




Crowe Perspectives

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TAX: Tax Implications on Digital Services

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Tax Implications on Digital Services



It is amazing to see how quickly people turned to digital services in order to continue with what they do during the recent Movement Control Order (MCO) in Malaysia or lockdown in other countries. Whether you are under a lockdown or quarantine or MCO, you are still required to continue to reach out to your customers and support them as usual. This is fortunately possible in the current age of high technology.

Wider Adoption of Digital Services in Business

For example, those in the education and training industry have quickly switched to providing their sessions online using video chat applications such as Skype or Zoom. Emails, virtual private networks (VPNs), WhatsApp and video chat applications have enabled many white collar staff to continue with their work while working from home.

Some of these digital services are free but for some, a payment is required. Let us take Zoom as an example. A user can subscribe to the Basic Plan for free. If more features are required, one can subscribe for the Pro version which will cost USD14.99 per month.

Withholding Tax on Payment of Software Charges to Non-Residents

Generally, there are no withholding tax implications for individuals who make use of these applications for private consumption.

However, businesses are required to account for the withholding tax in order to avoid being penalised by the Inland Revenue Board of Malaysia (IRBM) for not complying with the relevant withholding tax provisions. Although withholding tax is supposed to be the costs for the non-residents, often, the Malaysian businesses are made to pay in situations where the non-residents refuse to bear the tax costs. To add to this, a business will not be allowed to claim tax deduction on the expenses incurred for failure to observe the withholding tax provisions.

When it comes to payments for digital services, it is important to distinguish between payments for services vis-à-vis payments for royalties. The reason for this is that payments for services and payments for royalties have different withholding tax implications. Payments for services are subject to withholding tax only if the services were rendered in Malaysia.

On the other hand, payments for royalties are subject to withholding tax regardless of where the rights are seated. That is the reason why most taxpayers would argue that digital services are indeed services in nature so as to alleviate them from the withholding tax burden on grounds of absence of physical services in Malaysia.

Services vs. Royalties

According to Section 4A of the Income Tax Act 1967 (ITA), the payments for services which attract withholding tax under Section 109B of the ITA are as follows:

- *amounts paid in consideration of services rendered by the person or his employee in connection with the use of property or rights belonging to, or the installation or operation of any plant, machinery or other apparatus purchased from, such person;*
- *amounts paid in consideration of any advice given, or assistance or services rendered in connection with the management or administration of any scientific, industrial or commercial undertaking, venture, project or scheme; or*
- *rent or other payments made under any agreement or arrangement for the use of any moveable property.*

The withholding tax provisions under Section 109 of the ITA are applicable on royalty payments. The definition of "royalty" in Section 2 of the ITA is quite lengthy. Hence, an excerpt of the definition that is relevant to this article is reproduced below:

"Royalty" includes any sums paid as consideration for, or derived from—

- *the use of, or the right to use in respect of, any copyrights, software, artistic or scientific works, patents, designs or models, plans, secret processes or formulae, trademarks or other like property or rights;*



IRBM's Withholding Tax Position on Digital or Online Services

One will note that the word “software” in the definition of royalty is wide enough to potentially cover digital services and applications like Zoom even though one may see it as a “service” of providing video chat.



In practice, the IRBM is inclined to take the view that payments made to non-residents for digital services can be somehow associated with the right to use software, hence are royalties in nature. One clear example is the IRBM's view adopted on digital advertisements e.g. payment to Google, Facebook, etc. where such payments have been construed as royalty payments because the Malaysian payer is granted the right to use the non-resident's software to design and develop its own advertisement campaign.

Withholding Tax Rate

The withholding tax rate for both services and royalties is 10% but depending on the tax treaty between Malaysia and the respective countries, the rate may be further reduced. Malaysia has signed tax treaties with over 75 countries, including most countries in the European Union, the United Kingdom, China, Japan, Hong Kong, Singapore, Australia, etc. to name a few. Certain tax treaties provide for the withholding tax rate on services and royalties to as low as 5%.

On this note, the double taxation agreement between Malaysia and the United States of America is of limited scope and does not address double tax issues relating specifically to services and royalties. Thus, the 10% rate shall be applicable for both service and royalty payments to a US resident.

Withholding tax is usually payable to the IRBM within one (1) month of crediting or paying the non-resident.



▶ Summary

In summary, services performed outside Malaysia are not subject to withholding tax. In contrast, royalty payments are subject to Malaysian withholding tax regardless of where the rights are seated. Therefore, whether to comply or not to comply with withholding tax on payments made on digital services would require a careful study of the nature of the payment via understanding of the contractual terms between the non-resident service provider and the user, i.e. the Malaysian company.

What may seem to be a “service” to the company, can turn out to be a “royalty” in the keen eyes of the IRBM. The repercussions can be huge on the pocket of your business, especially over a long term if this is not clarified at the initial stage.

Hence, it is always best to seek professional tax advice if one is unsure of the nature of the payment for digital services.



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