

Examining Corporate Tax Evaders: Evidence from the Finalized Audit Cases

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Abstract—This paper aims to (1) analyze the profiles of transgressors (detected evaders); (2) examine reason(s) that triggered a tax audit, causes of tax evasion, audit timeframe and tax penalty charged; and (3) to assess if tax auditors followed the guidelines as stated in the ‘Tax Audit Framework’ when conducting tax audits. In 2011, the Inland Revenue Board Malaysia (IRBM) had audited and finalized 557 company cases. With official permission, data of all the 557 cases were obtained from the IRBM. Of these, a total of 421 cases with complete information were analyzed. About 58.1% was small and medium corporations and from the construction industry (32.8%). The selection for tax audit was based on risk analysis (66.8%), information from third party (11.1%), and firm with low profitability or fluctuating profit pattern (7.8%). The three persistent causes of tax evasion by firms were over claimed expenses (46.8%), fraudulent reporting of income (38.5%) and overstating purchases (10.5%). These findings are consistent with past literature. Results showed that tax auditors took six to 18 months to close audit cases. More than half of tax evaders were fined 45% on additional tax raised during audit for the first offence. The study found tax auditors did follow the guidelines in the ‘Tax Audit Framework’ in audit selection, settlement and penalty imposition.

Keywords—Corporate tax fraud, tax non-compliance, tax evasion, tax audit, fraudulent reporting.

I. INTRODUCTION

WORLDWIDE since the inception of income tax system, tax non-compliance is a pervasive problem. Taxpayers engage both legal and illegal methods to reduce the amount of tax payable. Tax evasion is an extreme form of tax non-compliance. Spicer and Lundstedt [1] has defined tax evasion as the reduction of tax liability by illegal or fraudulent means. Tax evasion is a serious social malady [2] and a universal phenomenon [3], [4]. With the advancement of Internet communication technology (ICT) and in a globalized economy, Alm [4] raised the issue on tax evasion, and viewed as one of the most common and widespread economic crimes. Moreover, tax evasion is harmful to the society and the economy if uncurbed, not only does it erodes the government revenue collection, it may cripple a government and cause serious damage to the proper functioning of the government. Additionally, tax evasion also diminishes people confidence in the tax system.

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In some incidence, tax evasion is associated with money laundering and underground economies, which inevitably have a negative effect on the whole community [5]. In Nigeria, Otusanya [6] reported that Multinational companies engaged tax evasion at almost any cost. Stimulated by profitability, intense competition to increase earnings, capitalist enterprises constantly see new ways to boost earnings by developing complex tax structure to exploit the loopholes in the tax laws to evade tax.

Tax evasion defines a specific revenue deficiency, known as the tax gap [7]. Tax gap is the result of tax evasion; tax gap represents the difference between what is expected to be paid by taxpayers and what is actually paid by them. Alm [4] stated that a fundamental difficulty in analyzing tax evasion and tax gap is the lack of reliable information on taxpayer compliance. Hence, there is no official statistics on tax gap estimates by each tax authorities, except those based on McKenzie’s [8] survey. On 6 January, 2012, based on McKenzie’s survey, the United States’ Inland Revenue Service released a new set of tax gap estimates for year 2006, it reports that the voluntary compliance rate (i.e., the percentage of total tax revenues paid on a timely basis) for tax year 2006 is estimated to be 83.1%, as compared to 83.7% percent calculated for tax year [8]. It appears that the United States’ tax compliance rate remains unchanged in the last five years and tax non-compliance rate is about 17%.

There are three main persisting causes for the tax evasion and tax gap: failure to file tax returns, underreporting income and failing to pay for taxes owed. Of these, the underreporting of income is the biggest contributing factor to tax gap in tax year 2006 in the US. The IRS estimates that about 250-300 billion US dollars is lost each year due to underreporting [9]. A tax gap statistic is a helpful guide to the scale of tax compliance and to the persisting sources of low compliance, but it is not an adequate guide to year-to-year changes in tax authorities’ enforcement initiatives to encourage tax compliance. Through tax audit and investigation, some portion of the tax gap is recovered each year by punishing and enforcing payment of taxes owed.

A. Tax Audit in Malaysia

In Malaysia, there is no official statistics on tax evasion and tax gap, however, the Chief Executive Official of IRBM had the opinion that voluntary tax compliance rate in Malaysia is in line with the McKenzie’s 2012 report, which is about 80% [10]. Thus, the tax-noncompliance rate in Malaysia is estimated to be about 20%.

