SST one year on — a tax system fit for the future?

BY RAJA KUMARAN AND TIM SIMPSON

Slightly more than a year ago, Malaysia reintroduced the sales tax and service tax to replace the Goods and Services Tax (GST), which was zero-rated a few months before it was abolished. While commonly referred to as SST, the sales tax and service tax operate as two distinct tax systems.

Given the short lead time for the implementation of the SST, the Sales Tax Act 2018 and the Service Tax Act 2018 are predominantly based on the Sales Tax Act 1972 and the Service Tax Act 1975. While both of the 2018 Acts have been enhanced as best as they could, business models and transactions are very different now compared with the time the underlying legislation was conceived some 45 years ago.

It is timely to look at some of the practical issues raised by businesses and consider if the SST should be considered a temporary measure, while Malaysia moves to an indirect tax system designed with the future in mind.

Defining taxable services

As the service tax applies to specific taxable services provided by taxable persons, the question that often gets asked is, "Is this service taxable?" The confusion arises because the service tax legislation seeks to group taxable services under a number of broad categories. Fundamentally, this manner of defining taxable services will always be open to interpretation. On the other hand, a more specific or narrow definition could mean a wide range of services falling outside the ambit.

In striking a balance between being prescriptive and ensuring the scope for tax collection remains broad, more specific definitions can help. But from our experience, even a specific definition of a taxable service is open to interpretation.

One such example in the current service tax legislation, where the broad term "management services" was made more specific to include 10 subsets of management services. One of these subsets is project management services which, on a first reading, seems specific. But when one tries to analyse what types of services fall within the scope of project management, it becomes significantly less so. The conventional wisdom is that organising or controlling the project should be regarded as "management", but execution should not. But the line between the two blurs significantly depending on (among other factors) the degree of input by each party in the decision-making process.

This is just one example of the many discussions between businesses, tax professionals and the Royal Malaysian Customs Department on a regular basis.

Complexity in exemptions

With the sales tax, some of the more common issues relate to the exemption system. Under the sales tax regime, registered businesses manufacturing taxable products can claim exemptions from the payment of sales tax. Exemptions are also available to specific persons or industries. The intention here is to prevent the sales tax from being levied more than once in the supply chain, or, at all, for policy reasons in the case of certain goods. The result is innumerable exemptions spread over three orders, each with their own attached conditions. These conditions may be difficult to meet, and could require a significant amount of monitoring for businesses. As a result, many taxpayers unknowingly invalidate their exemptions, often due to a lack of process or insufficient understanding of how exemptions work.

Consider the following scenario: ABC Co manufactures taxable and exempt goods partly for sale in Malaysia and partly for export. ABC Co uses the same packaging materials for all goods. ABC Co can claim an exemption from payment of sales tax on the packaging materials for all goods, excluding those exempt goods that are sold locally. But to do so correctly, ABC Co must apply for two separate exemptions, which sit in two separate parts of the exemption order. ABC Co must also monitor the usage of packaging materials to ensure that the exempt material is not used to package exempt products for local sale, or the exemption becomes invalid. If this is already sounding complicated, one can imagine the real-world issues where transactions are a lot more varied and complex.

A single-stage tax?

The sales tax and service tax are often referred to as single-stage taxes. This means that they are only levied once in the supply chain. While this is true in theory, in practice, the lack of interaction between sales tax and service tax can result in a compounding effect. Combined with the propensity of businesses to mark up their total costs, the single stage nature of the two taxes can result in an increase in costs resulting from such mark-ups compared with the amount of tax that is actually collected throughout the supply chain.

Let's consider support services first. These are services acquired by businesses in the supply chain to enable them to deliver their products to the end consumer. Not all will be subject to service tax, but certain support services such as consulting, advertising, legal and warehouse management are taxable. Service tax on these support services increases the overhead cost at each stage of the supply chain.

Next, we consider the direct supply chain. Sales tax is levied at 10% at the start, namely upon manufacture. This additional cost, together with the increased overhead costs becomes the basis for the mark-up by the manufacturer. Rather than marking up on pure cost, the manufacturer applies his mark-up on true costs plus associated taxes. This continues at each stage of the supply chain, each level embedding its own tax element as appropriate and applying a mark-up on what is perceived to be the total cost.

As a result of this, what are supposed to be single-stage taxes create a compounding effect, which eventually finds its way into the prices of products.

A future tax system?

On to the crux of the matter — what is the most efficient way to tax transactions relating to goods and services? Should businesses be made to bear these taxes? Or should consumption be taxed? These certainly require a lot more deliberation. In the meantime, some enhancements and simplifications may be needed to address the common concerns of businesses.

One possible solution to reduce the cascading effect to businesses is to consolidate the two taxes for exemptions to apply across both frameworks. A single registration system, in which registered persons do not charge each other tax, would mean that the service tax does not become embedded in the supply chain of goods and the sales tax does not become embedded in the supply chain of services. This would greatly reduce the number of exemptions required, making it simpler for businesses across the value chain.

The definitional issues in service tax are more challenging. One plausible way to reduce definitions is to move to a model where all services are subject to service tax but at a lower rate, with specific exemptions given for essential services such as life insurance, education and healthcare. With a reduced rate, the cost to the rakyat could be maintained but the definitional issues would be vastly reduced.

While these may not be the only solutions to the issues of the sales tax and service tax, they deserve to be part of the conversation as to how Malaysia should move forward with indirect taxes. This may be a difficult issue to address but a necessary one to help promote transparent growth for the nation while enhancing confidence in our tax system. E

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