

# Tax Knowledge, Tax Penalty and Tax Rate on Tax Compliance among Small Medium Enterprise in Selangor

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## **Abstract**

**Purpose:** This study is developed to examine the determinants of tax compliance in Small and Medium Enterprises (SMEs), focusing on how tax knowledge, tax penalty and tax rate affect tax compliance behaviour of SMEs in Selangor.

**Design/methodology/approach:** The determinants that serve as the independent variables are tax knowledge, tax penalty, tax rate and the dependent variable tested is tax compliance. The population of the study covers the SME in Selangor. A total of 105 questionnaires collected and usable for further analysis using descriptive, reliability, normality and correlation analysis.

**Findings:** As the results, the findings reveal that tax knowledge, tax penalty and tax rate demonstrated the significant relationship towards tax compliance among the SME.

**Originality/value:** The number of audited cases finalized is higher every year showing the level of tax compliance tend to be decreasing every year. This statistic is the fundamental component that drives the execution of this research.

**Keywords:** Tax Compliance, Small and Medium Enterprises (SME), Tax Knowledge, Tax Penalty, Tax Rate

## **Introduction**

Tax is defined as a compulsory obligation that can be the income for the country. While, tax compliance can be defined as act that lead taxpayer in comply with the taxation. Some researchers agreed that taxpayer would comply with taxation when they had the knowledge and

understanding about it (Ali and Ahmad, 2014). The objective for taxation collecting are for financial funding for government’s expenditure (Jaidi et al., 2013). According to Datuk Sabin Samitah, the IRB Chief Executive Officer, by collecting tax from the potential taxpayer, it will increase the revenue of the overall tax collection. This confirm that tax revenue has a large contribution in increasing the government revenue and it also shows that the taxpayer in Malaysia are obligate in fulfil their duty as taxpayer. SMEs contribution in the Gross Domestic Product (GDP) has increased from 36.3% in 2015 to 36.6% (SME, 2017). It is because of the increasing number of new SMEs companies. According to Mukhlis et al. (2015), the presence of the SME area has a vital part in advancing financial development and impartial circulation of monetary exercises. The part can be seen from the capacity in business, acquiring energy of creation, preparing nearby crude material, and an expansion in tax income. By having SMEs comply with tax, it will directly affect government income as in most developing countries, they are the greater part of business taxpayers (Maseko, 2014).

The SME can be defined as small-scale enterprise based on two criteria, which is annual sales turnover and number of employees (www.smecorp.gov.my). Based on the criteria, it shows that SMEs companies are liable to pay tax and automatically they are contributed in increasing the tax revenue for government (Mukhlis et al., 2015). Maseko (2014) also agreed that government tax revenue is mostly from the SMEs and it shows that they have high compliance level in fulfil the duty as the taxpayer. The taxpayer willing to fulfil their tax obligation if they have enough knowledge on the taxation matter. The knowledge on tax matter can make the taxpayers indirectly voluntary in paying tax. Mukhlis et al. (2015) said that tax knowledge is an understanding of the taxpayers in certain matter related to tax system that applied in the country. Due to the limitation on tax knowledge, it will cause the existing of tax non-compliance.

**Problem Statement**

Tax compliance defines as the accurate reporting of income and claiming of expenses in accordance with stipulated tax law. Thus, the failure of taxpayers to accurately report or pay their tax is considered as tax non-compliance (Sapiei et al., 2014). The issue of taxpayers’ non-compliance towards filling and paying their chargeable income tax is not something that is out of the ordinary. In order to detect the level of tax compliance, government will usually carry out tax audit. Tax audit is an examination of taxpayers' business records and budgetary undertakings to check that the perfect measure of pay ought to be announced and the appropriate measure of duty ought to be figured and paid are as per impose by laws and controls. Through tax audit, the level of compliance in Malaysia can be detected.

Table 1: The Statistic on Tax Audit

	2014 No. of case finalized	2013 No. of case finalized
Company	98,615	83,093
Non-Company	1,771,317	1,674,827
TOTAL	1,869,932	1,757,920

*Note: Annual Report of the Inland Revenue Board Malaysia, 2017*

As shows in Table 1, the number of audited cases finalized and the additional taxes and penalties imposed from tax audits for the 2 years respectively, it can be observed that the number of audited cases finalized for company in 2014 is higher compared to the number of audited cases finalized for company in 2013.

