

## **TAX EVASION: A FINANCIAL CRIME RATIONALISED?**

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### ***ABSTRACT***

The issue of tax evasion has been around ever since tax has been introduced. Complicating it more is the notion of tax avoidance, which is legal. The ability of tax agents advising their clients on how to legally reduce their tax amounts has always been admired, praised and sought after. However, a taxpayer or tax agent found guilty of tax evasion and penalized accordingly has always been seen in a bad light. This is a conceptual paper which discusses the tax evasion phenomenon, the dilemma faced by tax agents, the reasons behind tax evasion, and the importance of ethics in drawing the line between tax avoidance and tax evasion. It also proposes that tax evasion can be more effectively reduced by controlling the internal, rather than the external factors.

## **INTRODUCTION**

Taxation is an important source of revenue to the government. In Malaysia, the tax authority is known as the Inland Revenue Board Malaysia (IRBM). According to the IRBM, support and willingness to pay tax reflect the people's nationalism and patriotism in contributing towards the wealth and wellbeing of the country (Lembaga Hasil Dalam Negeri Malaysia, 2010). With the implementation of the self-assessment tax system (SAS), the responsibility to assess the tax liability is on the taxpayers. This means that taxpayers must not only have sufficient tax knowledge (Choong & Wong, 2011) but should also honestly report their taxable income. In order to further intensify voluntary tax compliance, the IRBM had also instituted tax audit and investigation systems (Choong & Wong, 2011) whereby taxpayers are now responsible to proof the amount declared should they be asked to do so by the tax authority

The probability of individual taxpayer being selected to tax audit is once in every five years. Any irregularities from the audit findings will be classified either as incorrect return under Section 113 or willful evasion under Section 114 of the Income Tax Act 1967. Choong and Wong (2011) reported that the then CEO of Inland Revenue Board Malaysia stated that one third of Malaysians eligible to pay tax did not do so in 2005, and 1.3 million potential taxpayers did not even file their tax returns.

In 2010, there were 4,443 cases of income tax defaulters who had been prohibited to leave the country, with the amount of tax amounting to RM205.29 million. Meanwhile, 14,363 summonses had been issued in 2010 alone, involving 12,192 cases for individual tax and 2,171 cases involving companies. Although the number of individual taxpayers who defaulted far outweighed the companies, the amount of tax involved was the opposite (RM274.29 million for individual taxpayers and RM1,198.40 million for companies). The amount of revenue lost by the government is significant and more alarmingly, the amount increases steadily over the years despite various measures taken by IRBM to ensure tax compliance (Lembaga Hasil Dalam Negeri Malaysia, 2010).

To date, there has been limited amount of research on ethics in the tax setting (Cruz, Shafer & Strawser, 2000). In addition, though much attention has been devoted to understanding and resolving the crises that have afflicted the accounting profession on the audit side, less emphasis has been placed on resolving the tax-related issues. Since the ethical decision making in the tax context is rather unique, understanding the unique issues facing the tax profession is indeed a high priority.

## **DILEMMA OF TAX AGENTS**

Though there has been a lot of concern on the ethical conduct of accountants and auditors, especially after the collapse of giant corporations throughout the world such as Enron, Xerox, WorldCom, Parmalat, Barings Bank, and Perwaja Steel, less attention has been given to the ethics of

tax agents who are also offering fiduciary services to the society. The main dilemma often faced by tax agents is 'should they be more loyal to their clients or to the profession'?

Tax agents can be defined as professionals who assist clients in fulfilling their tax responsibilities. They are also known as tax practitioners, tax professionals or tax advisors. In Malaysia, tax agent is defined in Section 153 of the Income Tax Act 1967 as a professional accountant authorized by or under any written law to be an auditor of companies, any other professional accountant approved by the Minister of Finance, or any person approved by the Minister on the recommendation of the Director General of Inland Revenue. They would have to be registered with the Inland Revenue Board Malaysia (IRBM) and are required to fulfill certain requirements stipulated by the IRBM before they are granted the license to operate. This is to ensure that the agents are competent in delivering their professional duties ([www.hasil.gov.my](http://www.hasil.gov.my)). Based on the Code of Ethics for Tax Agents, which was published by the IRBM, in discharging his duties, a tax agent shall always adhere to the principles of integrity, competency and professional advice.

According to Shafer and Simmons (2008), there seems to be growing concern of the ethical behavior of professional tax advisors. Cases of tax advisors being investigated for facilitating clients' tax evasion have raised important issues relating to ethics and professionalism of tax advisors. These cases raised concern that some tax advisors have largely abandoned concerns for the public interest or social welfare in favour of commercialism and client advocacy. In other words, the cases seem to suggest that some tax advisors promote the interest of the clients over the public welfare.

