

A Review of the Opportunities, Risk and Challenges of E-Commerce Tax Administration in Malaysia and Other Selected Countries

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Abstract: *This paper describes enormous opportunities offered by electronic commerce (e-commerce) to stimulate economic growth, as well as the risks and challenges that it poses based on the principles that form the basis of tax administration system in Malaysia and other parts of the world generally. It then discusses how businesses, the governments and tax authorities around the globe have so far addressed them, which should serve as a basis for Malaysia to learn from. To construct this paper in an orderly manner, the paper highlights the issues posed by e-commerce on the current tax systems with some references to the Malaysian environment. Such issues are enlightened with references to strategies adopted by the tax authorities in some selected countries to meet the challenges faced in the era of e-commerce. A brief conclusion relating to the issues is incorporated at the end of this paper.*

Keywords: E-commerce, withholding tax, royalty, tax evasion, double taxation agreement, permanent establishment

1. INTRODUCTION

The rapid growth of the so-called electronic commerce (e-commerce henceforth), which connotes the sale of goods and services using the facilities provided by the Internet, has given rise to the debate on which tax regimes should be adopted. The move from a traditional commercial environment (or brick and mortar system) to an internet-based environment has caused many significant issues in dealing with tax collection. Tax authorities around the globe have experienced difficult moments in protecting the revenue bases of e-commerce transactions without hampering both the development of new know-how and the engagement of the business community (comprising of both people and organisations) in the progressive and rising e-market place (Jones and Basu, 2002; Chong, 2015).

In the context of Malaysia, the government encourages the online business by granting tax exempt on goods worth not more than RM1,200 and are purchased through any e-commerce mediums fall under the Digital Free Trade Zone.

This incentive is offered to boost the e-commerce sector in the country as it has far reaching effects due to its cross-border nature. According to a report produced by DHL, cross-border e-commerce has been considered as one of the emerging opportunities in the merchandising (or retail) market (CFO Innovation, 2017). The report indicates that this form of e-commerce is expected to grow with an average rate of 25% per annum from 2015 until 2020 with forecasted revenues between US\$300 billion and US\$900 billion (CFO Innovation, 2017).

Nevertheless, despite the fact that e-commerce businesses are mushrooming, tax on digital goods and services is under-scrutinised by the whole world. In effect, many products and services transacted online go untaxed, although e-commerce transactions may be subject to business tax, withholding tax on the royalty payment and value added tax (VAT) or commonly known in some countries as Goods and Services Tax (GST).

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Various tax minimisation strategies have been applied by multinational companies on the cross border transactions. Tax authorities are looking at possible ways to tackle tax evasion by these companies. For instance, Apple Inc. iTunes unit in Japan was ordered to pay ¥12 billion (equivalent to US\$118 million) tax to Japanese government following its underreporting income. Apple Inc. iTunes in Japan did not pay withholding tax on the earnings generated from Japan subscribers that was sent to back to Apple unit in Ireland (Asia Tax and Trade Bulletin, 2016b).

In Malaysia, under the Budget 2017, the scope of royalty that attracts withholding tax and GST has been expanded to include the right to use software. Therefore taxpayers can no longer rely on the case of Alcatel-Lucent Malaysian Sdn Bhd & Anor v Ketua Pengarah Hasil Dalam Negeri (2011) (see Choong, 2017) whereby the Court of Appeal decided that payments to access the global network were not equivalent to payments of royalty. Indeed, withholding tax imposed on non-resident companies has been broadened to include the scope of software patenting. However, where the definition of royalty provided in a Double Taxation Agreement (DTA) differs from that of the Income Tax Act 1967, the DTA definition shall prevail.

The above serves as an introduction to some important issues that relate to e-commerce businesses and transactions. In order to meet the objectives of this paper that concern describing opportunities offered, and the risks and challenges posed, by e-commerce, as well as the strategies adopted by tax authorities, the following section will introduce the concept of e-commerce.