To enforce tax compliance and to combat tax evasion, after the implementation of self-assessment system in 2001 on companies, the IRBM has intensified tax audits (desk audit and field audit) to promote and encourage voluntary tax compliance. The desk audit is carried out at IRBM's office based on the submitted taxpayer's information. The field audit is carried out at taxpayer's business premise; prior to the visit, a notification letter will be sent to inform about the tax audit visit and the necessary documents that taxpayer is required to get ready. Tax audits aim to examine taxpayer's business records and financial affairs to ascertain that the right amount of income are declared and the right amount of tax are calculated and paid in accordance with tax laws and regulations.

In 2005, the IRBM reported that they finalized 2,303 audit cases involving companies with additional tax of Ringgit Malaysia (RM) 442 million being raised as the settlement amount after tax audits. This represented an increase of 40.2% in the amount of additional tax compared to 2004 in which only 1,635 audit cases were solved with settlement amount of RM315 million. Whilst, in 2005, taxes and penalties imposed through tax audits totaled RM635.40 million, compared to RM429.31 million in 2004; representing an increase of 69.48% [11].

On 14 December 2006, the IRBM held a tax dialogue with tax representatives from professional accounting bodies to discuss issues related to tax audits [12]. In the tax dialogue, tax representatives raised their concerns on the approach to tax audit. They found tax audit processes lack transparency and consistency, as some tax auditors did not carry out tax audits in a professional manner, whereby they performed tax audits with a preconceived mindset that the taxpayers are guilty and the field visit is to confirm the offences. In the tax dialogue, tax representatives complained that the tax audit processes took longer time than expected. Some audit cases took more than one year to finalize. Whilst, some audit cases were hurriedly closed to meet the three months datelines. As a result, notice of additional assessment was raised on dubious grounds, and taxpayers have to lodge an appeal against the additional assessment. There were cases that tax auditors refused to issue 'letter of clearance' after the field audit, and this caused psychological costs such as anxiety and worry to the taxpayers. There were cases that tax auditors advised taxpayers not to ask tax agent to represent them for tax audit [12].

Consequentially, in response to a call for a more transparent and efficient tax audit, in January 2007, the IRBM issued a 'Tax Audit Framework' to guide taxpayers, tax auditors and tax agent/representatives. Subsequently, in January 2009, the IRBM revised the 'Tax audit Framework' to ensure that tax audits are carried out in a fair, transparent and impartial manner. Among others, on page 3 of the 'Tax Audit Framework', it is clearly stated that "the main objective of tax audit is to encourage voluntary compliance with the tax laws and regulations and to ensure that a higher tax compliance rate is achieved under the self assessment system" [13]. It also spelled out on page 4 that "For the purpose of achieving voluntary

compliance, the tax audit activity is one of the measures undertaken by IRBM to educate and create awareness of taxpayers towards their rights and responsibilities under the provisions of the Income Tax Act" [13].

In the IRBM [13]'s 'Tax Audit Framework', it was stated that selection of cases for audit are by the computerized system based on risk analysis, information received from third party, selection based on specific industries and based on specific issues for a certain group of taxpayers, and selection based on locations. The timeframe for settlement of a tax audit should be 3 months from the commencement of the audit; the IRBM will inform the taxpayer on the progress of the audit in the event that the case needs more than 3 months to settle. In respect of tax penalty, it was stated that if it is discovered after the commencement an audit that there has been an understatement or omission of income, a penalty will be imposed under subsection 113(2) of the Income Tax Act in which the penalty rate equal to the amount of tax undercharged (100%) accordingly. However, the Director General of Inland Revenue in exercising his discretionary power may consider a lower penalty of 45% to be imposed for the first offence. In practice, the application of the 'Tax Audit Framework' remained unknown.

Meanwhile, the recent annual reports of the IRBM showed that the total number of taxpayers selected for tax audits has increased. As shown in Table I, over the past five years, the amount of additional tax and penalties imposed somewhat suggest that tax non-compliance and tax evasion seem to be on the rise, and a huge portion of tax lost has been recovered through tax audits.

