GST TO SST | THE EDGE cdm

Preparing for SST — let's begin with a heat map

BY **HUANG SHI YANG**
DIRECTOR OF INDIRECT TAX
KPMG TAX SERVICES SDN BHD

SAM FONG/THE EDGE

Transitioning to the Goods and Services Tax (GST) in April 2015 proved challenging to many in Malaysia despite having had the opportunity to learn from the experiences of other countries. Now, both the taxpayers and authorities in Malaysia are facing the task of changing from a multi-stage tax to one that is single-stage. This time around, we cannot learn from other countries because they have little experience in this. We will have to count on our own experience gained before 2015.

With this steep learning curve in mind, let us visit the key areas where risks and opportunities reside under the single-stage Sales and Services Tax (SST) system.

We know from the past that in a single-stage tax system, matters such as the determination of taxable value, product and service classification as well as utilisation of exemptions (and ensuring specific criteria/conditions are met) are amongst the most important to address. If you have noticed similarities to administering Customs duty, you may have also realised that the Sales Tax has the characteristics of an import tariff (see Chart 1).

Taxable value

To the government, a broad-based multi-stage GST system is much less susceptible to inaccurate taxable value.

Say you have merchandise that can fetch RM10,000 (excluding GST) from end consumers and Importer B reports an invoice value of RM1,000 as import value. Under the GST system, the government receives RM600 output tax on the assumption that Importer B does not claim other input tax as credits.

If the Sales Tax rate is 6% (for illustration purposes), the government will receive just RM60 from the importer (see Chart 2).

It is not surprising then to understand why under a GST system, little attention may be paid to valuation rules on importation.

Now assuming that B has the option to have the merchandise made by Producer X in Malaysia. B provides X with the designs, tooling and critical components at no charge while X is responsible to supply packaging materials and assembly service. X charges B a price that comprises the cost of packaging materials, labour, overheads and a profit for a total invoice price of RM100 per unit.

Under the GST system, the government collects RM600 output tax on the assumption that B does not claim other input tax credits. Under the Sales Tax system, if X reports only its invoice price as the taxable value without taking into consideration the value of designs, tooling and free components, the government receives only RM6 from X (see Chart 3).

For the Sales Tax payable on imported goods, the rules are the same as for Customs duty. A list of comprehensive rules is set out in the Customs (Rules of Valuation) Regulation 1999. The principles are largely in line with the World Trade Organization Valuation Agreement, requiring the taxable value to be determined by applying one of these prescribed six methods:

1. Transaction value
2. Transaction value of identical goods
3. Transaction value of similar goods
4. Computed value
5. Deductive value
6. Flexible value

For the Sales Tax payable on goods that are domestically manufactured and sold, used or disposed of, the relevant rules are set out in the Sales Tax (Rules of Valuation) Regulation 2002. The principles are also largely in line with the WTO Valuation Agreement where six methods are prescribed. Note that the Sales Tax is due with or without a sale taking place as long as taxable goods are being used or disposed of.

Failure to demonstrate that the price was not influenced by the relationship, or if part of the subsequent proceeds from the resale accrues directly or indirectly to the seller, may result in the transaction value method being denied, in which case the taxable value must then be determined by applying the other prescribed methods, which generally are significantly more complex to manage.

In the Service Tax Act 1975, requirements relating to the determination of the charge, premium or value in which the Service Tax is payable are set out in Section 4 of the said Act. Where a relationship exists or where there is no charge or premium levied, the provisions mandate a notional value representing a value that would have been charged between unrelated persons to be used for levying the Service Tax.

In the real world, a whole range of complexities may exist. Evidence in explaining how the price is arrived at between related sellers and buyers, whether manufacturing "assists" are accounted for in arriving at the invoice price, ascertaining whether royalty payment, trademark licence fee and other payments are taxable or otherwise are just some of the potentially complex processes of arriving at the taxable value.

Add to this the potential complexity of a situation where a combination of products and services is being rendered, typically in a turnkey contract delivery with progress billings or milestone payments without segregation of products and services, and the challenge is not straightforward for certain businesses.

In the single-stage SST system, how taxable value is arrived at becomes a top priority for the authorities safeguarding government revenue. Valuation audits will be the norm in an SST system. Demonstration of due care will not be adequate as full compliance is the requirement of law.

A legally binding valuation ruling warrants consideration within the SST system.