2. DEFINING E-COMMERCE

To have a clear understanding on the issues surrounding e-commerce, it is vital to describe what e-commerce is all about. E-commerce is commonly defined as any commercial transactions which involves placing an order through an electronic means in which the delivery of goods or services are done either through the tangible or intangible (i.e., electronic) mediums (Zwass, 1996; Jones and Basu, 2002). E-commerce is claimed to have vast potential in replacing the traditional ways of doing business in which business activities are conducted by placing orders electronically

via websites or electronic mail. Customers can easily purchase goods or services from a vendor who is located a thousand miles away. However, the idea that business would be conducted by way of e-commerce was not even thought of by the tax authorities for tax-related matters before. The signing of agreement between the Australian government and Alibaba (a large e-commerce business organisation in China) on 6th September 2016 witnessed the rapid booming in e-commerce industry. With this arrangement, fresh products and other goods and services coming from Australia can be easily channelled to China consumers. As at September 2016, Alibaba was having 434 million online shoppers (Asia Tax and Trade Bulletin, 2016a).

The new trend of doing business through e-commerce has received various responses from both tax professionals and tax authorities. For example, most tax professionals agree that existing tax rules are able to cater e-commerce transactions the same way the normal business transactions are treated. However, tax authorities might face some difficulties in enforcing existing tax rules to accommodate some e-commerce transactions emerging from big corporations such as Apple, Google, Facebook, Twitter, 11 Street, Lazada, Airbnb etc. This is due to the existing tax rules that require permanent establishment to be assessed using local tax. Therefore, it is timely for the tax authorities to redefine permanent establishment in the era of e-commerce.

Another problem concerns tax evasion. Some taxpayers are using e-commerce as an opportunity to evade taxes via an uncertain and unclear structure of the parent-subsidiary arrangements of an online business may expose a risk that tax authorities may not be able to detect taxes due for a period of time (Corkery et al., 2013). Thus, there is a need for tax authorities to develop sound techniques to detect tax evasion with the use of technologies. This also suggests that simplicity in the tax reporting is crucial to ensure compliance.

3. THE ROLE OF TAX AUTHORITIES IN E-COMMERCE ENVIRONMENT

In the e-commerce environment, tax authorities have to play a big role in dealing with e-commerce transactions. This includes their role in influencing fiscal policy through which e-commerce transactions are operated and in

ensuring that e-commerce is able to raise sufficient revenues to enable the government to finance the public expenditure (Owens, 1999).

In strive to achieve these objectives outlined by Owens (1999) above it is well recognised that there are mainly two types of e-commerce being practiced throughout the world: business-to-business, and business-to-consumers. Although the focus of most tax authorities concerns the business-to-consumer activities which involves pertinent issues relating to consumer and privacy rights, it is not uncommon that the business-to-business activities appear to dominate the e-commerce transactions. According to Owens (1999), it is noted that approximately 80 per cent of e-commerce in the US is conducted between businesses, excluding government transactions. He further claimed that the international organisations like multinational corporations have used advanced technologies to connect their subsidiaries and business units globally. At the same time, small and medium enterprises (SMEs) are using the internet facilities to explore opportunities in overseas markets. On another note, service-oriented companies providing professional services, such as those in the fields of architecture and finance, have already immersed themselves in using the Internet to widen their clientele base.

Given the above is not exceptional in the context of Malaysia, there is a need for the Inland Revenue Board (IRB) to treat these different patterns differently by designing more effective tax systems in catering the different needs of business-to-business and business-to-consumer transactions in Malaysia. The needs and problems posed by business to consumer transactions should not necessarily dictate the treatment of business-to-business transactions.

4. OPPORTUNITIES OFFERED BY E-COMMERCE

In this new business environment, it is important to note that the facilities provided by e-commerce do not only bring challenges for tax authorities but also opportunities particularly for IRB in Malaysia to administer and enforce the tax laws, particularly in collecting tax revenues and in interacting with a wider business community (both individuals and organisations), regardless of their location and size. This can be observed from examples outlined by Owens (1999) in which he suggested that tax authorities should

be in communications with taxpayers in order to enhance access to information. He further asserted that by so doing, taxpayers may find it easy to comply with their tax obligations to respective tax authorities. This also calls for the need for tax authorities to simplify registration of tax, including requiring taxpayers to use e-filing facilities that will enable them to pay taxes on time and to obtain tax refunds quicker.

