Digital Tax on Foreign Digital Service Providers to be Enforced from 1 January 2020

Introduction

The Government of Malaysia will impose a digital service tax of 6% on foreign digital service providers with effect from 1 January 2020, with the annual threshold being set at RM500,000, according to the Malaysian Deputy Finance Minister, Datuk Amiruddin Hamzah.

The digital tax regime was announced after the tabling of the Service Tax (Amendment) Bill 2019 ("**Amendment Bill**") on 8 April 2019, which was subsequently amended and passed by the lower house of the Malaysian Parliament. Upon the Amendment Bill being passed by the upper house of Parliament and receiving the royal assent, foreign digital service providers such as Spotify and Netflix will be taxed commencing 1 January 2020.

What is a Digital Tax?

The phrase "digital tax" generally refers to a levy mechanism imposed on providers of online or digital services. In the context of the Amendment Bill, "digital tax" refers to a service tax imposed on **<u>foreign</u>** providers of digital services that are targeted at Malaysian consumers.

The imposition of a digital tax on foreign providers of digital services follows on from an earlier announcement by the Finance Minister, Lim Guan Eng, during the tabling of Budget 2019, where the Minister first gave notice of the proposed implementation of a form of service tax on foreign digital services, including software, music, video streaming and digital advertising services.

Key Summary of the Recently Tabled Service Tax (Amendment) Bill

The proposed digital tax regime for Malaysia has been set out in the Service Tax (Amendment) Bill 2019.

Under the Amendment Bill:

(a) The proposed digital tax law will have extra-territorial jurisdiction, and shall be applicable to any person, of whatever nationality or citizenship, beyond the geographical limits and the territorial waters of Malaysia, if the person is a foreign service provider;

(b) A "*foreign service provider*" has been defined as any person who is outside of Malaysia providing any digital service to a consumer. It includes any person who is outside Malaysia operating an online platform for buying and selling goods or providing services (whether or not such person provides any digital service) and any person who makes transactions for provision of digital services on behalf of any person;

(c) A "*consumer*" has been defined as any person who fulfils any two of the following: (i) makes payment for digital services using credit or debit facility provided by any financial institution or company in Malaysia, (ii) acquires digital services using an internet protocol (IP) address registered in Malaysia or an international mobile phone country code assigned to Malaysia, and/or (iii) purchases or acquires digital services while residing in Malaysia;

(d) "*Digital service*", meanwhile, has been defined as any service that is delivered or subscribed over the Internet and other electronic network and which cannot be obtained without the use of information technology and where the delivery of the service is essentially automated.

The said digital tax will be imposed on digital services provided by foreign service providers and levied at the rate fixed in accordance with the Service Tax Act 2018, i.e. as determined by the Minister and by order published in the Gazette, by reference to the value charged by the foreign service provider. In this regard, the Minister has fixed the service tax rate under the Service Tax Act to be at 6%. The Minister has further prescribed that the said tax shall be applicable to all foreign digital service providers should they exceed the prescribed threshold value of RM500,000 in relation to the provision of digital services to Malaysian consumers.

Under the Amendment Bill, any tax defaulter can, upon conviction, be fined up to RM50,000, imprisoned for a term of up to three (3) years, or both.

Why Impose a Digital Tax?

This taxation measure is intended to level the playing field between physical and online stores, especially online stores owned by foreign companies.

"It's not fair if only the local digital service providers had to pay the tax. This is not a new tax, it's just having the scope extended to providers in other countries," according to the Deputy Finance Minister during the tabling of the Amendment Bill in the Parliament.

Once this digital tax regime is put in place, foreign digital service providers (such as Netflix, Spotify, etc) will be required to register with the Customs Department, apply the digital tax on their Malaysia resident consumers and remit the relevant tax to the Customs Department.

The Minister further stated that the Government has the power to enforce the law even if the foreign digital service providers were based offshore based on existing government-to-government (GTG) cooperation among countries involved in the Organisation for Economic Cooperation and Development (OECD), which would enable the Government to take legal action against foreign companies that refuse to pay the digital tax.

Digital Tax in Other Jurisdictions

Digital tax regimes have been introduced in several other jurisdictions as well. Countries such as Japan, South Africa, Norway, Russia, New Zealand, have similar taxes on digital services, with tax rates ranging from 5% to as high as 25%.

