



Digital Companies: Tax Threats & Opportunities

1. Introduction

The world's digital economy has been growing steadily over the past decade. Not to be left behind, the Malaysian government has recognized the opportunities as well as the challenges that the digital economy can bring to the growth of the Malaysian economy as well as an additional source of revenue.

To quote Bradley Walsh:-
"The times change, and if you don't change with them, you get left behind."

In the report on e-Conomy SEA 2021: Roaring 20s – The SEA Digital Decade¹ by Google Inc., Temasek Holdings Ltd and Bain & Co estimate Malaysia's digital economy to be at RM88.41 billion in gross merchandise value. It is also reported that Malaysia will have a fast digital market growth of 47% from

US\$14 billion to US\$21 billion in 2021 while expecting growth to continue to US\$19 billion by 2025¹. Such growth will help companies in other industries as the adoption of technology, i.e. Big Data, Internet of Things, artificial intelligence, etc. can improve the operational efficiencies of businesses and reduce costs.

The Malaysian government has also developed Malaysia Digital which is an initiative to accelerate the growth of the country's digital economy via three key principles, i.e. flexibility, agility and relevance. The government hopes that this initiative will transform Malaysia's digital economy ecosystem through the following three (3) strategic priorities²:

- 1) Drive digital adoption among entrepreneurs, companies and people.
- 2) Support local tech companies to become "Malaysian Champions".

- 3) Attract high value digital investments.

In this article, we will look at the key tax threats and opportunities faced by the digital companies incorporated in Malaysia, whether locally or via foreign investments and foreign digital service providers.

2. Tax opportunities

a) Tax Incentives for Malaysian Digital Companies

In line with the Malaysian government's initiative to promote the growth of the digital economy, several incentives have been introduced for digital companies. We will look into two (2) major incentives which are the MSC Malaysia Status (Pioneer Status) and the tax incentive for intellectual property ("IP") development.

¹ MIDA, Malaysia's digital economy to see higher boost on 2 December 2021, <https://www.mida.gov.my/mida-news/malaysias-digital-economy-to-see-higher-boost/>
² The Edge Markets, Malaysia Digital to boost growth of nation's digital economy, says PM on 4 July 2022, <https://www.theedgemarkets.com/article/malaysia-digital-boost-growth-nations-digital-economy-says-pm>

i) MSC Malaysia Status

Companies engaged in any MSC Malaysia promoted activities are entitled for tax incentives under the MSC Malaysia Status which is governed by the Malaysia Digital Economy Corporation (“MDEC”). The eligible company can qualify for Investment Tax Allowance (“ITA”), an incentive for which the application has to be submitted to the MDEC.

Category	Details
Eligibility Criteria	<p>To be eligible to apply for the award of MSC Malaysia Status, the company is required to meet the following criteria:</p> <ul style="list-style-type: none"> a) Company incorporated under the Companies Act 2016 and resident in Malaysia; b) Proposing to carry out one (1) or more of the MSC Malaysia promoted activities as listed below and has not issued any invoice for such proposed activities in Malaysia on the date of application (concession is given whereby a company which has issued an invoice may be eligible if it has at least 60% Malaysian equity ownership and has issued its first invoice for such proposed activities in Malaysia not more than twelve (12) months prior to the date of application); and c) Has not been granted tax exemption by the Malaysian government in respect of the income from any activity on the date of application. <p>If a company has a related company which has been granted tax exemption in respect of the income from an activity which falls under any of the items of the MSC Malaysia promoted activities, such company shall not be eligible to apply for the financial incentive under MSC Malaysia in respect of a proposed activity which falls under the same item.</p>
List of promoted activities	<p>The provision of services in relation to any of the following technologies qualify as promoted activities:</p> <ul style="list-style-type: none"> a) Big data analytics (“BDA”); b) Artificial intelligence (“AI”); c) Financial technology (“FinTech”); d) Internet of things (“IOT”); e) Cybersecurity (technology / software / design and support); f) Data centre and cloud (technology / software / design and support); g) Blockchain; h) Creative media technology; i) Sharing economy platform; j) User interface and user experience (“UI/UX”); k) Integrated circuit (“IC”) design and embedded software; l) 3D printing (technology / software / design and support); m) Robotics (technology / software / design); n) Autonomous (technology / software / design and support); o) Systems / network architecture design and support; or p) Global business services or knowledge process outsourcing excluding non-technical and/or low value call center; data entry; and recruitment process outsourcing. <p>The following activities do not fall under the MSC Malaysia Promoted Activities:</p> <ul style="list-style-type: none"> a) Trading; b) Manufacturing; and c) Provision of telecommunication services.

