplification of Other Tax Laws

Apart from income tax laws, the government also needs to simplify other direct taxes law, such as the PIA 1986 and the Stamp Duty Act (SDA) 1949. The major changes in the PIA occurred in 1991, but perhaps led to a greater complexity. For example, the full tax exemption for the pioneer company had been amended and accordingly, various categories, exemption rates and restrictions were introduced. Since most of the investment incentives are mutually exclusive, probably the major focus of the simplification should be directed towards reducing the number of incentives. The complex nature of record and book keeping requirements, and criteria, as well as other technical restrictions that leads to complexity in ascertaining the amount of deduction and tax payable need to be reduced substantially. Additionally, the incentives that are available for SME companies may be extended to include other SME establishments as well. As for the SDA 1949, since no major changes have taken place to date, simplifying tax law language (Boucher 1991) should be given priority (Crist 2004).

8 CONCLUSIONS

This paper has shown that much needs to be done in order to simplify the taxation of Malaysian SMEs and minimise their compliance costs. Overall, the paper has emphasised four major areas for policy consideration.

The first is the necessity to recognise fully the compliance burden of the SMEs at the national level, and, secondly, to adopt a uniform definition for SMEs in Malaysia.

Thirdly, establishment of relevant committees, such as the Beddall Committee and the Small Business Deregulation Task Force in Australia, involving all relevant parties, including the NSDC, TRP, relevant SMEs organisations, tax professionals and academics, is recommended.

Fourthly, to undertake simplification of the tax system for SMEs in a more comprehensive manner, or what may be termed a ‘package approach’, 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.

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18 Effective 2004, the pioneer exemption rate is 70 or 100 per cent, which depends on the sector and location of the company. The amount of exemption is transferred to an exempt account and further restriction is applicable to this account.

19 A company (carrying more than one business) enjoying incentives are required to keep separate records for each business. For example, separate records are required for pioneer and non-pioneer business.
REFERENCES