This is an issue that has concerned business ethics researchers in recent years but has not been explicitly discussed in the accounting literature (Shafer & Simmons, 2008). It needs to be addressed as avoiding the issue may lead to the rationalization of tax evasion, particularly in the face of clients pressure for tax minimization.

Without any doubt, there is inevitable tension in tax practice between serving the client and maintaining the integrity of the tax system. Cruz, Shafer and Strawser (2000) investigated professional tax practitioners' ethical judgments and behavioral intentions in cases involving client pressure and stated that one of the most difficult issues facing tax practitioners is dealing with client pressure to adopt overly aggressive reporting positions.

## **TAX AVOIDANCE AND TAX EVASION: THE WORLDWIDE PHENOMENON**

There has been a lot of definition distinguishing between tax evasion and tax avoidance. In general, tax evasion is defined as an illegal and unlawful practice where people intentionally avoid paying their tax liability. Meanwhile, tax avoidance has been defined as legal tax planning, and is the right of all citizens to reduce the amount of taxes they pay as long as it is by legal means (Green, 2009; Harun, Abu Bakar & Tahir, 2011).

However, distinguishing between tax evasion and mere tax avoidance is not always easy in practice. In other words, it is not always easy to draw the line between the two. Since tax evasion is where ‘people *intentionally avoid* paying their tax liability’, perhaps many forms of tax avoidance are also actually wrong or unethical; but non-punishable. For example, is ‘backdating’ certain payments in order to fully optimized tax reliefs considered as tax avoidance or tax evasion? It may be legal, thus it is tax avoidance. But is it ethical? Is not the amount of tax successfully avoided also evaded?

Previous research shows that tax evasion is a worldwide phenomenon, and has caused huge amount of losses in terms of government revenue (Greene, 2009; Choong & Wong, 2011; Ahangar, Bandpey and Rokny (2011); Ross & McGee, 2011). Greene (2009) reported that 25% of US taxpayers admitted to deliberately cheating on their taxes. The percentage is also the same for Australia, Netherlands and Sweden. It was also reported that the level of noncompliance with tax laws is higher in much of Europe, and higher still in the developing world. Along the same line, Stowhase and Traxler (2004) observe significant levels of tax evasion in almost all developed countries. For example, France lost Ff6 billion due to tax evasion (which equals the country’s deficit) while in Belgium, 20% of income tax were being evaded.

Tax gap, which is the difference between the amount of taxes owed and the amount of taxes paid (known as tax gap) can be attributed to three sources; under reporting, non-filing, and under payment. Under reporting can incur by under reporting income, over stating deductions, over stating business expenditure, and erroneously claiming credits. Non-filing is the case where the taxpayers do not even file the tax return. Meanwhile, under payment is the case where the taxpayers do not pay the full amount of tax liability to the tax authority. Similarly, Choong and Wong (2011) mentioned that offences of tax defaulters included failure to submit returns, declaring false returns, and not providing sufficient information.

## **PERCEPTIONS TOWARD TAX EVASION**

While many would agree that tax evasion is ‘wrong’ or ‘unethical’ (Harun, Abu Bakar & Tahir, 2011; Greene, 2009), many would be hesitant to either categorize it as a crime, offence, or violation. Burton, Karlinsky and Blanthorne (2005) who believed that tax evasion is a form of white collar crime, conducted a study to investigate US taxpayers’ perception of the severity of tax evasion relative to other offences in general and white collar crimes in particular. The study found that tax evasion was viewed as only “somewhat serious”.

In general, white collar offences tend to be more “morally ambiguous” than blue collar crimes. As such, tax evasion also draws different perceptions from different people. Harun, Abu Bakar and Tahir (2011) conducted a study on accounting and business students in a local university and found that accounting students’ seemed to believe that tax evasion is never or almost never ethical, while business students perceived that tax evasion may be ethical under some circumstances and unethical

under other circumstances. Greene (2009), mentioned that data obtained through the World Values Survey indicated that a significantly higher percentage of citizens outside the US also believe that cheating on one's taxes is not wrong.

Thus, one reason for the steady increase of tax gap may simply be because taxpayers do not perceive tax evasion as a particularly serious offence, and people seemed to view tax evasion more like a violation than a crime and fail to see the seriousness of the act. Burton, Karlinsky and Blanthorne mentioned a report by the Wall Street Journal, which showed that under reporting of income by US taxpayers is one of the contributing factors to the US economy deficit. The tax gap was USD95 billion in 1992 and USD 275 billion in 1998. The current tax gap is estimated to be approximately USD310 billion.

Since the impact of tax evasion may actually be detrimental to a country's economy, there is a need to examine the factors contributing towards tax evasion.

