

## Digital Services Tax Laws in Malaysia: A Changing Landscape

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### ABSTRACT

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The COVID-19 pandemic has accelerated global e-commerce growth and consequently, online transactions have become the new norm. Unfortunately, such digitalisation of the economy has not been adequately captured by the current international tax system as it only requires multinational enterprises to pay tax where production occurs. Therefore, numerous countries have imposed the digital services tax (DST) as an interim measure to address the tax leakage issue due to the expansion of market coverage. DST targets foreign service providers which do not have a physical business presence in jurisdictions where their consumers are located. Nevertheless, the establishment of such a tax has brought about some challenges. Hence, this research examines the structure and operation of DST in Malaysia, as well as the challenges associated with its implementation while contrasting them with the European countries, being the pioneers in DST. The research employs a qualitative method through a doctrinal study of the legal framework that regulates the execution of DST, as well as published works on the subject. The data is then analysed utilising the content analysis approach. Specifically, the findings of this research identify the possibility of a changing landscape in the implementation of DST due to the two-pillar approach approved by the members of the OECD/G20 Inclusive Framework on the Base Erosion and Profit Shifting (BEPS) project. As a result, this research provides a foundation for further research that will analyse the relevance of DST in light of the recent development within the international tax system.

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**Contribution/Originality:** This study contributes to the existing literature on the newly introduced indirect tax in Malaysia i.e., the digital services tax, which mirrors the global implementations, particularly in European countries. This study also highlighted

the challenges of its implementation, as well as the possibility of its change in the near future.

## 1. Introduction

Rapid technological advancements and digitalisation are influencing the world today, with countries and businesses shifting to more efficient and sustainable digital models. The COVID-19 pandemic has also accelerated e-commerce growth across the globe, where online transactions have now become the new norm. Businesses can now generate revenue from a broader consumer base, including those located outside their home country, thanks to digitalisation. Since e-commerce businesses generally do not pay tax in foreign jurisdictions where they do not have a physical business presence, the expansion of market coverage has indirectly resulted in tax leakages (Cheng & Ong, 2021) leaving many countries dissatisfied with how FSPs get away with not paying taxes while profiting from their jurisdiction (Ling & Fork, 2020). This is due to current international tax rules, which require multinational enterprises (MNE) to pay tax where production occurs rather than where consumers or, more specifically, users are located. Concerns have been expressed that the current international tax system does not adequately capture the digitalisation of the economy, and there is undoubtedly a lack of domestic tax rules addressing this issue (Asen & Bunn, 2021). To counter this, and to ensure a level playing field between local and foreign service providers (FSP), as well as to foster a sustainable business environment, several countries around the world imposed a service tax on digital services (DST) as interim measures despite abandoning the requirement that a foreign company have a physical presence in order to be taxed (Ling & Fork, 2020). In line with global taxation trends, Malaysia, along with Indonesia and Singapore, is one of the first countries in Southeast Asia to broaden the scope of its indirect tax to include the provision of foreign digital services. Malaysia has approximately 300 registered FSP as of July 23, 2021 (Yap, 2021). Reputable search engine companies, online gaming and software developers, leading online advertisement platform providers, and reputable internet-based telecommunications companies, primarily from China, Europe, Japan, Singapore, and the United States of America, are among these FSP (Cheng & Ong, 2021). In 2020, the Malaysian government collected approximately RM 427.6 million (\$101 million) in DST revenue through the Royal Malaysian Customs Department (RMCD) (Yap, 2021). This new taxation trend appears to be the best way for the government to increase revenue collection.

## 2. Literature Review

### 2.1. Information & Communications Technology (ICT) and the Digital Economy

As it is a much broader and more interconnected sector of the economy than more traditional sectors, the ICT industry plays a critical role in the nation's development, accounting for 15.6% of GDP in 2020. The ICT sector's services are diverse, encompassing ICT-related activities such as manufacturing, trade, as well as, content and media. In line with this, the ICT industry as a whole has provided employment opportunities to over 1 million people, accounting for 7.5% of total employment in Malaysia. Due to its diverse range of sectors and operational areas, the digital economy has become a rapidly expanding area of opportunity in Malaysia and around the world. The economic contribution of the digital economy to Malaysia's GDP is expected to rise to 22.6% by 2025,

