By Email

27 January 2021

YBhg Dato' Sri Dr. Sabin bin Samitah
Chief Executive Officer and Director General of Inland Revenue
Inland Revenue Board of Malaysia

Indirect Taxes and the Digital Economy – Impact on Financial Services

Dear YBhg Dato' Sri Dr. Sabin bin Samitah,

The growing importance of the digital economy, and the recognition that certain indirect taxation rules are ill-suited for a digital era, has led to the introduction of new indirect taxation rules in many jurisdictions around the world. Many of these new indirect taxation rules arise from policy work carried out by the Organisation for Economic Cooperation and Development (the OECD) since 2014. That policy work has since been incorporated into the OECD's International VAT/GST Guidelines.

The purpose of this document is to set out high level indirect tax policy principles (many of which have been expressly referenced by the OECD) which ASIFMA[1] and its members believe should be applied in determining whether new digital services rules should be applied to the financial services sector.

For ease of reference, we use the following references below*:*

- "VAT/GST" means a value added tax, a goods and services tax, and also includes consumption tax (Japan), service tax (Malaysia)

Core Principles of Value Added Taxes (VAT) / Goods and Services Taxes (GST)

The overarching purpose of VAT/GST is to impose a broad based tax on final consumption of goods and services by households. The OECD's International VAT/GST Guidelines make clear that the burden of VAT/GST should not rest on businesses (paragraph 1.4).

The *Ottawa Taxation Framework Conditions*[2], articulated in the context of taxation of electronic commerce, outlines the generally accepted principles of tax policy as being:

[1] ASIFMA is an independent, regional trade association with over 135 member firms comprising a diverse range of leading financial institutions from both the buy and sell side, including banks, asset managers, professional and consulting firms, and market infrastructure service providers. Together, we harness the shared interests of the financial industry to promote the development of liquid, deep and broad capital markets in Asia. ASIFMA advocates stable, innovative, competitive and efficient Asian capital markets that are necessary to support the region's economic growth. We drive consensus, advocate solutions and effect change around key issues through the collective strength and clarity of one industry voice. Our many initiatives include consultations with regulators and exchanges, development of uniform industry standards, advocacy for enhanced markets through policy papers, and lowering the cost of doing business in the region. Through the GFMA alliance with SIFMA in the United States and AFME in Europe, ASIFMA also provides insights on global best practices and standards to benefit the region.

[2] confirmed at the Ministerial Conference on Electronic Commerce held in Ottawa on 7-9 October 1998

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- **Neutrality** – Taxation should seek to be neutral and equitable between forms of electronic commerce and conventional and electronic commerce
- **Efficiency** – compliance costs for businesses and administrative costs for tax authorities should be minimised as far as possible
- **Certainty and simplicity** – clear and simple to understand so taxpayers can anticipate the tax consequences in advance of a transaction including knowing when, where and how to account for the tax
- **Effectiveness and fairness** – taxation should produce the right amount of tax at the right time. The potential for tax evasion and avoidance should be minimised *while keeping counteracting measures proportionate to the risks involved*.
- **Flexibility** – the system for taxation should be flexible and dynamic to ensure that it keeps pace with technological and commercial developments.

Ultimately, in considering a VAT/GST regime or law in relation to digital services, it is necessary for legislators to weigh up the amount of tax that is likely to be efficiently collected by tax administrators against the compliance burdens likely to be placed on both the tax administrators and foreign digital service providers. An overly complex law requiring detailed record keeping, bespoke systems to issue tax invoices and file VAT/GST returns may be a barrier to entry for smaller foreign service providers crucial for an economy in order to compete in a global world. It is therefore necessary to balance efficiency and effectiveness to arrive at the most effective design.

