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Digital Tax Regime In Malaysia

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With fast-paced technological advancement, the digitalisation of the economy has brought about a wide range of tax implications. For instance, there is a lack of domestic tax rules which brings to tax profit from digital services rendered overseas without a physical presence in the relevant country. To counter this, numerous countries around the world have introduced digital services tax (DST) recently to bring to tax services rendered in the virtual economy.

This alert discusses some key aspects of the services tax imposed on digital services and the potential legal issue that arises on this aspect.

Tax Challenges Of The Digital Economy

In light of the growth of the digital economy, the Base Erosion and Profit Shifting (BEPS) project by the Organisation of Economic Corporation Development (OECD) through Action 1 addresses the tax challenges faced by countries in the growth of digital economy. On 8.10.2021, 136 countries out of 140 members of the OECD/G20 Inclusive Framework on BEPS had reached an agreement to the Two-Pillars Solution, which states that:

- **Pillar One:**
Members are required to achieve a fairer distribution of profits by reallocating some taxing rights from a multinational enterprise (MNE)'s home country to market jurisdictions where it has business activities and profits, regardless of whether the firm has a physical presence in those jurisdictions.
- **Pillar Two:**
Certain MNEs will be subject to a minimum tax rate of 15%.

Amongst others, one of the key elements in Pillar One is the removal of DST and other relevant measures to prevent harmful trade disputes. There is a disparity in the reaction by participating countries in response to the Two Pillars Solution.

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At the time of writing, the United States had recently terminated its threat of tariff on some European countries¹. In exchange, those countries agreed to remove the DST imposed on US' large highly profitable corporations². Several countries such as Singapore³, India⁴, Indonesia⁵, Austria⁶, Italy⁷ and Norway⁸ have imposed DST with different tax rates ranging from 3% to as high as 25% before the said agreement was reached.

Malaysia's Position

Malaysia is one of the pioneer countries in South-East Asia, which extended the scope of its indirect tax to cover the supply of foreign digital services. As of 31.7.2020, there are approximately 248 registered foreign services providers (FSP)⁹ in Malaysia, which includes Netflix Inc, Spotify and Google. The Malaysian government through the Royal Malaysian Customs Department has collected approximately RM427.6 million¹⁰ in revenue from DST last year.

Effective from 1.1.2020¹¹, a FSP is required to pay services tax at the rate of 6% on the digital services that it provides to a consumer in Malaysia pursuant to Section 56A, Part IXA of the Service Tax Act 2018 (STA). In order to determine whether one is subject to service tax, it is crucial to refer to the definitions of the "foreign registered person", "digital service", and "consumer". Reference is made to the definitions of registered person which should be read together with the definition of the foreign service provider under Section 2 of the STA, which provides that:

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¹ <https://www.reuters.com/world/europe/european-countries-reach-digital-services-tax-deal-with-us-2021-10-21/>

² <https://www.reuters.com/world/europe/european-countries-reach-digital-services-tax-deal-with-us-2021-10-21/>

³ Goods and Services Tax Act (Chapter 117A)
<https://sso.agc.gov.sg/Act/GSTA1993>

⁴ Finance Act 2020

⁵ Regulation (Peraturan Menteri Kewangan) No.48 of 2020

⁶ Digital Tax Act 2020

⁷ Law No.160 of 27.12.2019

⁸ Value Added Tax (VAT) Act No.58 of 2009

⁹ <https://themalaysianreserve.com/2020/09/10/govt-to-collect-rm300m-of-digital-tax-this-year/>

¹⁰ <https://www.malaymail.com/news/malaysia/2020/12/17/deputy-minister-roughly-rm427.6m-in-tax-revenue-collected-from-digital-serv/1932779>

¹¹ Service Tax (Amendment) Bill 2019

“means any person who is outside Malaysia providing any digital service to a consumer and includes any person who is outside Malaysia operating an online platform for buying or selling goods or providing services (whether or not such person provides any digital service) and who makes transactions for provision of digital services on behalf of any person”

Under Section 2 of the STA, digital service is defined as follows:

“digital service means any service that is delivered or subscribed over the internet or other electronic network and which cannot be obtained without the use of information technology and where the delivery of the service is essentially automated”

Digital services will only be subject to service tax at 6% if the value of the services rendered in Malaysia exceeds the threshold of RM 500,000 for a period of 12 months. The service tax will be accounted for by the consumer at the time when the payment is received by the FSP and to be remitted to the Customs.