with efforts to boost digital transformation to enhance Malaysia's competitiveness, empowering all industries and local micro, small and medium-sized enterprises (MSME) to participate in complex activities with higher value-add (Prime Minister's Department, n.d.). Globally, the definition of the digital economy varies. Various entities, including academics and international organisations, have conceptualised the digital economy since the late 1990s. While there is no universal definition, digital technologies continue to be the distinguishing feature of the digital economy. In Malaysia, the digital economy is defined in Malaysia Digital Economy Blueprint (MyDIGITAL) as "economic and social activities that involve the production and use of digital technology by individuals, businesses and government" (Prime Minister's Department, n.d.). The government established the Multimedia Super Corridor (MSC) in 1996 to promote the country's digital economy as the first step toward transforming Malaysia into an advanced nation by introducing high-technology business districts and special economic zones. Since then, a number of initiatives have been launched to attract high-quality investment into Malaysia, while also acknowledging the digital economy's interconnected nature as a sector rapidly evolving beyond traditional ICT-related roots. MyDIGITAL is, indeed, one of these national initiatives that represent the government's ambition to successfully transform Malaysia into a digitally-driven, high-income nation and regional leader in the digital economy. It outlines the efforts and initiatives that will be undertaken to realise MyDIGITAL's goals. The Blueprint plots the trajectory of the digital economy's contribution to the Malaysian economy and lays the groundwork for driving digitalisation throughout Malaysia, including bridging the digital divide. For the purposes of its delivery, MyDIGITAL Corporation was established and amongst the initiatives laid down in MyDIGITAL is to introduce a tax framework that is appropriate for the digital economy's growth to ascertain that income earned in Malaysia from cross-border digital activities is taxed in Malaysia. Hence, to achieve this objective, clear tax frameworks and guidelines for businesses that derive income from the country's digital economy must be created, so that the government's tax base can be broadened, as well as fair competition for local businesses can be facilitated (Prime Minister's Department, n.d.).

## 2.2. Digital Services Tax Laws in Malaysia

### 2.2.1. *The Service Tax Act 2018 and the Service Tax (Digital Service) Regulations 2019*

Prior to 1 January 2019, no service tax was levied on any service imported by businesses or individuals. However, beginning on 1 January 2019, the government began levying service tax on imported taxable services consumed by businesses. Consequent to this, another change in service tax legislation is introduced via the Service Tax (Amendment) Act 2019, which was passed in 2019. With effect from 1 January 2020, FSP are required to pay DST at the rate of 6% under Section 56A, Part IXA of the Service Tax Act 2018 (STA) for the importation of digital services to Malaysian consumers (Ling & Fork, 2020). However, this 6% tax rate is likely to be a major concern for FSP as it is much higher than the digital service taxes in many other jurisdictions as can be seen in Table 1 below. To determine as to whom are subject to DST, the term FSP is defined under Section 2 of the STA, which provides that:

*"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”.*  
(Service Tax Act, 2018)

Nevertheless, according to Regulation 2 of the Service Tax (Digital Service) Regulations 2019 (the 2019 Regulations), digital services will only be subject to a 6% DST if their value exceeds RM 500,000 over a 12-month period, in which case they are required to register with RMCD for DST collection purposes (Ling & Fork, 2020). The consumer will account for DST when the payment is received by the FSP and must be remitted to the RMCD on or before the deadlines.

### 2.3. The Digital Services Tax in European Countries

In Europe, DST is in effect in Austria, France, Hungary, Italy, Poland, Portugal, Spain, Turkey, and the United Kingdom. Nonetheless, the structure of DST implementation in these countries differs significantly, as shown in Table 1 below (Asen & Bunn, 2021).

Table 1: Implementation of DST in European Countries

Country	Tax Rate	Scope	Remarks
Austria	5 percent	Online advertising	Narrow tax base
France	3 percent	Provision of a digital interface, targeted advertising, and the transmission of data collected about users for advertising purposes	Broad tax base
Hungary	7.5 percent (temporarily reduced to 0 percent)	Online advertising	Narrow tax base
Italy	3 percent	Advertising on a digital interface, multilateral digital interface that allows users to buy/sell goods and services, and transmission of user data generated from using a digital interface	Low tax rate
Poland	1.5 percent	Audiovisual media service and audiovisual commercial communication	Low tax rate
Portugal	4 percent and 1 percent	Audiovisual commercial communication on video-sharing platforms (4%) and subscriptions for video-on-demand services	Multiple tax rates
Spain	3 percent	Online advertising services, sale of online advertising, and sale of user-data	Low tax rate
Turkey	7.5 percent	Online services including advertisements, sales of content, and paid services on social media websites	High tax rate
United Kingdom	2 percent	Social media platforms, internet search engine, and online marketplace	Low tax rate

### 3. Methodology

This study's research design was qualitative in nature. This study took the form of doctrinal research, which deals with the law on a specific issue and analyses legal doctrine in terms of its development and applications (Abdullah, 2020). This type of research was chosen because the primary goals of this study are to discover, explain, examine, analyse, and present in a systematic manner facts, principles, provisions, concepts, theories, or the operation of specific laws or legal institutions (Yaqin, 2007). The study employs doctrinal analysis by reviewing existing primary sources such as statutory provisions and government reports, as well as secondary sources prepared by international organisations and academics.