VAT/GST on digital services

At its most basic level, the objective of VAT/GST rules seeking to tax cross-border digital services is economic equivalence between domestic and non-resident suppliers of those services to private consumers. That is, the rules seek to ensure that non-resident suppliers to private consumers (who do not have a taxable presence in a jurisdiction and therefore are not otherwise required to account for VAT/GST) do not have a tax advantage over domestic suppliers providing those same digital services to private consumers in that jurisdiction (who do have a taxable presence and are required to account for VAT/GST). Typically, digital services VAT/GST rules seek to achieve this outcome by requiring non-residents who provide services to private consumers to register and account for VAT/GST in the jurisdiction where consumption of the digital services by the private consumer occurs. This approach is consistent with Guideline 3.5 in the OECD's International VAT/GST Guidelines.

In the submissions set out below, ASIFMA adopts these principles and, where applicable, makes suggestions to achieve greater tax efficiency while being conscious not to compromise the tax base.

Key principles

1. *Preservation of reverse charge and similar mechanisms for business to business (B2B) transactions*

   The OECD VAT/GST Guidelines (at paragraph 3.47 and elsewhere too) make clear that the appropriate mechanism for taxing cross-border B2B supplies is a reverse charge mechanism. The reason for this approach is to avoid unnecessary compliance burdens on foreign suppliers and to mitigate the need for those foreign suppliers to register for VAT/GST under the local regime.

   The reverse charge approach is predicated on the fact that VAT/GST on B2B cross-border supplies should only be a real cost if the business receiving the service is ineligible to claim a full input tax credit. The existence of reverse charge rules are themselves a form of economic equivalence measure designed to ensure that domestic businesses who may incur VAT/GST as a real cost are unable to obtain an advantage

by sourcing supplies from foreign suppliers (who do not charge VAT/GST) as compared with domestic suppliers (who would charge VAT/GST).

By contrast, the object or purpose of the VAT/GST rules for digital services is to tax the cross-border supply of digital services to end consumers as a means of taxing final private consumption expenditure, and to ensure economic equivalence as between both foreign suppliers and domestic suppliers.

Unfortunately, ASIFMA members have noted that a small number of jurisdictions have also sought to include the cross-border supply of digital services to registered businesses (B2B) within the legislative amendments applicable to digital services (in addition to B2C services). Examples include Indonesia, Malaysia and the Philippines. This is causing a number of compliance problems, including:

(a) Non-resident businesses who engage in B2B transactions are being required to register and account for VAT/GST in various countries notwithstanding they don't have a presence in those countries or, alternatively, they are being forced to stop providing services where they consider the compliance costs exceed the commercial benefits. ASIFMA would suggest that requiring a B2B service provider to register is unnecessary given the local business recipient, being registered for VAT/GST, is already accounting for VAT/GST under the reverse charge mechanism. Indeed, as mentioned above, one of the main purposes of the original reverse charge regime was to minimise the unnecessary registration of foreign suppliers where they do not have a presence in a particular country. Furthermore, the administration of the reverse charge rules is much more efficient as the tax authorities have legal recourse to the local business recipient rather than being forced to 'chase' offshore businesses;

(b) Non-resident businesses who engage in B2B transactions will need to alter their systems and processes which may result in the duplication of the VAT/GST liability where the business recipient applies the reverse charge rules. Put simply, the concern is that unless the legislation is crafted carefully to prevent VAT/GST duplication, the non-resident may end up charging VAT/GST on its supplies, while the business recipient applies the reverse charge rules and ends up "self-assessing" additional VAT/GST on its VAT/GST inclusive expenses (i.e. VAT/GST cascading). The end result is potentially foreign suppliers may decline to provide those services to businesses in that country, or there may be significant non-compliance resulting in either double taxation or no taxation, as the case may be. The further point is that that the significant additional compliance burden does not actually result in any more tax being collected.

Accordingly, ASIFMA is of the view that the new VAT/GST rules for digital services should only apply to B2C transactions. This principle is consistent with the OECD VAT/GST Guidelines.