With regard to field audit, the IRBM reports that in 2010, tax auditors had initiated 15,813 field audits on companies and non-company cases as compared to 13,619 cases in 2009, which has resulted in a sharp increase of about 16.1% (IRBM, 2010). Of the 15,813 cases audited, 8,119 (51.3%) cases were resolved in the same year and taxes and penalties raised were RM621.23 million. The statistics indicate that the IRBM is serious in conducting tax audits to encourage voluntary compliance and at the same time to alleviate the occurrence of tax evasion.

TABLE I
TAX AUDITS (DESK AUDIT AND FIELD AUDIT)

Year	Number of tax audits resolved (company and non company cases)	Amount of additional taxes and penalties raised (RM Million)
2006	6,741	692.68
2007	279,175	1,410.57
2008	1,052,939	1,697.16
2009	1,399,660	3,054.95
2010	1,732,258	2,870.62

Source: The IRBM's annual report [14]-[17]

Although literature on tax non-compliance and tax evasion has blossomed since the work of Allingham and Sandmo [18], research on corporate taxpayers, in particular from developing countries like Malaysia either have been neglected or have been the subject of only limited investigation. Very few studies had been conducted to examine tax non-compliance and tax evasion

in Malaysia. For example, Choong and Lai [19] found Malaysian business taxpayers were not fully aware of their tax responsibilities. Juahir [20] had attempted to study fraudulent reporting based on tax audited cases in 2004; whilst Zainal Abidin [21] attempted to analyze tax non-compliance behavior of small and medium sized corporation based on audited cases finalized in 2002 to 2005. Khadijah and Pope [22] examined corporate tax compliance determinants. In practice, the IRBM generally does not disclose much information about compliance behavior of companies and types of tax evasion committed by companies. At the time of this study, except for the study by Juahir [20], Khadijah and Pope [22] as well as Zainal Abidin [21], published scholarly study on tax audit findings is scant. Some questions were raised. Do transgressors (detected evaders) have distinct firm characteristics? What are the common types of tax evasion committed by firms? What is audit timeframe, the amount of the penalties imposed on detected evaders and the additional tax adjustment? Do tax auditors follow guidelines stated in the 'Tax Audit Framework' in carry out tax audits? Hence, the lack of empirical evidence shaped the motivation for this study.

II. RESEARCH OBJECTIVES

This study aims to (1) analyze the profiles of transgressors (detected evaders); (2) examine reasons that triggered a tax audit, causes of tax evasion, duration of tax audit, tax adjustment and tax penalty charged; and (3) determine if tax auditors followed the guidelines as stated in the 'Tax Audit Framework' when conducting tax audits.

III. METHODOLOGY AND DATA

The population of interest is corporation registered in Malaysia that had been audited by the IRBM. In practice, the detailed tax audit findings are keyed and stored in the IRBM's Case Management System in the head office (headquarters?). This study sampled corporate audit cases that had been finalized in 2011. With official permission, tax audit findings of all 557 resolved cases in 2011 were obtained. Of these, 44 cases with incomplete information and 92 tax compliant companies (with no tax adjustment) were excluded. Hence, a total of 421 cases with complete information were useful for data analysis. We analyzed the firm characteristics of the 421 resolved audited cases; reasons that triggered a tax audit, issues detected, period under review, audit timeframe and tax penalty charged. The findings are presented next. We also examined if tax auditors followed the guidelines in the 'Tax Audit Framework' in audit selection, notification, settlement and penalty imposition.

IV. RESULTS AND FINDINGS

Table II presents the profiles of detected corporate tax evaders. Of the 421 corporate cases audited and finalized in 2011, about 58.2% were small and medium corporations (SMC), while 41.8% were larger corporations with paid up share capital of more than RM2.5 million. Note that in Malaysia, for taxation purpose, the Ministry of Finance in the

Budget 2003 defined SMC as company incorporated in Malaysia with paid-up ordinary share capital of not more than RM2.5 million at the beginning of the basis period for a year of assessment. Whilst, more than half (50.1%) had sales turnover between RM10 million and RM100 million.

