

# The Influence of Tax Penalties Towards Tax Compliance Among SMEs in Selangor

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## **Abstract**

**Purpose:** This study is developed to examine the influence of tax penalties towards tax compliance among Small and Medium Enterprises (SMEs) in Selangor.

**Design/methodology/approach:** The factors which serve as independent variables are rate of penalty, punishment of tax penalty, knowledge of tax penalty, education on tax penalty and psychological behavior of taxpayers toward tax penalty. Whereas the dependent variable tested is tax compliance among SMEs in Selangor. The questionnaire were distributed to 150 respondents, with 130 responded to the questionnaire which is 86.7% response rate.

**Findings:** Kolmogrov-Smirnov test is be used in this study since the sample of this study is more than 100. In this study, Spearman correlation coefficient is tested for both independent and dependent variables in order to indicate the relationship between the independent variable and dependent variable. Overall the finding show that rate of penalty, knowledge of tax penalty, education on tax penalty and psychological behavior of taxpayers toward tax penalty is significantly influencing the tax compliance. On the other hand, the variable of punishment of tax penalty indicate that there is insignificant influence towards tax compliance.

**Research limitations/implications:** The limitation of this study is having limited resources and research related to the tax penalties among SMEs. Previously, most of the researchers focuses on individual taxpayer on other tax issues rather than tax penalties among SMEs. It will make difficulty to find the previous data regarding tax penalties towards tax compliance among SMEs.

**Practical implications:** The finding arising from this study has provide a valuable information on the tax penalties' variables that manage to influence the compliance behavior which are very beneficial for policy makers in the area of taxation. The information gathered has provides guidelines and suggestion to the tax authority in a way to improve the effectiveness of tax penalties system in Malaysia

**Originality/value:** To determine the relationship between tax penalties on the level of tax compliance among Small and Medium Enterprises in Malaysia.

**Keywords:** Tax Penalties, Malaysia Taxation, SMEs in Selangor, Tax evasion

## **Introduction**

Tax compliance has become an important subtopic for personal and corporate taxation subject in both developed and developing countries and it emphasizes a taxpayer's responsibility to report income and determine tax liability. Tax compliance is a fundamental to be good and sustainable business whether a business is a sole proprietorship, a self-employed business or a partnership, businesses in all kind of industries are subject to taxation. This is important because income tax is the largest component of the country's revenue contributing around 50% to 55% annually, to finance the nation's development policy and the continuity's of the people well-being (The Sun Paper, January 2018).

From year to year there has been increasing in the total amount of tax penalties and additional assessment that has collected by Inland Revenue Board Malaysia (IRBM), for example from the beginning of the year 2015 until July 2017 the total amount of penalties and additional assessment that has collected by IRBM is up to RM 22.329 billion (The Sun Paper 2017). The additional and penalties imposed by IRBM on individual and corporate taxpayers who failed to comply with the requirement under Income Tax Act 1967.

Previously, in 2017 the revised Federal Government Revenue is estimated to increase 6.1% to RM225.3 billion (2016: -3%; RM212.4 billion). Out of RM225.3 billion of Federal Revenue RM 180,194 billion is contributed by tax revenue. The increase is attributed to the higher tax revenue collection mainly from companies, individual, and petroleum income taxes, Ministry of Finance Malaysia (2018). In the current's globalization era, Small and Medium Enterprise (SMEs) become expanding across the Malaysia. Most of the large companies in the Malaysia were started from the Small and Medium Enterprise (SMEs) which is they build the SMEs as their roots to expand their business for future as large companies. All the SMEs that exist in Malaysia should be complied with the tax compliance, yet there are a few factors that can influence SMEs deference towards tax compliance. It is a well-known fact that the revenue generated from the taxation from individuals or business is an important income for the government. Therefore, SMEs in Malaysia have played an important role in the economic growth of the nation.

This study will also examine whether the tax penalties will be influenced the tax compliance because there are a few factors such as tax rate of penalties, punishment of penalties, knowledge of the penalties, education related to penalties and physiological behavior. From this data, it showed that the factors of service quality and tax penalty by the tax authority towards tax compliance among taxpayers are very important. This is to increase the level of awareness of the taxpayers about tax compliance to voluntary comply the tax payment on a timely basis. The general research objective that has been proposed to carry out this study is to determine the relationship between tax penalties on the level of tax compliance among Small and Medium Enterprises in Malaysia.