Double Taxation

Section 2 of the STA defines the word “consumer” as follows:

“Consumer” means any person who fulfils any two of the following:

“1. Makes payment for digital services using credit or debit facility provided by any financial institution or company in Malaysia;

2. Acquires digital services using an internet protocol address registered in Malaysia or an international mobile phone country code assigned to Malaysia;

3. resides in Malaysia.”

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It is observed that the definition of “consumer” under STA does not limit to only business-to-consumer. The definition of “consumer” is wide enough to include to Business-to-Business (B2B) model which includes Malaysian incorporated companies. The implementation of DST raises concerns about local businesses in Malaysia due to the wide definition of the “consumer” under STA. It does not seem to be consistent with the Parliament’s intention of creating a competitive environment for the local and foreign suppliers as it increases the cost of business by foreign service providers¹². As a result, this would not only raise the costs borne by the FSP but also the costs that are borne by the local companies that subscribe to the digital services.

Another concern raised is that Malaysian businesses could be subject to double taxation if the same service falls within the ambit of “digital services” and “imported taxable services” under Section 2 of the STA. In order to mitigate double taxation and its impacts on businesses, several measures were introduced such as B2B exemption under Service Tax (Persons Exempted From Payment of Tax) Order 2018 (the Exemption Order), intra-group relief¹³, exemption on online distance learning services, online newspapers, online journals, and periodicals.

Pursuant to paragraph 3 of the Exemption Order, a Malaysian company that acquires digital services from FSP which is subject to service tax, is exempted from self-accounting for service tax. As a result, the imported digital services would only be subjected to service tax for only once if the stipulated conditions are fulfilled.

Enforcement Of The DST

To date, there are no reported cases in Malaysia in respect of DST related matters. As most FSPs do not have any legal presence in Malaysia, it remains uncertain as to how the Customs will enforce the new digital tax regime at this juncture. For instance, how the Customs intend to compel FSPs which meet the threshold stipulated and register for digital service tax.

¹² <https://www.malaymail.com/news/malaysia/2020/12/17/deputy-minister-roughly-rm427.6m-in-tax-revenue-collected-from-digital-serv/1932779>

¹³ Regulation 5A, Service Tax (Digital Service) Regulations 2020

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It is foreseeable that the Customs will face difficulties to identify the type of digital services that fall within the ambit of STA due to the wide definition of the word “digital service”. As such, it is pertinent to assess tax and regulatory implications involving the business structures of the FSP. Furthermore, no clear measures in the enforcement of the DST are in line with the existing double taxation treaties with other countries were proposed.

Conclusion

As the law in respect of digital services tax is still evolving, it is pertinent for the FSP to keep abreast of the updates in respect of the STA. In view of the above, it is crucial for businesses to maintain proper documentation in ensuring compliance under the STA. As stipulated under the STA, failure to comply with the provisions is an offence and subject to penalties. Examples include the failure or late application for registration, late payment of service tax on digital service, failure to keep records etc. In this regard, FSPs are encouraged to seek consultation from tax solicitors to ensure compliance with local regulations and to preserve its rights.

Whilst the Customs have the power to sanction non-compliant companies. It should be noted that such power must be within the jurisdictions accorded by the STA. As Malaysia is one of the countries that has imposed DST, this may undermine tax certainty and investments and increase the compliance and administration cost of the MNEs. As such, it is noteworthy to observe the development of the legislation change in Malaysia considering the recent agreement in the Two-Pillars Solution to guarantee tax certainty, which is essential to the economy.

Authored by Yap Wen Hui, an associate from the firm's Tax, SST and Custom practice.

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