TABLE II
FIRM CHARACTERISTICS OF DETECTED CORPORATE TAX EVADERS BASED ON
AUDIT CASES FINALIZED IN 2011

		Year tax audit was initiated (quantity, percentage)		Total audit cases finalized in 2011 (quantity, percentage)
		2010	2011	
Firm size	Small and medium corporation	186 (66.7%)	59 (41.5%)	245 (58.2%)
	Large corporation	93 (33.3%)	83 (58.5%)	176 (41.5%)
Size based on sales turnover	Less than RM500,000	6 (2.2%)	1 (0.7%)	7 (1.7%)
	Between RM500,001 to RM1,000,000	6 (2.2%)	4 (2.8%)	10 (2.4%)
	Between RM1,000,001 to RM10,000,000	111 (39.8%)	56 (39.4%)	167 (39.7%)
	Between RM10,000,001 to RM100,000,000	142 (50.9%)	69 (48.6%)	211 (50.1%)
Type of industry	Above RM100,000,000	14 (5.0%)	12 (8.5%)	26 (6.2%)
	Construction	98 (35.1%)	40 (28.2%)	138 (32.9%)
	Manufacturing	42 (15.1%)	34 (23.9%)	76 (18.1%)
	Service	42 (15.1%)	24 (16.9%)	66 (15.7%)
	Wholesale	28 (10.0%)	7 (4.9%)	35 (8.3%)
	Transport	22 (7.9%)	9 (6.3%)	31 (7.4%)
	Real estates	20 (7.2%)	7 (4.0%)	27 (6.4%)
	Mining	8 (2.9%)	9 (6.3%)	17 (4.0%)
	Other industries	10 (3.6%)	5 (3.5%)	15 (3.6%)
	Government service	6 (2.2%)	2 (1.4%)	8 (1.9%)
Profitability of the firm	Agriculture	3 (1.1%)	5 (3.5%)	8 (1.9%)
	Firm with net Profit	81 (29%)	72 (50.7%)	153 (36.3%)
	Firm with net Loss	198 (71%)	70 (49.3%)	268 (63.7%)
Total		279 (100%)	142 (100%)	421 (100%)

The political cost theory formulated by Watts and Zimmerman [23] suggested that large firms are more exposed to government examination than small firms. Additionally, Joulfaian and Rider [24] found that corporate tax compliance correlates positively with larger firm. However, this study found that in Malaysian tax setting, both smaller and larger firms are subject to tax audits, and there is no statistical evidence that larger companies are more compliant than smaller firms.

Based on Table II, the three main tax evaders were from construction industry (32.8%), followed by manufacturing (18.1%) and service industries (15.7%). It is worth noting here

that the service industries comprises of education, electricity, water and gas, financial intermediary, hotels and restaurants. With respect to the financial performance of the firms, notably, about 63.7% were facing financial loss and just 36.3% were profit making companies.

A. What Triggers a Tax Audit?

So what triggers a tax audit in Malaysia? In the era of self-assessment system, tax audit is a routine activity; the IRBM generally does not need any reason to select taxpayers for tax audit. This study found the key selection criteria were based on risk analysis (67%), 11.2% were based on information from third party (such as insurance, broker, creditor and real property gain tax), another 7.6% were due to low profitability and fluctuating profit pattern, 1.2% were directive from top management and a few (0.07%) were suggested by desk audit.

B. Year of Assessment Selected for Tax Audit or Period under Review

Normally, a tax audit may cover a period of one to three years of assessment in accordance with the audit focus, however, the years of assessment to be covered in a tax audit may be extend beyond 3 years depending on the issues identified during an audit [13]. This study found the tax auditors will not hesitate to extend the audit beyond 3 years of assessment in 2010 and 2011 (see Table III).

TABLE III
YEAR OF ASSESSMENT SELECTED FOR TAX AUDIT OR PERIOD UNDER REVIEW

Year of assessment selected for audit	The year audit is initiated or commenced		Cases finalized in 2011
	2010 (count, %)	2011 (count, %)	Total (count, %)
2003	1 (0.4%)	1 (0.7%)	2 (0.5%)
2004	0 (0%)	0 (0%)	0 (0%)
2005	4 (1.4%)	0 (0%)	4 (1.0%)
2006	4 (1.4%)	0 (0%)	4 (1.0%)
2007	13 (4.7%)	1 (0.7%)	14 (3.3%)
2008	245 (87.8%)	8 (5.6%)	253 (60.1%)
2009	12 (4.3%)	130 (91.5%)	142 (35.7%)
2010	0 (0%)	2 (1.4%)	2 (0.5%)
Total	279(100%)	242(100%)	421 (100%)

C. Persistent Causes of Tax Evasion

Consistent to past literature, as presented in Fig. 1, this study found that of the 421 cases audited and resolved cases, three persistent causes of tax evasion or issues that resulted to tax adjustment were over claiming expenses (46.8%), various fraudulent reporting (38.5%) and overstating purchases (10.5%).