## **FACTORS AFFECTING TAX EVASION**

According to Greene (2009), apart from the difficulty to distinguish between tax evasion and tax avoidance, there are several other reasons why people seem undecided about the seriousness of tax evasion, for example the inadequacy of enforcement practice, arbitrariness of enforcement, the sense that “everyone is doing it”, demonization of taxes, perceived unfairness of the tax code, and dissatisfaction with the use of revenues. Meanwhile, Fallan (1999) concluded that attitudes toward taxation have turned out to be an important predictor of tax evasion and tax compliance behavior.

Ahangar, Bandpey and Rokny (2011), did a study on tax evasion in Iran and concluded that among the factors contributing towards tax evasion are weakness of tax rules, accumulation of tax cases, complexity of tax laws, lack of proper tax culture, and corruption of tax agents.

Based on literatures, the factors affecting tax evasion can actually be categorized into two – internal and external. Examples of external factors are the inadequacy and arbitrariness of enforcement, and the loopholes and complexity in the tax laws. However, much more important is the internal factors – factors inside the individual doing the act; for example the need for more money, the knowledge on how to break or bend the tax laws, and the rationalization of the act.

Rationalization, which is a very dominant internal factor, is when people find reasons to justify their wrongful acts. Examples of rationalizations are denial of responsibility, denial of injury, denial of the victim, condemnation of the condemners, appeal to higher loyalties, everyone else is doing it, and entitlement (Brooks & Dunn, 2012).

Examples of rationalizations among taxpayers may be as follows:

- denial of injury – no one gets hurt if I do not pay tax
- denial of the victim – no one is a victim if I do not pay tax since I am not stealing from anyone

- condemnation of the condemners – it is alright not to pay tax since the tax laws are unfair, the tax collected will not be used appropriately
- everyone else is doing it – many other people, with more income than me, actually cheat on their tax
- entitlement – I have the right to reduce my tax payment, the country has already collected substantial amount of tax

Meanwhile, for tax agents, the rationalizations may be as follows:

- denial of responsibility – I am not actually responsible for this, my clients asked me to do so
- denial of injury – no one gets hurt if my client does not pay the actual amount of tax
- denial of the victim – no one is the victim if my client does not pay the actual amount of tax, my client does not steal from anyone
- condemnation of the condemners – the tax laws are unfair and the tax collected will not be used appropriately, therefore it is alright if my client does not pay the actual amount of tax
- appeal to higher loyalties – my main duty is to help my clients reduce their tax payment, I was paid to do just that
- everyone else is doing it – all other tax agents are also assisting their clients to reduce tax
- entitlement – I have the right to assist my clients in reducing their tax payment

While external factors can be controlled by constant improvement of the tax laws and more effective enforcement of the laws, it is more difficult to do so for the internal factors. Ideally, the presence of internal self controls and supportive professional self-regulatory controls are very much needed in order to curb tax evasion intentions (Stuebs & Wilkinson, 2010). When internal factors such as rationalizations and intentions are concerned, perhaps a better way to address the tax evasion problem is by cultivating an ethical culture towards the payment of tax. Taxpayers and tax agents alike should first ask themselves whether what they intend to do is ethical or not, rather than whether it is legal or not. Ethical values should be used to help draw the line in deciding what can or cannot be done to reduce tax payments.

## CONCLUSION

It is undeniable that the amount of tax gap, which is basically due to tax evasion, is significant and increasing. Though many would agree that tax evasion is unethical, the act is still taking place despite various measures taken by the tax authority. People need to be educated that tax evasion is a breach of the moral obligation to obey the law, which may be likened to cheating and stealing. Tax evasion is a type of money laundering and a financial crime, and should not be rationalized in any

way by both taxpayers and tax agents. Tax agents, who are accountants by nature, not only have the responsibility towards their clients, but also towards the profession and society at large. They not only have to advise their clients on how to effectively and legally reduce their tax liability, but they also need to educate their clients that these should be done ethically.

To date, there have not been many studies done on the tax practitioners' intention to assist in tax evasion. Since the environment encountered by tax practitioners is different from accountants or auditors (Doyle, Recknall-Hughes & Summers; 2009) and most recent empirical studies relating to ethics in taxation have focused on taxpayers rather than professional tax advisors, it is suggested that more research is done to determine the factors affecting tax practitioners' perception and intention towards tax evasion. Judging from the increasing amount of tax revenue lost due to tax evasion, this kind of research is important and timely as it will enable the tax authority to understand those factors and take actions to alleviate the problem. Findings of those research could provide an understanding of the circumstances leading to, and enabling any kind of offence, violation, or white collar crime, and the motivation for those acts. This will definitely provide the foundation for preventive measures which would subsequently increase the country's tax revenue.

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