## **Literature Review**

### ***TAX COMPLIANCE***

Tax compliance has become a major concern for most of the country including developed and developing country (Tapan K. Sarker 2003). There is a lot of tax compliance definition that have come out from researchers. Singh (2003) defined the tax compliance as a person's act of filling their tax returns, declaring their incomes which are taxable and non-taxable within some period without having to wait or follows up from the authority. A wider definition of tax compliance is defined as the degree to which taxpayers comply with the tax law (James and Alley 2004). Furthermore, tax compliance means to comply with the tax reporting requirement which is taxpayer need to files all required tax returns and accurately report tax liability

according to the tax laws and regulation setting up by government at the proper time (Hijattullah and Pope 2008).

According to the study by McBarnet (2001) tax compliance can be distinguished into various different forms. She explained the differences between taxpayers who voluntary comply with the law and taxpayers who comply with the law because of enforcement activities. From her study, she categorizes taxpayers' differences into three major group which are the taxpayers who really committed compliance, capitulated compliance and creative compliance. For those who are committed compliance is for those who are willing to pay taxes without complaint whereas capitulated compliance is those who reluctantly pay taxes and creative compliance for those who seeks to reduce taxes by taking advantage of opportunities to redefine income and deduct expenditures according to the law and regulation (McBarnet 2001).

Taxpayers need to obtain and forwarding the Income Tax Return Form (ITRF) to the IRBM. Taxpayer will follow up with submit the estimation and pay the amount installment. The process continued with computing the company income tax and then declare their income and expenses based on the regulation. (<http://www.hasil.org.my>). All the records and document should be kept by taxpayer for seven years.

In contrast with tax compliance, the tax non-compliance may include in several forms. According to the study by (Hijattullah and Kasipillai 2006) tax non-compliance may include failure to submit a tax return within the stipulated period or non-submission, understatement of income, overstatement of deduction and also failure to pay assessed taxes by the due date. Tax non-compliance is difficult to measure because it involves individuals and firms concealing the true level of their assessable income whether intentionally or unintentionally (Oh and Lim, 2011). Tax non-compliance can be divided into two categories which are tax avoidance and tax evasion which is the taxpayers are failure to meet the obligation according to the tax rules (Jaffar et al 2014).

## **Theoretical Framework and Hypothesis Development**

### ***Theoretical Framework***

This illustration shows the relationship between independent variable and dependent variable. The independent variable for this study would have five factors which may influence the tax penalties that need to measure and also these factors are expected to directly correlate with the dependent variable which is the tax compliance.

### ***Hypothesis Development***

This section is focusing on the relationship of factors influences that relate to tax compliance among Small and Medium Enterprises (SMEs) in Malaysia.

### ***RATE***

Devos K., (2014) define tax penalty as a deterrent measure used by government tax authority towards taxpayers. Allingham and Sandmo (1972) has found a positive relationship between tax penalty rate and tax compliance behavior which is an increase in tax penalty rate will increase the tax compliance behavior. According to the past research on the influence of tax penalties on taxpayers' compliance by Sheikh Obid (2014), the finding shows that the penalty rate and detection rate have a significant effect on the tax evasion which is increased the taxpayers' compliance. Apart from that, Mohd Yusof, N. A @ Ghani, Lai Ming Ling, and Yap Bee Wah (2014) found an insignificant relationship between lower tax penalty rate and corporate tax non-compliance. In this study, the researcher indicates that by lowering tax penalty rate can increase corporate tax non-compliance.