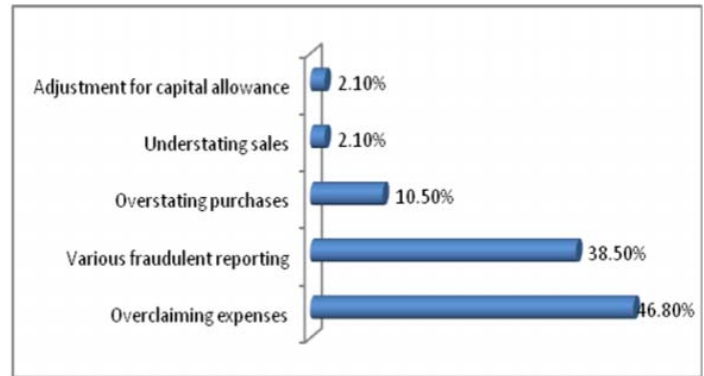


Fig. 1 Persistent causes of tax evasion

D. Audit Timeframe or Duration of Tax Audit

Fig. 2 shows that only 1.4% cases were closed within 3 months, most of the cases took more than one year to settle. Results in Fig. 2 show empirical evidence that most tax auditors took between 6 to 18 months to close a case. Upon checking, the particular company which took more than two years to settle was from wholesale industry. Overall, this study found tax auditors took a long time to close and finalize corporate tax audit, and these is a little surprising as the timeframe for the settlement of a tax audit should be 3 months from the commencement of the audit. The plausible explanation for the audit timeframe to extend beyond 3 months could be due to the size of the business and the complexity of business transactions, the form of which records are kept and the extent of co-operation from the taxpayers.

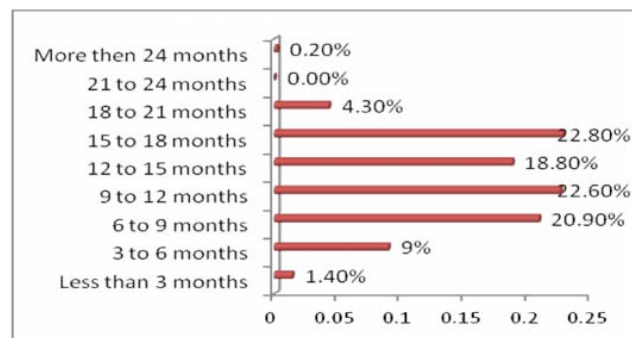


Fig. 2 Audit timeframe or duration of tax audit

E. Penalty Imposition

As for penalty imposition, about 10% were charged 100% penalty on additional tax adjustment due to understatement or omission of income. Notably, more than half of the resolved cases were imposed a lower penalty of 45% on additional tax adjustment found during audit. These findings are in accordance with the penalty rate stated in the 'Tax Audit Framework' for first time offenders.

V. CONCLUSION

This study used archival audited and resolved data from the IRBM, which is not publicly available. In view that there is little study on corporate tax evasion in Malaysia, hence, this study has

the merit as it fills the knowledge gap in tax fraud in developing countries. The limitation of this study is that the researchers could not gain access to scrutinize the original audit reports. Based on the resolved audit cases official obtained, some information were not available in order to perform an in depth analysis. Hence, it is inconclusive to provide evidence that firm size and type of industry correlate with tax evasion, nonetheless, that the audit timeframe taken to settle audit cases appears to be too long, and generally, tax auditors did follow the guidelines as stated in the 'Tax Audit Framework' in audit selection, settlement and penalty imposition.

On the other hand, there is no clear evidence to suggest that the extent of tax evasion problem is decreasing in Malaysia. However, in view that tax evasion has an adverse impact on the economy; tax evaders must be detected and penalized to enhance public confidence in the tax system. The IRBM plays a crucial role in protecting the tax system for the benefit of the society. It is suggested that the IRBM to increase its reporting on the enforcement activities, so that the public will know what efforts have been taken to curb tax evasion, and who are the notorious corporate tax evaders, and to certain extent, naming the tax evaders publicly might deter others.

This study has some limitations. It only analyzed audited and cases resolved in 2011 and hence, the findings cannot be generalized to other years. In view of the scant theoretical and empirical literature on business tax evasion in developing country, future study can be conducted to examine the determinants of corporate tax evasion or a time series analysis can be conducted to track corporate tax compliance behavior to predict corporate tax evasion.

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