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Challenges Of Introducing Digital Tax

Recently, Deputy Finance Minister Datuk Amiruddin Hamzah revealed that a government study on the new tax mechanism for overseas digital service providers is under way. However, the government is undecided on whether digital taxation can be incorporated in the upcoming Budget 2019.

What then is digital tax? There is a common occurrence for digital businesses around the globe to escape taxes as they do not need any stores, factories or fixed places of business to provide their services to consumers in a country. The concept of permanent establishment, which essentially relies on effective physical presence and actual fixed places of business to determine where taxes are payable, is outdated as the digital companies can operate business virtually.

European Union's attempt to introduce digital tax

The European Commission has recently spearheaded a plan to introduce digital tax in the European Union. The first solution is to completely reform tax rules so that companies pay taxes in the countries where they have significant "interaction" with users through digital channels.

The second solution is an "interim tax", which is expected to be introduced by the end of this year. The tax will apply to profits created from activities such as online advertising space, digital intermediary activities and sale of data generated from user-provided information.

Value creation

Examples of user-provided information will be personal information collated by the likes of Instagram, Facebook and Twitter. Users on these platforms access news feeds and access is generally provided without requiring a fee.

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As these social media platforms offer access to users like us without any consideration, they have been collecting data about user interests, preferences and searches. Such data, used to generate profits from targeted advertising and to study or influence consumer behaviour, is of tremendous value in this day and age. However, at present, there is no effective mechanism to tax such activities and, if successfully implemented, the European Union will be the first jurisdiction to do so. Similarly, when one leaves a review or comment on Facebook regarding a restaurant or product, these reviews increase the value of the restaurant or product but again, such value creation is not taxed.

In addition, the presence of a huge Facebook, Instagram or Twitter user base in Malaysia, for instance, does not entitle the government to tax the business profits. This is also in part due to the fact that under the current concept of permanent establishment, large user participation is not directly equated to fixed place of business or effective business presence.

OECD's Task Force on the Digital Economy has mooted the idea of digital permanent establishment, but it remains to be seen whether this will be fully implemented in the near future.

OECD's position

The OECD has also recently issued the "Tax Challenges Arising from Digitalisation — Interim Report 2018". Among others, it acknowledges that goods or services are effectively traded without compensation, against other valuable inputs such as user engagement, user data or user-generated content. Therefore, because of such barter transactions, jurisdictions are unable to tax on both the purchase of those free goods/services or value created from data.

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For instance, digital platforms such as Uber will collect a significant amount of data of value, being the ride history, including origin and destination, payment details and basic user information, such as name, phone number and email address, which can be analysed to help the company tailor its services and pricing. The value created from the collation of data is, however, free of tax.

OECD also found that most countries take the view that non-financial compensation of such barter-trades is resulting in a huge loss of revenue. These countries support the notion that interaction between users and the digital platforms are transactions that should be subject to taxation. However, most, if not all, jurisdictions do not have a tax system in place as of yet that could tax on such interaction.

Conclusion

Malaysia should study the chain of value creation of all digital platforms in a thorough manner, as this is an issue that even the OECD Task Force has conceded to be extremely complicated and challenging. It is notable that neighbouring countries such as Singapore are in no rush to introduce digital tax (except to consider taxing it as a supply for GST purposes) and, as such, it begs the question why Malaysia is focusing on this when the existing tax laws are not effectively enforced against tax evaders, especially those with a disproportionate or unexplained amount of wealth.

If you have queries on matters pertaining to tax litigation, we are available to assist you. Please contact our tax partners Datuk D P Naban or S Saravana Kumar at tax@lh-ag.com

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