**H1: There is a significant relationship between penalty rate and tax compliance.**

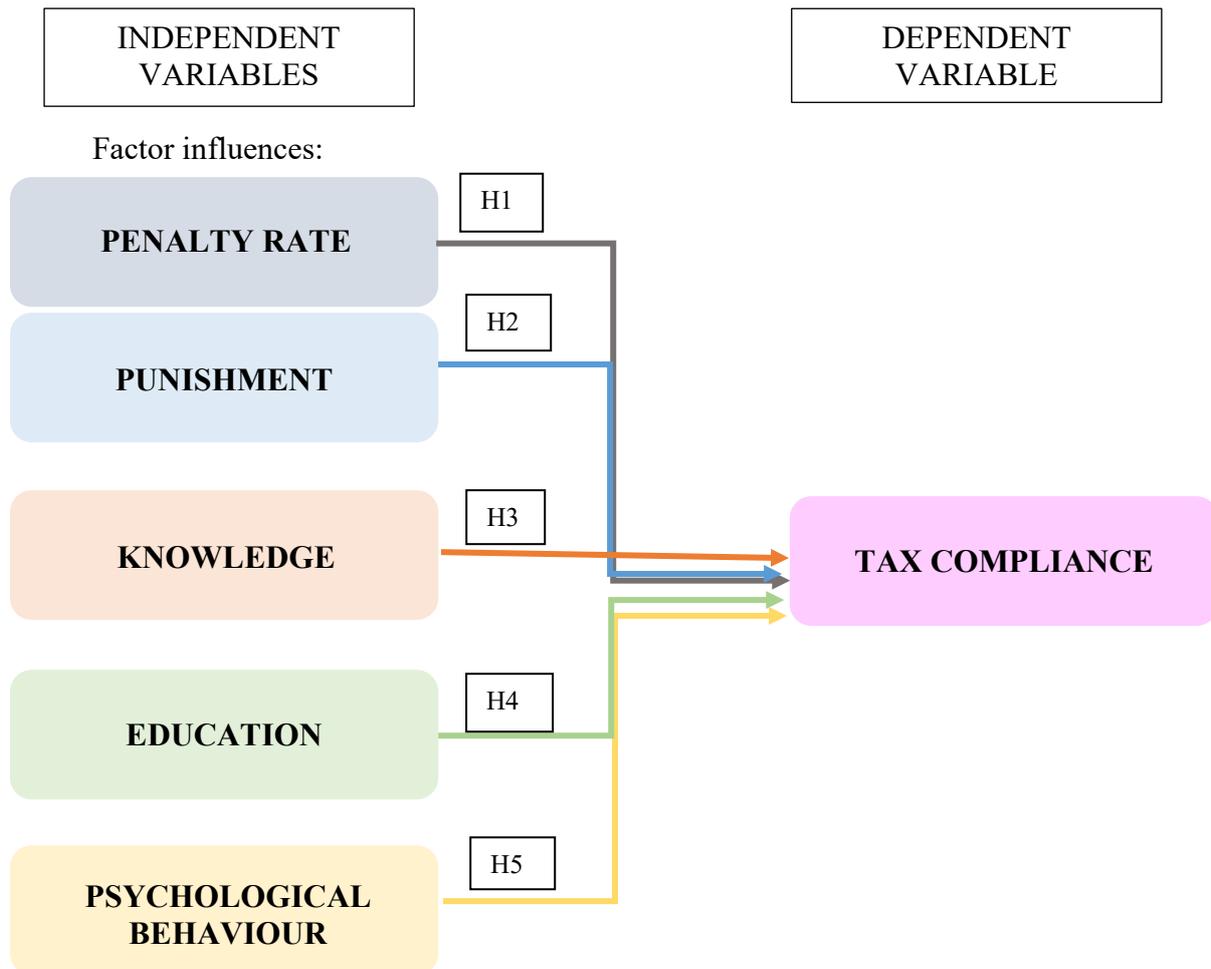


Figure 1: Theoretical Framework

### ***PUNISHMENT***

Every taxpayer who commit with an illegal act such as not comply with the tax rules and regulation and do tax evasion will be imposed punishment under Income Tax Act 1967 by the tax authority. Referring to the study on the impact of the threat of punishment by Mohd Ali, Isa and Yusoff (2014), the result found that there is a negative relationship between threat of punishment and the tax compliance behavior of taxpayers. In other words, the higher the punishment, the more people will not comply. The used of threat punishment encourage taxpayer to be less comply towards tax compliance. On the other hand, taxpayer behavior on the tax law such as whether comply or do not comply does shape by the severity of punishment (Murphy, 2008). Therefore, based on E. Kirchler, E. Hoelzl and I. Wahl (2008) finding, there is a significant relationship between threat of punishment and tax compliance. The previous discussions lead to following hypothesis.

**H2: There is a significant relationship between punishment and tax compliance.**

### ***KNOWLEDGE***

According to Nurlis and Islamiah Kamil (2015) in her study of tax knowledge towards tax compliance state that when the taxpayers have a good understanding in tax rules, the taxpayers will have a better understanding relating the importance of paying taxes which is this

understanding will lead the taxpayers are open minded. At the same time, the level of fraud that may occur can be minimized and the level of compliance will be increased.