In Singapore, the government has announced plans to impose a goods and services tax on digital service providers that render their services from outside of Singapore, including content and music streaming services as well apps and games. Foreign digital service providers providing digital services to consumers in Singapore will have to register with the Singaporean tax authority for GST, where the provider: (i) has an annual global turnover exceeding SGD1 million, and (ii) offers B2C supplies of digital services to customers in Singapore exceeding SGD100,000. The tax on international digital services is set to come into effect from 1 January 2020 as well.

In the European Union, an earlier plan to introduce an EU-wide digital tax was recently scrapped after opposition from several member states. This latest development is likely welcomed by digital giants, such as Google and Facebook, who would otherwise been subjected to the envisaged 3% tax levy. Nonetheless, these digital service providers may still be subjected to similar taxes that several member states in th EU, such as France, Italy, Britain and Spain, have introduced and implemented at the national level. Austria, for example, has even recently announced its plans to increase its planned digital tax from 3% to 5%.

Potential Implications on Consumers of Digital Services

While the Deputy Finance Minister is optimistic that foreign digital service providers will be able to absorb the increased costs when the new tax is imposed (on the basis that the tax rate to be imposed in Malaysia would be lower than that charged in a majority of other jurisdictions with similar taxes), it remains to be seen if such a digital tax will result in an increase in service / subscription fees paid by Malaysian consumers as a consequence of foreign digital service providers passing on the cost to Malaysian consumers.

Apart from the above, the introduction of this digital tax regime may also be seen as an additional deterent factor and/or an added cost concern by potential new entrants considering entering the Malaysian online or digital services market. These concerns may potentially work to the detriment of Malaysian consumers, as this may ultimately result in there being fewer options for Malaysian consumers of digital services, as well as there being less downward pressure on service / subscription fees paid by Malaysian consumers as a consequence of lesser competition between digital service providers, in the event these potential entrants choose not to enter the Malaysian market.

Potential Implications on Foreign Digital Service Providers

Considering that digital tax is not an entirely new concept and has been introduced and implemented in several other jurisdictions, we have analysed some of the legal and commercial implications such a tax may have on foreign digital service providers:

a) Scope of "Digital Services" & Meaning of "Consumer"

Foreign service providers will need to identify and determine the type of services that will be subject to the proposed Malaysian digital tax.

The current definition of "*digital services*" appears to be wide enough to cover not only streaming services (such as Spotify or Netflix), but also the provision of any service that is delivered or subscribed over the Internet and other electronic networks, which may include the provision of e-commerce, cloud and matching platform services (such as eBay, Amazon Web Services or Airbnb).

Additionally, the definition of "*consumer*" under the Amendment Bill does not appear limited to only individuals using digital services for personal consumption or use, but can be interpreted widely enough to include Malaysian corporate entities and businesses as well.

If this is confirmed to be the case, digital services taken on by local corporations and businesses from foreign service providers, such as cloud computing (including Infrastructure as a Service, Platform as a Service, Software as a Service, Content as a Service), online advertising, social media content, software subscription, payment services, and platform services, may be construed to fall within the scope of the digital tax.

The impact of this on sectors such as banking and insurance, information technology services and telecommunications, which have readily adopted the use of such technologies, will need to be assessed and urgently addressed with the Government of Malaysia.

b) Registering with the Royal Malaysian Customs Department

Deputy Finance Minister Amiruddin Hamzah has stated that foreign digital service providers are to register with the Royal Malaysian Customs Department, from 1 October to 31 December 2019. With this timeline in mind, foreign service providers must ascertain their liability to be registered. Failure to register may result in a fine not exceeding RM30,000 or to imprisonment for a term not exceeding two years or both.

Being a registered foreign service provider carries an obligation to collect and remit the digital tax, and may also include the obligation to comply with requests for audits by the Customs Department.