Category	Details
Scope of tax incentive	MSC Malaysia Status companies are granted an income tax exemption of 100% or 70% (depending on the selected tier) of its statutory income for a period of five (5) years which may be extended for another five (5) years.
Conditions	Depending on the selected tier, the following conditions will apply with varying complexity: <ul style="list-style-type: none"> • Location of approved MSC Malaysia Promoted Activities. • Minimum number of full-time employees consisting of knowledge workers with monthly base salary. • Percentage of Malaysian knowledge workers. • Minimum annual operating expenditure. • Minimum paid up capital.

ii) Tax Incentive for IP Development

Companies engaged in the development of intellectual property (“IP”) can qualify for tax incentive in the form of income tax exemption for income such as royalty and licensing fees. The company must make its application which has to be received by the Malaysian Investment Development Authority (“MIDA”) from 1 January 2020 to 31 December 2022.

Category	Details
Eligibility Criteria	New or existing companies that own the rights of qualifying intellectual properties (“IPs”) and are receiving income from the qualifying IP activities related to the promoted activities/list prescribed under the Promotion of Investments Act, 1986 and Malaysian Income Tax Act, 1967 (“MITA”), are eligible. Companies currently enjoying incentives under Section 34A/34B of MITA will not be eligible for this IP Development incentive.
Qualifying IP Assets	Types of qualifying IP assets under this incentive are as follows: <ol style="list-style-type: none"> Patent or utility innovation under the Patents Act, 1983 [Act 291] or the equivalent law of any country or territory; and Copyrighted software under the Copyright Act 1987; Family qualifying IPs (two or more qualifying IPs that are inter-linked in such a way that it is not possible to identify): <ul style="list-style-type: none"> • which part of any expenditure incurred in the R&D resulting in the creation of those rights is incurred solely in the creation of a particular right; or • which part of any income derived using those rights is derived solely from using a particular right.
Qualifying IP income	Types of qualifying IP income under this incentive are as follows: <ol style="list-style-type: none"> Royalty. Licensing Fees.
Scope of tax incentive	Full income tax exemption on qualifying intellectual property (“IP”) income for a period of up to ten (10) years. The tax exemption is subject to the guidelines on Modified Nexus Approach (formula adopted by the Forum on Harmful Tax Practices (“FHTP”) to calculate qualifying income based on actual R&D expenditure incurred by companies) to ensure that only income derived from IP developed in Malaysia is eligible for the incentive.

3. Tax Threats for Malaysian Digital Companies

Tax threats often arise when digital companies incur expenses or receive income which have unique tax implications. To identify these threats, we have to understand the nature of their operations.

Digital companies help their customers by providing them with digital services and hardware to improve administrative and operational procedures for efficiency and cost reduction. In Malaysia, many digital companies provide services such as big data analytics, artificial intelligence, financial technology, cybersecurity, autonomous processes, etc. Typically, they buy software, data, images, etc for their use and for incorporation into new software products. They may also license software from third parties and use Internet technologies extensively eg broadband, SaaS Services (software as a service), etc. Since knowledge workers are scarce in Malaysia,

employing of foreign nationals to render services to clients or for product development is very common.

Investors looking into setting up digital companies in Malaysia should take note of certain tax concerns that may arise from setting up operations in Malaysia. In this article, we will look at some of the major tax concerns that digital companies may face.

a) Withholding Taxes

Digital companies frequently subscribe for software usage or purchase software outright for their own use. These and other payments eg interest paid to non-residents on loans and service fees paid to non-residents may attract withholding tax. Withholding tax is an amount to be withheld by a payer on the income to be received by non-resident payees. It is the responsibility of the payer to withhold and remit the amount to the Inland Revenue Board of Malaysia ("IRBM").