2. *Ensure equivalence with existing VAT/GST principles governing financial services*

A number of jurisdictions in the Asia Pacific region apply exemptions from VAT/GST for financial services. The scope of those exemptions vary from jurisdiction to jurisdiction, typically being either:

(a) relatively broad based – i.e. most financial services are exempted from VAT/GST (e.g. Indonesia, Korea, New Zealand[3], Philippines);
(b) applicable only to margin based financial services, with fee based financial services typically being taxed for VAT/GST purposes (e.g. Australia, Malaysia, Singapore); or

[3] New Zealand treats B2B financial services as zero rated supplies and only denies the recovery of input tax credits where they relate to B2C financial supplies

(c) relatively narrowly based – i.e. there are very few exemptions, with most types of financial services being subject to VAT/GST (e.g. China and India).

ASIFMA and its members are of the view that new rules applying VAT/GST to cross-border digital services should not override the treatment of existing VAT/GST exemptions for financial services. That is, if a financial service is exempt from VAT/GST if supplied by a domestic provider, then it should also be exempt if supplied by a non-resident supplier notwithstanding the financial supply may fall within the definition of a "digital service". This is particularly applicable in jurisdictions which adopt a very broad concept of a digital service.

The suggestion that digital services should not override existing exemptions for financial services is to preserve economic equivalence between non-resident and domestic suppliers of financial services (a core OECD principle).

3. *Ensure equivalence with existing VAT/GST principles governing domestic supplies*

An extension of the second principle is that any new VAT/GST rules dealing with cross-border supplies of digital services should not result in a transaction being subject to VAT/GST if that same transaction would not have been subject to VAT/GST were it supplied domestically. For example, where existing VAT/GST rules allow intragroup transactions to be ignored for VAT/GST purposes, then those rules should apply equally to the supply of cross-border digital services within a corporate group too.

A key concern is with intragroup IT service arrangements, related IP licensing arrangements within a corporate group, and centralized IT procurement functions within corporate groups. Put simply, in jurisdictions such as Malaysia a concern has been raised by ASIFMA members that the new digital services rules potentially trigger service tax registration and payment obligations, whereas the existing domestic service tax rules would have resulted in exemption.

For the sake of clarity, there should be no revenue leakage in allowing cross-border intragroup transactions involving digital services to be treated on the same basis as normal intra-group domestic transactions for VAT/GST purposes. That is because any VAT/GST will eventually be levied on the subsequent supply of those services by the domestic group member to a party outside of the group, or already taxed through existing reverse charge mechanisms.

4. *Ensure equivalence with alternative indirect taxes*

A further extension of the second principle is that countries should not seek to levy VAT/GST on cross-border digital services in circumstances where those same services, if provided domestically, would have been taxed under an alternative form of indirect tax. In the Asia Pacific region, a number of jurisdictions levy alternatives to a VAT/GST on financial services – for example, Specific Business Tax (Thailand), Gross Business Receipts Tax (Taiwan), Education Tax (Korea), Gross Receipts Tax (Philippines). Each of these taxes is a form of turnover based tax which, by and large, does not allow for credits on inputs.

The scope of any VAT/GST on cross-border digital services should not be so broad as to cover transactions which fall within the scope of these existing alternatives to a VAT/GST on financial services. Otherwise, there will be a cascading tax liability arising.

In short, and for the reasons noted, ASIFMA is of the view that these problems would be overcome by jurisdictions more closely following the OECD VAT/GST Guidelines. That is, in seeking to limit the

application of cross-border digital services rules to B2C transactions only; in applying reverse charge mechanisms to deal with cross-border B2B transactions involving recipients ineligible for full input tax credits; and in ensuring that existing policy settings applicable to the financial services sector not be detrimentally impacted by new rules covering digital services.

Finally, it should be noted that imposing additional indirect taxes like this has the propensity to increase the cost of banking services for ultimate consumers. It is important to recognize that banking services such as lending activities seek to bring forward consumption activity upon which VAT/GST is already imposed. Consequently, levying VAT/GST on such services can potentially involve a form of double taxation, and in any event ultimately increases the cost of these services to the community.

We hope that you find this document useful and will consider the recommendations we have made. We look forward to hearing from you. Please do not hesitate to contact Patrick Pang (ppang@asifma.org).

Yours sincerely,

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