This means that the level of tax compliance between company taxpayers decreases between the two consecutive years. This statistic is the fundamental component that drives the execution of this research as this component indicates the fluctuations of level of compliance.

Therefore, this study will focus on the effect of tax knowledge, tax penalty and tax rate on tax compliance. Based on previous studies conducted, Oladipupo and Obazee (2016) observed that tax knowledge plays an important role in boosting tax compliance. Tax knowledge could conceivably urge taxpayers to be more reasonable in finishing their tax returns. However, Fauziati et al. (2016) concluded that tax knowledge has no influence on tax compliance among SMEs. Brainnyah (2013), observed that tax knowledge variable which comprises of general learning, legitimate knowledge and technical learning in this research did not altogether influence assess consistency conduct of SMEs. Based on the different findings on the effect of tax knowledge on tax compliance, the role of tax knowledge has been selected with the intention to help make clear of the different findings. Tax penalties was selected based on the findings of the previous study conducted by Camille and Yona (2016), which concluded that there is a positive relationship between tax penalties and tax compliance. Camille and Yona (2016) and Mas'ud et al. (2014) also concluded that there is a positive connection between tax rate and tax compliance, which resulted to the selection of tax rate as one of the element to be discussed.

## **Literature Review**

### ***Tax Compliance and Tax Non-Compliance***

Tax compliance and evasion is global phenomena hassling both developed and developing countries (Mas'ud et al., 2014). Fauziati et al. (2016) defined tax compliance as all the required tax returns are filled at proper time and tax liability in accordance with tax law applicable at the time the return is filed is accurately reported in returns. This statement is supported by Brainnyah (2013) which stated that tax compliance can be defined as the degree to which a taxpayer complies or fails to comply with the tax rules of their country. According to Mas'ud et al. (2014), there are two types of tax compliance, which are judicious compliance and administrative compliance. Judicious compliance is when taxpayers adhere to tax laws that are stipulated in relevant regulations while administrative compliance is the filling of tax return forms with accuracy.

Meanwhile, tax non-compliance is the act of not complying with the tax law and administration set up in a country. Kasipillai (2012), stated that the term non-compliance encompasses both intentional evasion and unintentional non-compliance, which is due to memory lapses, calculation errors and inadequate understanding of tax laws. Tax non-compliance can be divided into two types, which are tax avoidance and tax evasion. According to Kasipillai (2012), tax avoidance is the legal utilisation of the tax regime to one's own advantage, to reduce the amount of tax that is payable by means that are within the law while tax evasion is the non-payment of the tax which would properly be chargeable to a taxpayer if the taxpayer made a full and true disclosure of assessable income and allowable deductions.

### ***Tax Knowledge***

Based on a study conducted by Oladipupo and Obazee (2016) stated that tax knowledge plays an important role in increasing tax compliance as tax knowledge could potentially encourage taxpayers to be more discreet in completing their tax returns. The findings from Oladipupo and Obazee (2016) is further supported with a few studies by Machogu and Amayi (2016), Kamil (2015), Mukhlis et al. (2015) and Palil et al. (2013). Kamil (2015) and Machogu and Amayi (2016) also stated that tax knowledge has a significant effect on individual taxpayers' compliance. Their study also suggested that intensive counselling to taxpayers should be provided by the tax service office in order to raise awareness of the taxpayer to comply in paying their tax obligations. This action is considered as an effort to increase the tax revenue. Mukhlis et al. (2015) affirmed that tax knowledge has significant positive effect on tax compliance. Based on Palil et al. (2013), employees with adequate tax knowledge, can minimize unintentional non-compliance, in other word, it means that tax knowledge can increase the level of tax compliance. However, Brainyyah (2013) claimed that tax knowledge does not significantly affect tax compliance behaviour of SMEs. This is because, it is believed that more SMEs entrepreneurs to be acquainted with the ins and outs of taxation, there is a probability that they would also know the ways to escape the taxation regulations. This, in return may even result to tax evasion. Fauziati et al. (2016) concluded that tax knowledge has no impact on tax compliance among SMEs.

