



**IF** given the choice, would you pay taxes? Maybe not! That is why a well-structured and equitable penalty system is crucial

to encourage voluntary compliance with tax laws and payment of taxes. This is especially critical to the success of a self-assessment system like ours, where a taxpayer computes, self-assesses and pays the correct amount of tax due.

### Offences and penalties

Offences under the Income Tax Act 1967 (the Act) include underestimating taxes, failing to file tax returns on time, incorrect returns, late payment of taxes, wilful default and tax avoidance.

Are our existing penalty provisions – which have remained pretty much unchanged since the inception of the Act in 1967 – still relevant under the current self-assessment system? Let's examine a few common offences and the resulting penalties.

### Late filing of returns

If you file your tax returns (either manually or electronically) late, you would end up paying a penalty which, in practice, is computed at rates ranging from 20% to 35% (depending on the extent of lateness) on the tax charged.

As a taxpayer, you pay income tax in instalments to the Inland Revenue Board (IRB) during the year based on the Schedular Tax Deduction system (for individuals) or your tax estimates (for non-individuals). Any balance of tax (shortfall between your final tax liability and tax instalments paid) is payable on the due date for the submission of your tax return.

Here's an example. Let's assume three taxpayers in the table below filed their tax returns only two years after the due date. Applying the penalty table, all three taxpayers will be liable to a late filing penalty of RM50,000 each. This is computed at 25% of the final tax liability of RM200,000 and not the balance of tax due at the submission date.

The current penalty system does not distinguish the three taxpayers – taxpayers A and C with a balance tax payable of RM10,000 and RM200,000 respectively, while taxpayer B is in fact in a tax refundable position.

Although the three taxpayers have committed the same offence by filing their returns late, the penalty imposed is disproportionate to the impact of the offence committed.

### Incorrect returns

If an incorrect return is filed, the law dictates that a penalty of up to 100%



# Time to reform tax penalties?

Penalty provisions may be irrelevant as they've practically remained unchanged since 1967



by Phan Wai Kuan

**“What's needed is a robust penalty system that will deter non-compliance, yet isn't so punitive that it totally discourages compliance by taxpayers.”**

of the tax undercharged is imposed. In practice, this is usually reduced to a concessionary rate of 45%. The main issue, however, is the lack of clarity on what constitutes an “incorrect” return. Tax returns which intentionally disregard tax laws obviously are classified as incorrect returns. But differences in technical interpretation between the taxpayer and the IRB, should not automatically render a return incorrect. In reality, every time a taxpayer takes an opposing technical position to the IRB, the tax return is deemed incorrect.

This blanket treatment by the IRB has led to a recent trend of appeals to the courts against the imposition of penalties for incorrect returns. The courts in many of these cases have ruled in the favour of taxpayers that the penalty provision for incorrect returns should not apply. The judges have clearly stated that the law would punish taxpayers who deliberately submit incorrect tax returns and information. Where a taxpayer has demonstrated that the “incorrect” return was submitted in good faith,

no penalty should be imposed as there is no wrongdoing on the part of the taxpayer.

### Amendment of tax returns

Very often, there is a need to amend tax returns filed to correct errors made. These errors are either unintentional (such as arithmetical or transposition errors) or unavoidable (such as due to subsequent late accounting adjustments). What is disturbing is the authorities will invariably invoke the incorrect return provision of the Act, and impose penalties resulting in additional tax, when a voluntary amendment is made. This means taxpayers are punished for trying to do the right thing! This practice could undermine voluntary compliance, which goes against the objective of penalties.

### A balancing act

What's needed is a robust penalty system that will deter non-compliance, yet isn't so punitive that it totally discourages compliance by taxpayers. A delicate balancing act, indeed.

To address the shortcomings of the existing penalty provisions, here are my recommendations:

### ► 1. Differentiate penalty from compensation

The authorities could consider differentiating penalty (which is a punishment for the offence committed) from compensation (for loss of use of money suffered by the government that results from non-payment or late payment of taxes). The compensation should be computed on outstanding taxes and not the final tax liability as in the example above. This is not only fair but also clearly seen as equitable by taxpayers.

### ► 2. Degree of culpability

The severity of penalty should be based on the seriousness of the offence and not purely the tax liability involved. In many countries, a heavier penalty is imposed for more serious offences as compared with lesser ones. In the United Kingdom, repeated offences attract a higher penalty. Australia practises a penalty units system where more serious offences will be subjected to more penalty units, each unit being a fixed sum of fine (currently a single penalty unit is A\$170).

### ► 3. Reasonably arguable position

To overcome the unjust treatment of difference in technical interpretation, the concept of “reasonably arguable position” (RAP) is worth exploring. If a taxpayer can demonstrate that the treatment adopted by him is a RAP based on the tax laws, he should not be penalised despite the IRB taking a different view. However the introduction of a RAP has to be carefully thought through and clear guidance provided as to what is acceptable as a RAP.

### An overdue reform

An effective penalty system should complement the self-assessment system. The hallmarks of a good tax penalty system – equitable, proportionate, clearly defined and even-handedly administered – should feature in the system. At the same time, tax administrators should give due consideration to the facts and circumstances of each case, and enforce the penalty provisions judiciously.

Perhaps, most importantly, when crafting and implementing tax laws on penalties, we should not lose sight of the reason these tax penalties exist at all: to encourage voluntary compliance and deter tax offenders. **FOCUSM**

**Phan Wai Kuan** is senior executive director of PwC Taxation Services Malaysia

### Blanket treatment for late filing of returns

	Taxpayer A RM	Taxpayer B RM	Taxpayer C RM
Taxpayer's final tax liability	200,000	200,000	200,000
Less: Tax instalments paid	(190,000)	(220,000)	-
Balance of tax payable/(refundable)	10,000	(20,000)	200,000
Penalty for late filing of returns @ 25%*	50,000	50,000	50,000

\* Assuming the tax return is filed two years after the due date