As mentioned above, many countries have considered and implemented, or are considering the implementation of digital taxes. For foreign service providers with a worldwide client base, this may result in the need for monitoring and complying with multiple tax jurisdictions, resulting in increased compliance costs.

c) Enforcement

At this juncture, it is uncertain as to how our Customs Department will enforce the proposed digital tax regime on foreign based service providers. It is unclear if the digital tax will be in line with existing double taxation treaties that Malaysia has in place with other nations. The tax and regulatory implications involving the business structures of the foreign service provider will need to be assessed.

It is difficult to see how the Malaysian Customs Department will carry out enforcement actions on foreign service providers that have no legal presence in Malaysia. There is no incentive for such foreign companies to register with Customs Department. On the other hand, big players such as Netflix and Spotify are likely to comply with the tax provisions due to reputational concerns. To sanction non-compliant companies, authorities may potentially take steps to ban websites or platforms hosting such non-compliant service providers using technical measures such as geo-blocking. A more positive long-term effort would be for the Malaysian Customs Department to engage in international and inter-agency co-operation with other jurisdictions to ensure compliance by foreign service providers.

We trust that the above provides you with a quick update and analysis in relation to the forthcoming digital tax regime.

If you would like to discuss any of the above or if you have any questions regarding technology, media and telecommunications, please get in touch with any of the individuals listed below.

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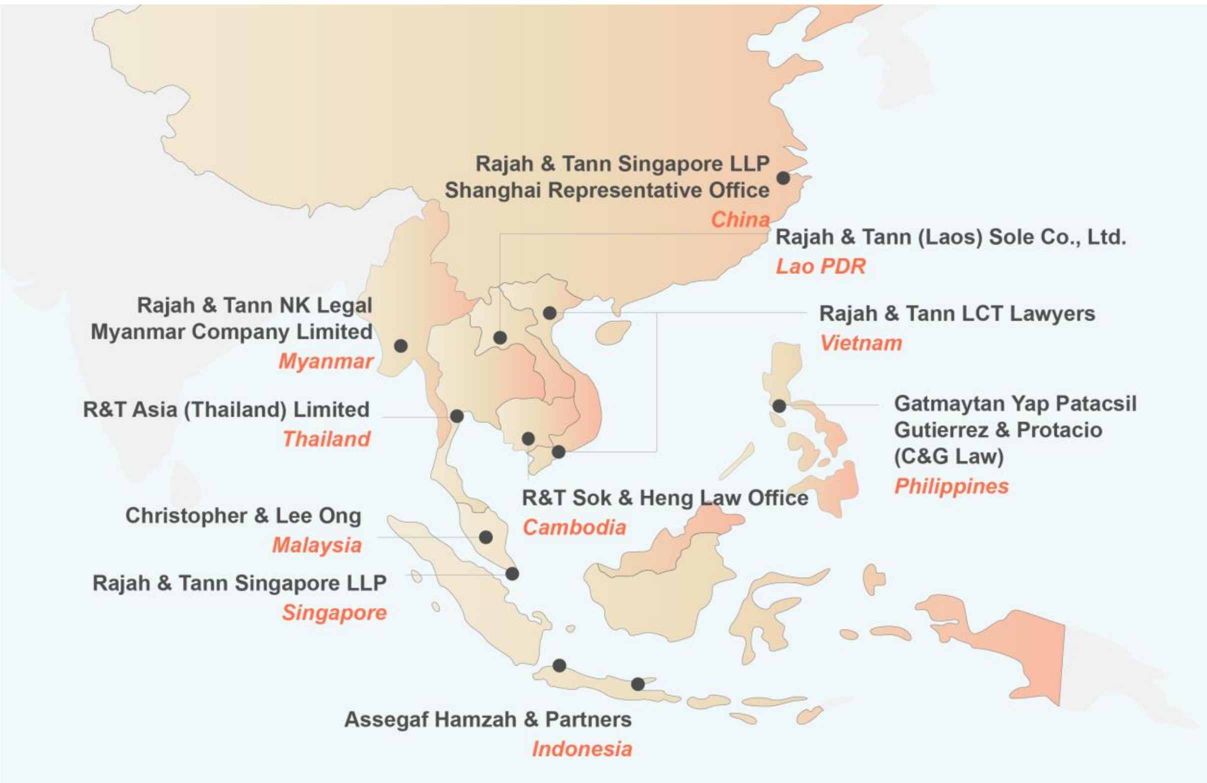

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