The result from Yunus, N., Ramli, R. and Abu Hassan, N. S. (2017) stated that the knowledge of tax penalties play a significant role towards the tax compliance behaviour whereby it found that there are positively affected between the knowledge of tax penalties with tax compliance behaviour. This result is in line with Fany Inasius (2018) which is the higher of tax knowledge will lead to increase the level of tax compliance behaviour. Based on the study, it shows that the tax knowledge is a significant factor towards the tax compliance because of the better understanding of tax knowledge is mostly will increase the level of tax compliance. Therefore:  
**H3: There is a significant relationship between tax knowledge and tax compliance.**

### ***EDUCATION***

The tax penalty system through the education that provided by tax authorities will lead the taxpayers to be more familiar and understanding in using that system. (Nurlis and Islamiah Kamil (2015). From the survey of Natrah Saad (2012) found that the lower educated of taxpayers' will lead to the lower of disclosure on tax compliance information and there is also lower knowledge in information relating to the tax regulations. According to the result of Yunus. N., Ramli. R. and Abu Hassan. N. S (2017) found that there is a significant effect of tax educations on the tax compliance. Based on the study, it shows that tax education is a significant factor towards the tax compliance because of the more educated taxpayers' will lead to more relevant information disclosure relating to the tax compliance. Therefore, the research proposed the following hypothesis:

**H4: There is a significant relationship between the tax educations and tax compliance.**

### ***PSYCHOLOGICAL BEHAVIOR***

According to Misu (2011) summarize that in order to encourage the compliance behaviour, the tax authorities need to choose the proper enforcement strategy. This is because the increasing numbers of tax non-compliance will occur when there is bribery in the taxation which is this corruption happened when the tax penalties are considered too extreme or high. Other than that, the taxpayers are trying hard to avoid from paying taxes when they are considered that the fines are too high then it would lead to the taxpayers' perception of retributive justice. The resulted from the study of Yunus. N., Ramli. R. and Abu Hassan. N. S (2017) is found that in order to encourage the taxpayers to comply with tax compliance, the tax authorities need to provide the guidelines on better enforcement strategy such as giving rewards to the taxpayers who is comply with the tax laws by tax authorities which is this rewards will be an incentive for the other taxpayers to comply with the tax compliance. Therefore:

**H5: There is a significant relationship between psychological behaviour and tax compliance.**

### ***Method***

This study will apply the quantitative research method. Quantitative research method is a research that obtain the data in numerical form which it can be put into categorization or rank order. This type of research can be transformed into the statistic. The sample size is usually small, and the respondents are selected to fulfil a given quota. the target population for this study is the chief executive, account manager and clerk of the Small and Medium Enterprises (SMEs) that are located in the Central Region, namely the state of Selangor. There are a few reasons in choosing the population, first reason is why Selangor is been chosen because it is based on the establishment of SMEs, manufacturing, services and other sectors of SMEs in

Selangor is the highest total establishment of SMEs ([www.smecorp.gov.my/list-of-companies](http://www.smecorp.gov.my/list-of-companies)). Based on this study, questionnaire is used as a primary source of data to gather information from the respondents. A questionnaire method is chosen because this study involves a large number of SME population entire Selangor. The questionnaire for this study is adopted from Nuridayu, Rosiati and Norul Syuhada, A. H. (2017). It consists of three section with the objective of determining the factors influencing tax penalties towards tax compliance among SMEs in Selangor. Section A contains questions about the demographic details of the respondents such as position, legal structure of SMEs, type of SMEs business, turnover of the company and number of employees. Section B has divided into four parts represent each of the independent variables of the study that are rate of tax penalty, punishment, education, knowledge and psychological behavior of taxpayers. These part consists of 22 statements questions surveys that will be carried out. On the other hand, section C consist of the tax compliance behavior among SMEs. The respondents need to answer the question based on Likert scale with the following anchors, 1= Strongly Disagree, 2=Disagree, 3=Neutral, 4=Agree, 5=Strongly Agree.

### **Findings**

To conduct this study, a few tests will be use such as Descriptive Analysis, Normality Test, Reliability Analysis and Correlation Test. This test will help our study to obtain the statistical result and prove the hypotheses developed earlier. The data will be analyzed by using the Statistical Package for Social Science (SPSS) Software Version 24.0.