5. CHALLENGES POSED BY E-COMMERCE

There are some challenges that can be associated with the e-commerce transactions. Some of which are briefly explained below.

5.1 Legislation, Procedures and Practices Challenges

There are a number of challenges facing tax administrators in this new means of electronic dealings. One of them is to adjust to the prevailing legislation, procedures and practices. This should be taken as a measure to overcome deficiencies that might arise from implementing the new approach of e-commerce. In view of this, the Organization for Economic Co-operation and Development (OECD), in cooperation between OECD-member countries and non-OECD-member countries, including Malaysia, has been working together to develop an universal agreement in deciding the best approach to tax e-commerce transactions. The issues that are of concern include, for example, continuous support to address challenges in tracing private identities of some potentially harmful individuals and/or organisations that are involved in e-commerce activities. This is crucial given that there is a need to strike a balance between privacy and regulations. Another challenge faced by some tax authorities under this e-commerce business environment concerns reconciling different national interests, such as fiscal boundaries, within the borderless world of e-commerce.

On the other hand, issue arises in the Malaysian context pertains to the characterisation of payment for software, whether the payment for the software represents royalty payment for tax purposes or is it merely the purchase of a product (Anthony, 2004). By virtue of Section 109B of the ITA 1967, Malaysian Withholding Tax will be applied if the payee is a non-resident while the gains arising from the sales of a software product will only be subject to Malaysian tax if the trading activities are

undertaken via “permanent establishment” (defined as business presence) in Malaysia. From 2017 onwards, sales of software products by non-residents will attract withholding tax.

In most cases, the central issue that appears to be crucial in a cross border transaction is concentrated on the issue of which country has the power to tax on the gains earned therefrom. The “permanent establishment” concept is employed in the double taxation agreements between Malaysia and the treaty countries. In the case of a foreign business that carries its business through a “permanent establishment” and earning its profits in Malaysia, there will be an imposition of Malaysian taxes. This in return will grant a tax relief from its country of origin. This is done to avoid double taxation.

5.2 Tax Administration Challenges

Undeniably, taxation issues certainly pose administrative challenges to IRB in identifying the taxpayers, tax computation, and taxable amounts emerging from e-commerce activities. Within the context of conventional system, IRB may face little difficulty in identifying the taxpayer, accessing to information from various sources (e.g., Suruhanjaya Syarikat Malaysia, Bank Negara Malaysia, Employee Provident Fund, and Royal Malaysian Customs Department) in terms of taxes to be imposed and collected from their business activities given that it has established sound tax systems to collect taxes when they are due. However, in an e-commerce environment whereby online businesses are transacted through the Internet, the transactions may be only identified using URL domain addresses (e.g., www.amazon.com). Besides, there is a problem in identifying online businesses’ identities as they may not have properly registered with respective government agencies and have no physical business presence. Thus, these problems may lead to unhealthy business exploitation that may cause the government to lose some income though tax collection.

Another issue to consider under the tax administration system is the identification of taxpayers. We acknowledge that the taxes are relatively difficult to be levied if the identification of taxpayers is ignored or done inaccurately. Even if the taxpayers can be easily identified, their physical locations cannot be clearly determined as they may have operated in different locations throughout the world.

Consequently, this may lead to inter-governmental disputes in collecting the taxes. This situation is relatively difficult to resolve when it involves some implications on any tax elements such as double taxation. Nora and Noraza (2015) mentioned that e-commerce is a new way for taxpayer to evade tax as they may not register their business and therefore there are some impact and challenges for tax authorities to deal with them. Noraza and Lamidi (2015) discussed the features and nature of e-commerce environment that leads to the challenges to charge taxes on business transaction that causes revenue losses to the countries.

Agrawal and Fox (2016) analysed the various administrative changes to European Union’s VAT resulting from e-commerce businesses in the US. They found that remote transactions could easily avoid from being taxed mainly because they are not subject to tax at the locations where transactions took place or destination where the location of consumption and sale for digital products (e.g., software, online music, etc.) took place at two different areas with imperfect enforcement capacity.