### ***Tax Penalty***

Tax penalty can be defined as a disciplinary effort the tax law levy for any act of conduct that can be considered as prohibited or for the failure to form an obligatory act for example failing to submit the file return at the proper time or filling erroneous or underestimated the returns. If a taxpayer is required to document an income or excise tax return and unable to do so in the given time, a late filing penalty may be evaluated Oladipupo and Obazee (2016). Savitri and Musfiaily (2016) defined penalties as negative punishment to those who break the rules and fines are punishment by paying money for breaching the rules and applicable law, it can be concluded a penalty is negative punishment to those who break the rules by paying money. According to IRB, if taxpayer fails to pay taxes as required, they will be charged penalties under Section 103(3) for non-business income sector and Section 103(4) business income sector stated in provision of Income Tax Act 1967. The penalties are 10% increment from the tax payable and 5% additional if the payment not received after 60 days from the final date.

Reference to past studies, deterrence elements such as the likelihood of being investigated and being noticed by tax authorities that were established by government are found to reduce non-compliance activities among taxpayers (Allingham and Sandmo, 1972; Doran, 2008; Oladipupo and Obazee, 2016). For instance, if taxpayers have submitted incorrect return and these issues identified during audit process that there are underreporting or undisclosed amount, a penalty will be levied under Section 113 provision of the ITA 1967. However, revenue authorities in Malaysia which is IRB persuade taxpayers who under report their income to willingly make disclosure of the income. Failure to do so will result to taxpayer being liable to penalty or fine depends on the time that has expired between omission and voluntary disclosure.

In addition, according to Moravec and Radyan (2016), there are two types of tax penalties, which is administrative sanctions and criminal sanctions. Administrative sanctions will be imposed if there are any taxpayers make such abuses and administrative sanction penalties, interest and

rising. For criminal sanctions are liable to a jail sentence. Swistak (2016) and Chebusit et al. (2014) examined the influences of tax penalties towards SMEs' tax compliance. It revealed that tax penalties have positive impact on taxpayers if those penalties are fair and acceptable. If they are perceived as oppressive, they are possible to create resistance and will result more on non-compliance behaviour.

### ***Tax Rate***

Taxpayers from SMEs sector are expected to be deterred by threat of any punishment from the tax structure in a country for example through tax audits, penalties and tax rates. In ordinarily, there are lots of theoretical and empirical evidence to support the punishment perspectives such as greater audit probabilities and penalties will encouraged compliance but increment on tax rates will discouraged compliance (Swistak, 2016).

According to Hai and See (2011), they found that the high tax rate would cause more on tax compliance. In the tax return consent, Mas'ud et al. (2014) stated that any taxpayers that alert with their tax rate change and become highest than average tax rate that others paid will have more probability to evade any tax charged to them. By consequences, the taxpayer's perception on their payment with high tax rate is that they can exceed their overpayment through the tax evasion. Moreover, majority of the research findings showed that the high tax rate is positively related to tax evasion and negatively related to tax compliance, but other studies were found that there is no relationship or in fact even positive relationship between tax rate and tax compliance Freire and Panades (2013). Furthermore, in a past study that was conducted in one of the African countries, the results show that tax rate do not have any positive or negative effect on tax compliance Modugu, Eragbhe and Izedonmi (2012).

Besides that, Seidu et al. (2015) examined and modelled the causes of tax default among SME in Tamale Metropolis of Ghana. The findings revealed that the reasons for tax default are high tax rates, inadequate tax education by tax authorities and multiple taxation. They encouraged government to design tax policies that make tax payment attractive and unavoidable by both formal and informal sectors. Atawodi and Ojeka (2012) and Mas'ud et al. (2014) found that high tax rates, complicated filling procedure will cause tax non-compliance among SME. They proposed that SMEs sector should be charged at lower percentage of tax rates to authorize enough funds and capital for business development and better possibility of survival in a competitive market.

### **Hypothesis Development**

Three hypotheses have been developed to show the differences and relationship between independent variables and dependent variable.

