As palm oil production requires close coordination between harvesting and processing, large-scale plantations, in theory, have comparative advantage over smallholders. But in Malaysia, the planted area of smallholder land continues to increase. We try to explain this by examining the details of land and labor use of oil palm smallholders in Malaysia. We hypothesize that “smallholders” are not exactly like what people perceive – local indigenous people who own land and cultivate using family labor. We examine how they are using their land and labor in detail based on fieldwork. The findings were then analyzed using a transaction costs approach to explain the rationale of smallholders’ current practices. We find that landownership and family labor are not the defining features for oil palm smallholders. In the smallholder sector, an oil palm plantation cultivator may be a landowner, a rent tenant, or a specialized service provider known as contractor. Regardless of the landownerships, smallholders rely on foreign hired labor to complete the major tasks in plantation. Family labor is only in charge of miscellaneous tasks such as making input decisions, supervising and monitoring labor, and search for buyers. Typically, a smallholder-manager is appointed among the family members to run the plantation. We further reveal that the hired labor is paid on a piece-rate basis, which is similar with that of large-scale plantation. We find that the physical environment attributes of a smallholder plantation make policing theft a costly effort, hence smallholder’s physical presence is required to monitor labor behavior even when piece-rate contract is in place. The appointment of a family member as smallholder-manager is the best available option, even though this practice runs a risk of the other family members being cheated by the appointed one. Our findings indicate that smallholders, though indirectly provide an avenue for foreign workers to earn higher (and fairer) income, suffer from high transaction costs that inhibit the more effective use of resources and the adoption of innovative means of production.