Considering all these, there is a need for tax authorities like IRB to effectively trace the taxpayers’ identities. Amongst the particulars required are registered business names, contact details, and others, which may have been useful for the e-commerce businesses to promote their products and services to customers and enhance customers’ confidence level in e-commerce transactions.

6. STRATEGIES FOR IMPLEMENTING E-COMMERCE TAX

In an attempt to address the challenges of e-commerce businesses, significant international cooperation has been initiated by various tax authorities. Although the OECD is considered as the most influential international organisation for tax issues, its roles are rather limited to its member countries. Nonetheless, more recently, the OECD has initiated some efforts to get suggestions and feedback from non-member countries in dealing with unhealthy tax competition between tax administrators in different countries (OECD, 1999).

Below are some strategies used or proposed to be used by tax authorities to address some e-commerce issues upon taxation.

6.1 Neutrality in Taxation System

There are a number of opinions proposing that taxation for e-commerce and conventional trading should be made indifferent. This is important as tax systems should treat comparable economic income fairly, irrespective if it is earned through e-commerce mediums or through traditional mediums. As OECD (2001) indicates, there should not be any discrimination to the forms of income earned, such as whether the income is derived from tangible products' proceeds, licensing of intangible products, or provision of services, because tax should be assessed equally.

6.2 International Cooperation

Tax authorities should also consider to strengthen their cooperation with their international counterparts in addressing the e-commerce challenges in terms of country-by-country reporting. This requires tax authorities to establish more transparent reporting systems as per requirement by base erosion and profit shifting (BEPS) developed by OECD. Currently, the international tax laws only concentrate on developed countries (i.e., capital-exporting nations) concerning tax treatments as compared to developing countries (i.e., capital-importing nations). This situation emerges as developing countries in general have to charge their income taxes at lower rates over business profits emerging from most significant and active business activities. Such a situation gives rise to the need to separate revenues derived from e-commerce activities for tax computation. Although this might sound sensitive to most governments as they might lose out from e-commerce battle, over time, this new business mode may eventually match the conventional way of doing business. Consequently, these governments may avoid themselves from entering into agreements that may put them in a risky situation in losing revenues. Although we see greater cooperation between governments at the international level being advocated to avoid unhealthy tax competition, the developed countries have to consider creating more ties with developing countries to enjoy some economic benefits from such cooperation.

6.3 Administrative Simplicity

Proposals that taxation of e-commerce should be simple should not be taken light by tax

authorities. An overly complex system may hinder e-commerce taxpayers to cooperate in the circle of taxation. This is due to the fact that the international tax regime of many developed countries are complex and strict in enforcing their rules. As a result, taxpayers are overwhelmed with so many complex requirements and lead to either under-reporting taxable income or immersing themselves into tax avoidance activities. Therefore, recognising simplicity is important in promoting cross-border e-commerce business as this may lead to reduced administrative burden.

6.4 New Rules

Another challenge encountered by tax authorities in dealing with e-commerce businesses concerns classifications of profits derived from the digital economy. This is simply because e-commerce is regarded as a revolutionary way of doing business conventionally. Generally, international e-commerce transactions involve a huge amount of money. In view of this, there appear to be flaws in the current international tax regime, such as issues in determining "permanent establishment" status, transfer pricing, etc. Such flaws call for new rules to be established so that a more digital tax approached can be applied for e-commerce transactions.

6.5 Education and Support to Taxpayers

Lastly, there is a need to impart continuous education and support on taxpayers in order to make e-commerce a viable business solution which will enable tax authorities to collect taxes. In so doing, tax authorities must play their role in assisting taxpayers to understand tax rules and regulations which will ultimately enable them to fulfil their tax obligations.

6.6 Cross Countries Analysis

As tax on e-commerce is still new and evolving, we have done some cross countries studies to serve as references to the Malaysian tax authorities. Below are some examples on how government in other countries collected and are going to collect tax on e-commerce trade and services.