Generally, the type of withholding tax and the withholding tax rates will depend on the types or nature of payments to the non-resident person. In Malaysia, the following payments made to non-residents may be subject to withholding tax:

- i) Special classes of income under Section 4A of the MITA such as technical and consultancy fees, fees for installation of machinery, rental of moveable properties, etc.;
- ii) Royalty payments made to non-resident companies such as subscription fees or license fees paid for software that are used as an underlying component to the final software that the digital company is developing for commercialization.
- iii) Interest payments to an overseas related company for interest charges on loans provided to the digital company in Malaysia.
- iv) Payments under a contract made to a non-resident person under Section 107A of the MITA;
- v) Guarantee fees and commission paid to a non-resident under Section 4(f) of the MITA; and
- vi) Payments made to public entertainers.

For the purpose of this article, we will focus on the withholding tax on interest, royalty and service fee payments made to non-residents. The withholding tax rates and other particulars are:

Details	Interest	Royalty	Service Fees
Governing Section	Section 109 of the MITA	Section 109 of the MITA	Section 109B of the MITA
Withholding Tax Rate (Preferential rates may apply based on the Double Taxation Agreements signed between Malaysia and various countries)	15%	10%	10%
Applicability	On interest payments made to a non-resident.	On royalty payments made to a non-resident.	On service payments made to a non-resident for services that are performed in Malaysia.
Due date for remittance of withholding tax to the IRBM	Within one (1) month from the date of paying or crediting the amount to the non-resident.		

Digital companies that incur payments to foreign recipients need to be aware of the potential withholding tax implications of such payments.

b) Foreign Source Royalty Income

Prior to 1 January 2022, tax exemption is given on “income received in Malaysia from outside Malaysia” or foreign source income (“FSI”) received by Malaysian taxpayers pursuant to Paragraph 28, Schedule 6 of the MITA (“Paragraph 28”). However, this exemption was amended via the Finance Act 2021 which was gazetted on 31 December 2021 whereby Paragraph 28 was amended by removing the exemption previously enjoyed by tax residents. Moving forward, certain foreign income received by digital companies may be subject to Malaysian income tax.

Effectively, income tax will be imposed on resident persons in Malaysia on income derived from foreign sources and received in Malaysia with effect from 1 January 2022. Such income will be treated equally vis-à-vis income accruing in or derived from Malaysia and taxable under Section 3 of the MITA.

Digital companies, especially those that have investors or holding companies outside Malaysia, potentially may have IPs that are developed and registered overseas, and commercialized overseas, which generate royalty income for the company. Pursuant to the changes of Paragraph 28, this foreign sourced royalty income when remitted back to Malaysia will be taxable income in Malaysia which has to be reported in the company’s annual income tax returns. Double tax relief or unilateral tax relief may however, be available to reduce the Malaysian tax burden on the recipient.

c) Anti-tax avoidance provisions

i) OECD’s Inclusive Framework on Base Erosion and Profit Shifting (“BEPS”) Two Pillar Approach

The Government of Malaysia has committed to implement the OECD’s BEPS Two-Pillar approach in Malaysia which is expected to be implemented starting 2023. The BEPS Two-Pillar approach, namely Pillar 1 and Pillar 2 is expected to help in preventing revenue leakages and profit shifting. Briefly, Pillar 1 focuses on taxing rights by way of reviewing the profit allocation and nexus rules (connection in simple terms) to ensure that each country will gain their fair share of taxes if the revenue is generated from that country. On the other hand, Pillar 2 aims to prevent tax planning that may result in tax leakages and profit shifting by introducing a minimum effective tax rate of 15% at the global level to level the playing field between countries.

Digital companies that are part of a global group of companies, whether headquartered in Malaysia or overseas, may be affected by the implementation of BEPS Two-Pillar in Malaysia. One such example is when the digital company in Malaysia is enjoying any tax incentives which results in the company’s effective tax rate falling below 15%.