### 4. Result and Discussion

#### 4.1. DST Implementation Issues

The concept of digital taxation is not new. Since 2013, “there has been talk at G20 level over the Base Erosion and Profit Shifting (BEPS) rules for the tax challenges arising from digital deals” (Schwab, 2021). Since then, DST has been implemented in many other countries that have passed laws governing digital services. However, there are issues and challenges in meeting the DST requirements in Malaysia. First and foremost, it is critical to refer to the definition of the term “digital service” in order to determine whether one is subject to DST. The STA defines “digital services”, in its interpretation provision, Section 2 as follows:

*“any service that is delivered or subscribed over the internet or other electronic network, which cannot be obtained without the use of information technology and where the delivery of the service is essentially automated”.* (Service Tax Act, 2018)

To reflect the above-mentioned definition, it is submitted that software or application provision, video games, music, e-books, films, online advertising services or platforms, online search engines and social networks, database and hosting, internet-based telecommunications, and online training courses are among the examples of digital services caught by the broad definition within the provision (Cheng & Ong, 2021). These examples of digital services, however, raise some intriguing questions. One of these questions is whether software, such as Microsoft Office 2019, should be classified as a digital service rather than digital goods, making its online purchase subject to DST. While purchasing Office 2019 grants the user a perpetual software licence, access to Office 365 is subscription-based. Besides, Office 365 will always be constantly improving with the most recent updates and features, whereas Office 2019 will not. Subscribing to Office 365 is thus analogous to paying for regular services over time, and the same cannot be said for Office 2019 (Ling & Fork, 2020). Further, the next question that arises is regarding the interpretation of the imposition of DST on the use of an online advertising platform. The reason why such use would be subject to DST is not immediately apparent to the layperson; for example, online advertising platforms, such as Lazada and Shopee, are typically free to end users, so there is nothing to tax in the first place. It, instead, aims to impose DST on payments made by sellers to an online advertising company in exchange for a platform on which to advertise and sell their products online (Ling & Fork, 2020). Next, the definition of digital service is expected to result in differences between the RMCD and FSP. One potentially contentious issue is what constitutes “essentially

automated” service delivery. There is certainly room to argue that online training and learning courses that include live lectures from a lecturer are not essentially automated because there is a significant amount of manual input involved (Ling & Fork, 2020). Another point of potentially contentious issue is whether the sale of goods bundled with digital services, such as the sale of a Google Home smart speaker with a three-month music subscription, is subject to the DST (Ling & Fork, 2020).

On another note, the implementation of DST also raises concerns for Malaysian businesses due to the broad definition of “consumer” under the STA as follows:

*“means any person who fulfils any two of the following: (a) makes payment for any digital services using credit or debit facility provided by any financial institution or company in Malaysia; (b) acquires digital services using an internet protocol address registered in Malaysia or an international mobile phone country code assigned to Malaysia; (c) resides in Malaysia.” (Service Tax Act, 2018)*

According to this definition, consumer comprises not only the Business-to-Consumer (B2C) model but also the Business-to-Business (B2B) model, which includes Malaysian-incorporated companies. This clearly contradicts the goal of creating a competitive environment for both domestic and foreign suppliers, as it increases the cost of doing business for FSP (Yap, 2021). As a result, the FSP’s costs would rise, as would the costs of local businesses that subscribe to digital services. Apart from this concern, such definition of “consumer” may lead to the contention that payment for digital services by a Malaysian resident using a credit or debit card issued by a Malaysian bank to FSP while travelling abroad should not be subject to Malaysian service tax as service tax should be charged only by the jurisdiction where consumption occurs unless, of course, those digital services are also consumed in Malaysia upon their return (Ling & Fork, 2020). The controversial definition could also be manipulated to provide a channel for DST avoidance, particularly for Malaysian residents with foreign debit or credit cards and those who can conceal their internet protocol addresses (Ling & Fork, 2020). Consumers of digital services can use Virtual Private Network (VPN) services to send encrypted data to the pages or websites they visit (Kesuma & Nurhidayati, 2022). According to Namecheap (2020), VPNs work by routing the internet connection network through the VPN 9 server that the consumer is on rather than the server of the internet service provider. In other words, the data sent comes from the VPN rather than the consumer’s computer. A person who accesses a page or website from an FSP that has been designated to collect DST can use the VPN to avoid current tax payment obligations. The use of a VPN can also make it appear as if the consumer in Malaysia is someone who lives or consumes services in another country. This can result in the loss of potential Malaysian DST receipts and/or the DST receipts being channelled as if they were receipts from other countries’ digital taxes (Kesuma & Nurhidayati, 2022).