6.6.1 Australia

Overseas business supplying digital goods and services to Australian-based customers that meet the Australian GST registration rules with turnover exceeding AUD75,000 are required to satisfy the registration rules by registering themselves with the Australian tax authority and to subsequently pay GST (Asia Tax and Trade Bulletin, 2016f). This has been effective starting from 1 July 2017 (Asia Tax and Trade Bulletin, 2016f). According to May (2016), imposing a GST on consumer imported digital products and services is a relatively new rule and is still considered as developing area of law. Generally, the draft seeks to amend the GST law primarily by altering the “connection with Australia” test as enshrined in Section 9-25 of the Goods and Services Tax Act 1999 (see May, 2016).

6.6.2 Taiwan

Under the current Taiwanese tax system for business-to-business e-commerce transactions, revenues derived from services rendered by foreign e-commerce operators in the course of their business to Taiwanese purchasers who are also doing business, the responsibility of paying tax lies with Taiwanese purchasers using the reverse charges mechanism. This was implemented rather smoothly on companies. However, in case of business-to-consumer e-commerce transactions (i.e., the purchasers are individuals), the individual purchasers are not being enforced by the existing tax system to voluntarily pay the tax. As a consequence, this has caused the Taiwanese tax authority to face difficulties in collecting the business tax when it is due. In order to address the issue of under-collection of tax from individual purchasers, the then draft amendments were released to the Value-added and Non-value added Business Tax Act in late September 2016, imposing foreign e-commerce operators to provide services to Taiwanese individual purchasers to register with Taiwan’s tax authority for tax computation purposes and consequently pay business tax in Taiwan. The responsibility of paying e-commerce tax will be shifted from the individual purchasers to the operators (Asia Tax and Trade Bulletin, 2016c).

6.6.3 New Zealand

Using the same approach as Taiwanese government in tackling tax collection on

individual consumer, starting 1st October 2016, the New Zealand tax authority imposed “Netflix” tax on offshore sellers or non-resident businesses that supplying online services to New Zealand private consumers. They would have to register for New Zealand GST if the threshold exceeds NZ\$60,000 annually. The online services include services that are supplied remotely containing digital content, such as online movies and music, online magazine and newspaper subscriptions, and e-book and games (Asia Tax and Trade Bulletin, 2016d).

6.6.4 Indonesia

In 2016, Indonesia tax office estimated that online companies were making advertising revenue amounted to USD830 million, with Facebook and Google accounted for almost 70% of this revenue, and yet they were paying less than 0.1% of the total income and VAT they owed in 2015 to the Indonesia tax office (Suroyo and Danubrata, 2016). Targeting on giant lucrative world renowned conglomerate, Alphabet Inc.’s Google, the Indonesian government is pursuing five years’ back taxes. It was estimated to collect the tax amounted to USD 400 million for 2015 alone if it is found to have evaded tax payments (Asia Tax and Trade Bulletin, 2016e).

6.6.5 Thailand

Eying on Google again, the Thai government is planning the strategies to toughen tax collection rules for internet and technology firms. The plans also cover mobile transfers and internet payment sectors (Asia Tax and Trade Bulletin, 2016d). The draft legislation was discussed in cabinet in the month of June 2017 on taxing e-commerce operators and social media in Thailand, as a consequence of global OECD BEPS (Base Erosion and Profit Shifting) projects (Asia Tax and Trade Bulletin, 2017).

6.6.6 Vietnam

Hanoi Tax Authority has released the guidance on tax on online sales via social networking platforms, for example Facebook, Zalo, YouTube, Instagram, Twitter, Blog etc. Individual or businesses that engage with online sales have to register for tax and declare tax (Asia Tax and Trade Bulletin, 2017).

6.6.7 India

Indian Tax Authority lost revenue collection in the case of Right Florists where payment to Google and Yahoo for advertising services aimed at the Indian market could not be taxed because Google and Yahoo do not have permanent establishment in India. Therefore in February 2016, an Indian Equalization Tax of 6% withholding tax on certain digital transactions into India was proposed to be imposed on those with non-resident status, who do not have "permanent establishment" entitlement in India if the transacted amount exceeds INR 100,000 (Avi-Yonah, 2016).

7. CONCLUSION

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