*H<sub>1</sub> = There is a significant relationship between tax knowledge towards tax compliance.*

*H<sub>2</sub> = There is a significant relationship between tax penalty and tax compliance.*

*H<sub>3</sub> = There is a significant relationship between tax rate towards tax compliance.*

### **Method**

#### ***Population and Sample***

The population in this research is SMEs and been focused on a top three which have the top rank of listing for SMEs in Malaysia. This study interested to conduct survey in Selangor as it has the highest number of SMEs among the top three states and decided to focus on the services provider



sector as it also has the highest number of SMEs and thus providing higher probability to receive feedback from respondents. Figure 1 shows the service sectors and the samples from each state.

Sectors/State	Number of SMEs			
	Johor	Selangor	KL	Total
Business and professional service	191	914	929	2,034
Hospitality service	11	43	32	86
Services provider	561	1,875	1,471	3,907
Tourism	17	107	124	248
Healthcare	55	212	134	401
Education and Training	68	307	194	569
Pharmaceutical	27	129	70	226

Note: SME Corp (Malaysia) official website, 2017.

Figure 1: Service Sectors and the Samples from Each State

Hence, services provider has been selected because it was according to percentage share and annual percentage change of gross operating surplus (2015-2016) which is 52% and it was the highest contributor in the economy. Figure 2 shows the percentage share and annual percentage change of compensation of Gross Operating Surplus, (2015-2016). The SMEs population in Selangor (services provider) amounted 1,875 and 317 out of them will be selected as sample in this study (Sekaran and Bougie, 2013).

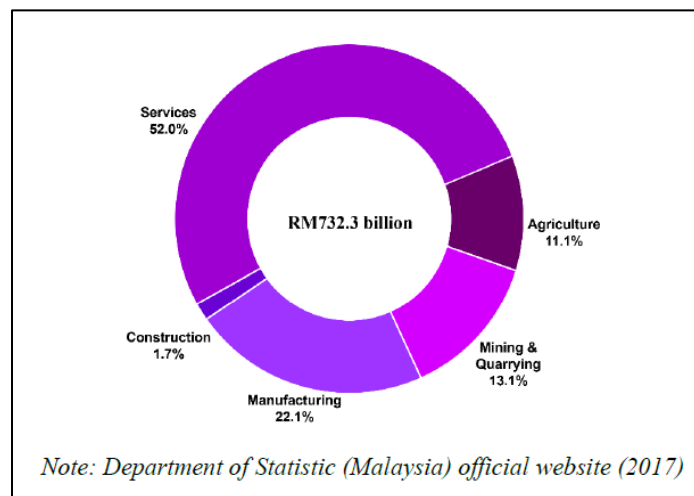


Figure 2: Chart of Gross Operating Surplus

**Data Collection**

The data collection based on the questionnaire that has been distributed to SMEs in Selangor. The questionnaire used in this study adopted from Ndirangu (2014), Camille and Yona (2016) and Sapiei et al. (2014). The scale utilized as part of the questionnaire is Likert scale (1-strongly to 5-strongly agree).

## Findings

### Data Analysis

The total of 317-questionnaire surveys had been distributed to SMEs for this research. 115 questionnaires collected but only 105 were usable and the remaining is rejected. It is due to the respondents were unwilling to answer the entire question properly and lack of knowledge about the topic.

### Normality Test

The Normality test is conducted to determine whether the data is normally distributed or not. In this study, Kolmogorov-Smirnov model used because the sample size is more than 50. As the result from the normality test, all significance value is less than 0.05, which indicates the data is not normally distributed. Therefore, non-parametric tests are used to interpret the data.

### Reliability Test

Reliability test is to point out to how much a test is consistent and stable in measuring what it is planned to measure. Cronbach's Alpha range from 0.5 to 0.6 are consider having acceptable reliability while those in range of 0.70 are considered acceptable, and those over 0.80 are good. The reliability test conducted shows that all questions in tax knowledge, tax penalty and tax rates having good reliability at 0.664 to 0.084.

### Frequency Analysis

Figure 3 shows the result of the level of education. Diploma/certificates and bachelor's degree holder has the highest percentage which is 36.2% and 33.3%, respectively. Looking at SPM/STPM holder and PHD, the score is 20% and 4.8% respectively.