### ***Descriptive Results***

The results of the demographic factor which consists of age, designation, education, legal structure of SMEs, SMEs primary business, turnover, employees and experience. For the age factor, the highest percentage is the respondent in range of 21 years old to 30 years old which consists of 86 respondents (66.2%) that responded to the questionnaire. This followed with the respondent in below 20 years old which consists of 15 respondents (11.5%) and 14 respondents (10.8%) for the respondent in range of 31 years old to 40 years old. For the designation factor, the option of the answers are Chief Executive, Manager, Account Manager and Clerk. Based on the data collected, there are majority of 71 respondents (54.6%) is Clerk. For the education level factor, the highest respondent is Bachelor Degree/Professional Degree which consists of 50 respondents (38.5%) that responded to the questionnaire. This followed by the Certificate/Diploma which consists of 39 respondents (30%) and SPM/STPM which consists of 31 respondents (23.8%). For the type of legal structure of SMEs factor, there are 61 respondents (46.9%) from private limited companies, 47 respondents (36.2%) of Individual proprietorship and 22 respondents (16.9%) of partnership responded to the questionnaire. In term of primary business consists of 2 types which are Manufacturing and Services and others. For the company turnover of SME, there are 73 respondents (56.15%) from micro company, 38 respondents (29.23%) of medium company and 19 respondent (14.61%) from medium company. The following demographic analysis is company annual turnover. The highest respondent is SMEs that has less than RM300,000 annual income which consists of 73 respondents (56.2%) responded to the questionnaire. For the employees' factor, there are 3 option to answer which are the SMEs that have employees less than 5 person, in range of more than 5 persons but less than 75 persons and in range of more than 75 persons but less than 200 persons. Based on the data collected, SMEs that have employees in less than 5 persons has the highest respond rate which is 72 respondents (55.4%) responded to the questionnaire. For the experience factor, there are 108 respondents (83.1%) that have no experience in tax enforcement for their companies responded to the questionnaire. The balance of 22 respondents

(16.9%) were experienced in tax enforcement for their companies responded to the questionnaire.

### **Reliability Test**

Reliability test was performed on the data that have been collected to measure on how far that the data is accurate and reliable. The results indicated that the data collected is reliable, since that all data collected are more than 0.5. A rule of thumb suggests that the acceptable Cronbach's Alpha should exceed 0.5.

Table 1: Reliability Test

Independent /Dependent Variable	Cronbach's Alpha	N of items
Rate of Penalty	.882	5
Punishment of Tax Penalties	.881	5
Knowledge of Tax Penalties	.893	5
Education on Tax Penalties	.883	5
Psychological Behaviour of Taxpayers towards Tax	.743	5
Tax Compliance	.711	5

### **Normality Test**

In this study, Statistical Assessment of Kolmogorov-Smirnov (K-S) testing has being used because they have sample size of more than 100. All variable tested for normality test in this study is less than 0.005 which indicate the data that has been collected is not normally distributed.

Table 2: Normality Test

	Kolmogorov-Smirnov <sup>a</sup>		
	Statistic	df	Sig.
Rate of Penalty	<b>.159</b>	<b>130</b>	<b>.000</b>
Punishment of Tax Penalties	<b>.140</b>	<b>130</b>	<b>.000</b>
Knowledge on Tax Penalties	<b>.140</b>	<b>130</b>	<b>.000</b>
Education on Tax Penalties	<b>.105</b>	<b>130</b>	<b>.001</b>
Psychological Behaviour of Taxpayers toward Tax Penalties	<b>.110</b>	<b>130</b>	<b>.001</b>
Tax Compliance	<b>.159</b>	<b>130</b>	<b>.000</b>

**Correlation Analysis**

Table 3: Correlation analysis

		<b>ROP</b>	<b>POP</b>	<b>KOP</b>	<b>EOP</b>	<b>PBOP</b>	<b>TC</b>
<b>Rate of Penalty (ROP)</b>	Correlation Coefficient	1.000	.351**	.507**	.281**	.244**	.400**
	Sig. (2-tailed)		.000	.000	.001	.005	.000
	N	130	130	130	130	130	130
<b>Punishment of Tax Penalties (POP)</b>	Correlation Coefficient	.351**	1.000	.265**	.020	.278**	.123
	Sig. (2-tailed)	.000		.002	.820	.001	.165
	N	130	130	130	130	130	130
<b>Knowledge on Tax Penalties (KOP)</b>	Correlation Coefficient	.507**	.265**	1.000	.332**	.473**	.486**
	Sig. (2-tailed)	.000	.002		.000	.000	.000
	N	130	130	130	130	130	130
<b>Education on Tax Penalties (EOP)</b>	Correlation Coefficient	.281**	.020	.332**	1.000	.319**	.364**
	Sig. (2-tailed)	.001	.820	.000		.000	.000
	N	130	130	130	130	130	130
<b>Psychological Behaviour on Taxpayers towards Tax Penalties (PBOP)</b>	Correlation Coefficient	.244**	.278**	.473**	.319**	1.000	.366**
	Sig. (2-tailed)	.005	.001	.000	.000		.000
	N	130	130	130	130	130	130
<b>Tax Compliance (TC)</b>	Correlation Coefficient	.400**	.123	.486**	.364**	.366**	1.000
	Sig. (2-tailed)	.000	.165	.000	.000	.000	
	N	130	130	130	130	130	130

\*\* Correlation is significant at the 0.01 level (2-tailed).