Apart from the above-mentioned issues which revolve around the definitions of the terms in the STA, another issue raised which is slightly distinct is the possibility of double taxation faced by Malaysian businesses if the same service falls under the purview of “digital services” and “imported taxable services” under Section 2 of the STA, for example, online advertising services and certain information technology services provided by foreign digital companies to local businesses. In this regard, several measures, including B2B exemption under the Service Tax (Persons Exempted from Payment of Tax) Order 2018 (the Exemption Order), intra-group relief, and exemption on online distance learning services, online newspapers, online journals, and periodicals, have been

implemented to reduce double taxation. A Malaysian company that purchases digital services from a service-taxed FSP is also exempt from DST self-accounting. As a result, if the conditions are met, imported digital services will be subject to DST only once (Yap, 2021).

#### 4.2. Enforcement of the DST

Failure to comply with the provisions is a violation of the STA that is punishable by fines. Failure or late registration application, late DST payment, failure to keep records, and so on are examples of these violations. Nonetheless, no DST-related cases have been reported in Malaysia to date. Because the majority of FSP do not have a legal presence in Malaysia, it is difficult to determine whether the FSP is in default, despite the fact that the RMCD has the authority to sanction non-compliant companies under the STA (Yap, 2021). As a result, it is ultimately up to the goodwill of FSP to comply with the law, which is easier to secure from highly visible online giants such as Google, Facebook, Apple and Amazon so that they could avoid bad press. On another note, to facilitate cooperation and to rule out tax avoidance, particularly among small FSP, the RMCD should keep compliance costs to a minimum, such as simplifying the registration process and remittance of service tax (Ling & Fork, 2020).

#### 4.3. OECD Base Erosion Profit Shifting (BEPS) Project

To address the challenges of taxation in the digitalisation of the economy, Malaysia, along with another 136 members of the OECD/G20 Inclusive Framework on the Organisation of Economic Corporation Development's (OECD) Base Erosion and Profit Shifting (BEPS) project, approved a framework for the reform of international tax rules in November 2021 to end tax avoidance and ensure that multinational enterprises (MNE) pay a fair share of tax wherever they operate. Domestic tax BEPS caused by MNE exploiting gaps and mismatches in various countries' tax systems affects all countries. Because developing countries rely more heavily on corporate income tax, BEPS affects them disproportionately. As business operates on a global scale, governments must collaborate to combat BEPS and restore trust in domestic and international tax systems. Each year, BEPS practises cost countries up to 240 billion USD in lost revenue (Motala, 2019), which equates to 4-10% of global corporate income tax revenue. Despite differing reactions from participating countries such as the United States, Singapore, India, Indonesia, Austria, Italy, and Norway (White et al., 2021), a two-pillar approach to combating tax evasion, improving the coherence of international tax rules, ensuring a more transparent tax environment, and addressing the tax challenges posed by economic digitalization has been developed (OECD, 2021). Ultimately, these changes are expected to take effect from 2023 onwards. The first pillar of this two-pillar approach requires Members to reallocate some taxing rights from an MNE's home country to market countries where it has business activities and profits, regardless of physical presence (OECD, 2021). In other words, the company will be taxed regardless of whether it has a physical presence in those jurisdictions. As a result, Pillar One would supersede some existing MNE taxation norms and contradict some policies that countries, including Malaysia, have implemented to tax digital companies, most notably a DST to avoid damaging trade disputes (Yap, 2021). As a result, DSTs are expected to be repealed during a transition period that will conclude by the end of 2023 (Asen & Bunn, 2021). Pillar Two, on the other hand, seeks to establish a minimum global tax rate of 15% for MNEs with more than €750 million in annual gross revenue (OECD, 2021).

## 5. Conclusion

Since Malaysia is one of the countries that has implemented DST, this may jeopardise tax certainty and investments while also increasing MNE compliance and administration costs. According to the findings of this study, Malaysia's DST laws are still evolving. As a result, the evolution of Malaysian legislation in light of the recent agreement on the two-pillar solution to ensure tax certainty, which is critical to the economy is worth noting. In order to ensure compliance with the STA and avoid financial and reputational consequences, the FSP must also stay current on updates while maintaining proper documentation (Yap, 2021).

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