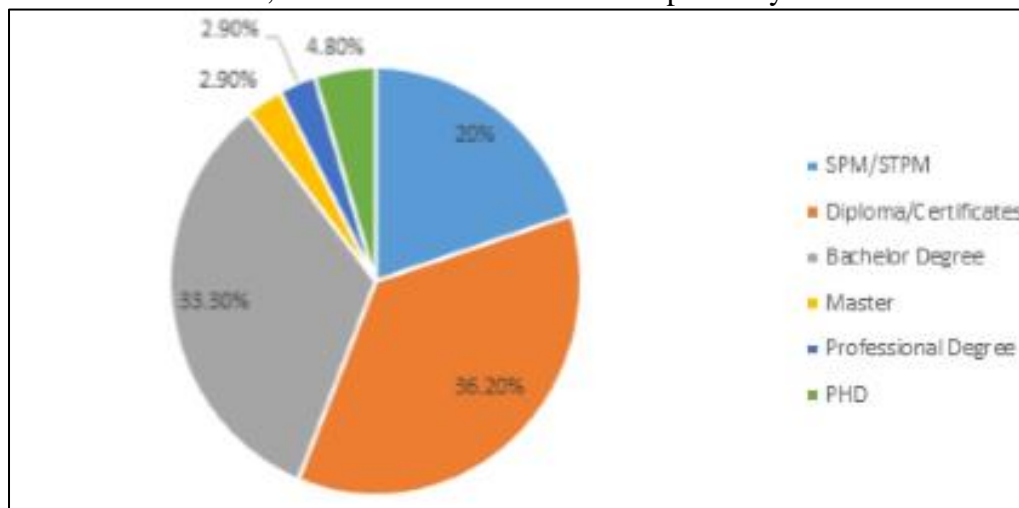


Figure 3: Level of Education

Figure 4 shows that micro companies has the majority number in company size, which is 48% (50 respondents). Second highest was small companies with 39% (41 respondents) and the medium sized companies was 13% (14 respondents).

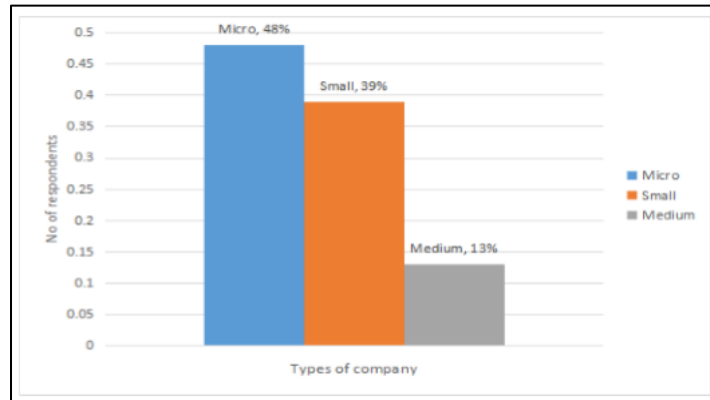


Figure 4: Company Size

### Correlation Test

As shown in Table 2, all the independent variables have significant positive relationship with tax compliance (p-value, which are less than 0.05). This shows that all the independent variables can influence the level of compliance among taxpayers.

Table 2: Correlation Analysis

Dependent Variable: Tax Compliance	Independent Variable		
	Tax Knowledge	Tax Penalty	Tax Rates
Sig. (2-tailed)	0.008	0.042	0.000
Correlation Coefficient	0.256**	0.199*	0.460**

\*\* Correlation is Significant at the 0.01 Level (2-Tailed)

\* Correlation is Significant at the 0.05 Level (2-Tailed)

The result for tax knowledge shows that the relationship has a degree of 25.60% ( $r = 0.256$ ), which is adequate to highlight the significant relationship. This result is consistent with Mukhlis et al. (2015), and Palil (2010). However, the result is in contrast with other studies by Brainyyah (2013) and Kamil (2015).

Meanwhile, the relationship for tax penalty has a degree of 19.99% ( $r = 0.199$ ), which is adequate to highlight the significant relationship. The result is consistent with the studies by Alm, Sanchez and De Juan (1994), Chebusit et al. (2014), Kamil (2015) and Savitry and Musfialdy (2015).