Based on Table 3, there is significant relationship between the penalty rate and tax compliance at 0.400. Devos K., (2014) define tax penalty as a deterrent measure used by government tax authority towards taxpayers. Hence, this hypothesis (H<sub>1</sub>) is supported and consistent with previous study. there is insignificant relationship between the punishment on tax penalty and tax compliance at 0.123. Therefore, based on E. Kirchler, E. Hoelzl and I. Wahl (2008) finding, there is a significant relationship between threat of punishment and tax compliance. Hence, this hypothesis (H<sub>2</sub>) is rejected. There is significant relationship between the tax knowledge on tax penalties and tax compliance at 0.486. According to Nurlis and Islamiah Kamil (2015) in her study of tax knowledge towards tax compliance state that when the taxpayers have a good understanding in tax rules, the taxpayers will have a better understanding relating the importance of paying taxes which is this understanding will lead the taxpayers are open minded. This result is in line with Fany Inasius (2018) which is the higher of tax knowledge will lead to increase the level of tax compliance behaviour. Hence, this hypothesis (H<sub>3</sub>) is supported and consistent with previous study. there is significant relationship between the tax education and tax compliance at 0.364. Based on the previous study, Palil (2010) stated that when there are educated taxpayers, that taxpayers will be more aware with their responsibility to pay the taxes and that taxpayers also will concern on what kind of the penalty should be imposed if the taxpayers are failed comply with the tax law. Hence, this hypothesis (H<sub>4</sub>) is supported and consistent with the previous study. there is significant relationship between the psychological behaviour and tax compliance at 0.366. According to Misu (2011) summarize that in order to encourage the compliance behaviour, the tax authorities need to choose the proper enforcement strategy. Hence, this hypothesis (H<sub>5</sub>) is supported and consistent.

Table 4: Summary of findings

Number	Hypothesis	Findings
H <sub>1</sub>	There is a significant relationship between penalty rate and tax compliance.	Supported
H <sub>2</sub>	There is a significant relationship between punishment and tax compliance.	Not Supported
H <sub>3</sub>	There is a significant relationship between tax knowledge and tax compliance.	Supported
H <sub>4</sub>	There is a significant relationship between the tax educations and tax compliance.	Supported
H <sub>5</sub>	There is a significant relationship between psychological behaviour and tax compliance.	Supported

### Discussion and Conclusion

Currently, there is a few emphases placed on tax penalties and tax compliance issues in Malaysia. However, there are not much studies being conducted as the sources obtain information are highly limited. In addition, most of prior studies focus on individual taxpayers' perception, tax avoidance, and self-assessment system rather than tax penalties and tax compliance issues among small medium enterprise. This paper aim to find the relationship between tax penalties factors and tax compliance among small medium enterprise (SME) in Selangor. Throughout this paper, it will reveal what is the level of tax compliance between SME, is there any significant relationship between tax penalties and tax compliance and to identify is there any relationship between independent variable and dependent variable. The questionnaire contained question that covered five factors of tax penalties which are rates of tax penalties, punishment of tax penalties, knowledge of tax penalties, education on tax penalties and psychological behavior on tax penalties. It comprises a total of 130 enterprises in Selangor and a questionnaire survey testing all these variables was distributed. The response rate for the questionnaire distributed were around 86.7% (n=130).

The finding arising from this study has provide a valuable information on the tax penalties' variables that manage to influence the compliance behavior which are very beneficial for policy makers in the area of taxation. The information gathered has provides guidelines and suggestion to the tax authority in a way to improve the effectiveness of tax penalties system in Malaysia has been suggested by Abdul Mohani (2001) and Phan (2013) which recommends a better tax penalty system. The limitation of this study is having limited resources and research related to the tax penalties among SMEs. Previously, most of the researchers focuses on individual taxpayer on other tax issues rather than tax penalties among SMEs. It will make difficulty to find the previous data regarding tax penalties towards tax compliance among SMEs.

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