Digital companies need to be aware of the BEPS Two-Pillar approach in order to avoid any tax complications or to achieve effective structuring and tax planning of the group’s companies globally.

ii) Tax Threats for Foreign Digital Services Providers under Section 12 – whether they have a place of business in Malaysia

Foreign digital companies need to be wary about whether they would be creating a PE in Malaysia if they are a foreign digital company operating in a country which has a DTA with Malaysia. Similarly, foreign digital companies need to consider whether

they have a place of business in Malaysia under Section 12 of the Malaysian Income Tax Act 1967 (“MITA”) if they are a foreign digital company operating in a country which does not have a DTA with Malaysia. A foreign digital company may trigger a Malaysian place of business under Section 12 of the MITA or PE status simply by operating a physical server in Malaysia, employing an employee that is based in Malaysia or having a person based in Malaysia that acts on behalf of the company and has the authority to conclude contracts on behalf of the foreign digital company.

It should be noted that merely having a website which may be operated on a third-party server in Malaysia will not trigger a place of business or PE in Malaysia.

The implications of a foreign digital company having a place of business or PE in Malaysia is that the company would need to take care of the compliance requirements such as filing Malaysian tax returns to declare and bring to tax the income that was derived in Malaysia. Additionally, the foreign digital company would also need to prepare audited financial statements as the filing of Malaysian tax returns are required to be based on audited financial statements pursuant to Section 77A(4) of the MITA. All these would result in additional risks, costs and time that the foreign digital company would need to incur.

d) Service Tax on Digital Services

Some foreign digital companies may overlook that Service Tax may be chargeable on their digital services rendered to clients. Service Tax is a consumption tax governed by the Service Tax Act 2018 and its subsidiary legislation. Effective from 1 January

2020, service tax shall be charged and levied on any digital service provided by a foreign registered person (“FRP”) to any consumer in Malaysia. The service tax rate is 6%. As a result, foreign digital companies which do not have a company in Malaysia will

need to be aware that they may be liable to be registered for Service Tax and are required to charge 6% Service Tax on their digital services rendered to Malaysian consumers. The customers who buy from these foreign digital companies will need to

be aware of the additional 6% Service Tax which will be an additional cost to them for procuring the digital services. Further details of the law are as follows:

Category	Details
Definition	<p>“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.</p> <p>“foreign service provider” 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 and selling goods or providing services (whether or not such person provides any digital services) and who makes transactions for provision of digital services on behalf of any person.</p> <p>“consumer” means any person who fulfils any two of the following:</p> <ol style="list-style-type: none"> makes payment for digital services using credit or debit facility provided by any financial institution or company in Malaysia; acquires digital services using an internet protocol address registered in Malaysia or an international mobile phone country code assigned to Malaysia; resides in Malaysia.
Liability to be registered	A Foreign Service Provider (“FSP”) who provides digital services to consumers in Malaysia and the value of digital service for a period of twelve (12) months or less exceeds the threshold of RM500,000 is liable to be registered under section 56B of the Service Tax Act 2018.
Registration application	<p>A FSP who is liable to be registered for service tax on digital services shall apply for registration not later than the last day of the month following the month in which he exceeds the threshold. A FSP who has been registered will be referred to as a Foreign Registered Person (“FRP”).</p> <p>The registration application is to be submitted electronically at https://mystods.customs.gov.my/</p>

Conclusion

With the growing importance of the digital economy internationally, the Malaysian government has taken the initiative to boost the local digital economy by incentivizing digital companies as well as encouraging companies to use Malaysia as their hub for their regional or international operations.

However, investors planning to set up digital companies in Malaysia should be aware of the potential tax opportunities in order to take advantage of any benefits as well as the potential tax threats to plan and structure the business effectively to avoid any issues arising in the future.

To quote Benjamin Franklin:-
 “If you fail to plan, you are planning to fail.”

Authors

This article was written by Michael Cheah Liat Sheng, a Tax Advisory Senior Manager and Norhayati Ruslan, an Indirect Tax Manager at Crowe Malaysia. If you wish to seek clarification on any of the above issues, please contact michael.cheah@crowe.my or norhayati.ruslan@crowe.my