Finally, for tax rate, the relationship show that degree of 46.00% ( $r = 0.460$ ), which is adequate to highlight the significant relationship. The result is consistent with a study by Alm et al. (1994) which concludes that higher tax rates lead to somewhat preminent tax compliance. On the other hand, the result of this study is at variance with the results of the studies conducted by Atawodi and Ojeka (2012), Ching (2013) and Palil et al. (2013) which concludes that tax rates are a negatively significant determinant, which affects tax compliance behaviour of taxpayers.



### **Discussion and Conclusion**

The findings in this study enhance the tax compliance literature in terms of factors that are likely to influence the tax non-compliance of SMEs taxpayers. Specifically, objective of this study conducted is to investigate the relevant factors that give effect to tax compliance among SMEs in Malaysia. This is because there is no much emphasis placed on tax compliance issued in Malaysia nowadays. Besides that, Sapiei et al. (2014) stated that most of existing studies examined the determinants of tax compliance behaviour in general. This study took the approach a step further by observing different factors that may lead to tax compliance which are tax knowledge, tax penalty and tax rate.

This study found out that tax knowledge has the significant impact on tax compliance among SMEs. This is because most of the respondent agreed that tax knowledge is the most influential factor to determine taxpayer's compliance behaviour. McKerchar (1995) stated that small business taxpayers as if SMEs are not even aware of their tax knowledge shortfall might lead to unintentional noncompliance behaviour. Besides, lack of technical knowledge among SMEs taxpayers will increased the demand for taxed agents. Due to limited knowledge on this aspect, it has eventually forced them to seek tax professional's assistance and the cost incurred to hire them will burden the SMEs financial.

Subsequently, Alm et al. (1994) stated that penalties are effective to enforce compliance and regulators should increase awareness of tax obligations and compliance to SMEs taxpayers. The findings revealed that tax penalty have significant relationships towards tax compliance. Last of all, this study also found that there is a significant relationship between tax rate and tax compliance among SMEs taxpayers. SMEs taxpayers should be levied lower amounts of taxes so that they will have enough funds for other activities that will lead to business growth and development. Additionally, it will help SMEs get better equipped to survive in a competitive market nowadays.

### ***Limitation***

There are some limitations throughout the study was being carried out. Since this research only focus on SMEs as respondents, some of them were reluctant in filling up the survey. For SMEs that not have any experience in paying tax are unable to understand the questionnaire given even though the researchers apply face to face interview with the respondents. SMEs taxpayers also afraid that their information will be disclose to regulators, which is Inland Revenue Board (IRB). From that issues, its will affect to the number of participation in the survey conducted.

Data collection process of this study involved questionnaire survey, which were distributed among SMEs in Selangor. However, there were some number of questionnaire that were failed to be returned. This shows the lack of interest and cooperation among SMEs in participate in this survey. It also indicates that there is a lack of knowledge and awareness on tax matters among SMEs.

Other than that, this study only focused on several places due to geographical limitation, thus the findings may not reflect the other entire sector of SMEs in Selangor. Next, the variables tested in this study is limited to only three variables, which are tax knowledge, tax penalty and tax rate. As a result, the findings cannot be generalized to all other factors involved in tax compliance.

### ***Recommendation***

The data collected shows that SMEs in Selangor have lack of knowledge on tax compliance. The government should create more awareness activities about tax compliance among SMEs. This objective can be achieved through campaigns and training for the SMEs. Acquiring tax knowledge has many benefits because it would save the taxpayers from hiring any consultants to compute taxes for their businesses and thereby saving huge amount of tax consultancy cost. Furthermore, it can assist taxpayers accurately compute tax payable and avoid unintentional noncompliance resulting from low level of tax knowledge.

There are some recommendations that could be given to enhance the research content of the future researcher. Future researcher could conduct their research with more independent variables. They may identify more factors that will influence the level of tax compliance among SMEs in Malaysia. Additionally, future researcher can use larger sample size to widen their scope of research. Increase sample size will lead to higher reliability on the data collected, thus the data obtained could be normally distributed.

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