Classification

The Sales Tax rate is determined by tariff codes. There are 21 sections, 98 chapters and about 10,000 individual tariff codes of 10 digits under about 5,000 headings or sub-headings (six digits). To determine the tariff code of a product, it is necessary to apply clas-

Chart 1. **Sales Tax has the characteristics of an import tariff**

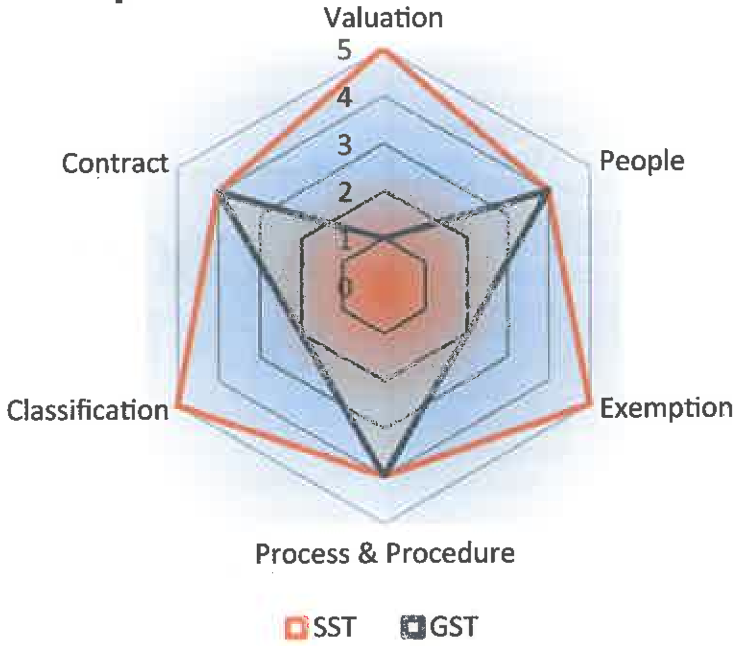


Chart 2. **Government receives higher output tax from importer under GST system**

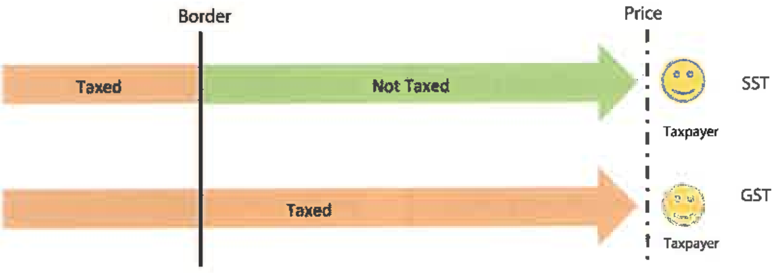


Chart 3. **GST is multilayered**

sification rules known as General Rules of Interpretation. Broadly, the process of accurately classifying a product begins with first gaining a full understanding of the product that is being appraised, identifying the relevant chapters and headings that merit consideration, and then applying the relevant sections notes, chapter notes, headings or sub-headings notes (and possibly national notes as well where they exist).

A wrong classification can lead to applying the wrong Sales Tax rate, resulting in under-payment or charging of Sales Tax and possibly, the consequence of fines and penalties. While over-payment of tax is equally possible with poor classification, a refund is rarely justifiable. In situations where prices are restricted by terms of contracts that are not reviewable, the impact of getting tariff codes wrong can deliver a devastating blow to the business.

On the other hand, there are fewer than 500 tariff codes set out in the GST (zero-rated supply) Order 2014, consisting of items such as foodstuff and medicines that are relatively straightforward to identify. The probability of a misclassification here is therefore relatively low under the GST system.

Clearly, under the Sales Tax, classification is a much more complicated process where errors are likely to be more common.

The Service Tax applied to a narrow range of services prior to 2015. The main problem with a prescriptive system is interpreting what is taxable and what is not. For example, there were numerous arguments with regard to what were consultancy services and management services.

Some believe that the new Service Tax will be broader in scope. However, unless all services are taxable with the exception of a clearly defined "negative list", ambiguities in interpretation may remain a sticky issue for many.

The question is, are you gambling with classification or managing it?

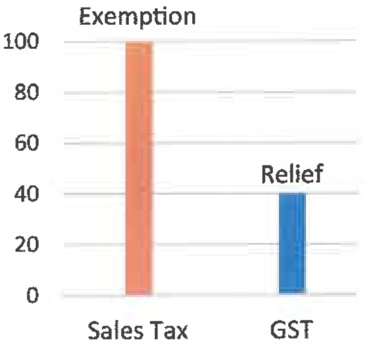
The benefits of a legally binding ruling should be considered where it makes sense to do so.

Exemption utilisation

There are fewer than 40 specific persons, goods, and conditions listed in the GST (Relief) Order 2014. In Schedule B and Schedule C of the Sales Tax (Exemption) Order 2013, there are 100 or more, some with prescriptive tariff headings, sub-headings or complete tariff codes stated. Most, if not all, of these require specific applications and certifications in advance, where the process and conditions differ from one another (see Chart 4).

Chart 4.

More exemptions in SST than reliefs in GST



Unlike under the GST system, where tax paid can be claimed as a credit, under the Sales Tax system, the eligible person must take steps to apply and obtain the necessary approvals in advance before the tax is paid or the tax paid becomes irrecoverable. These exemptions cover a whole spectrum of transactions, from goods for evaluation or testing and empty containers to equipment and raw materials and more, with specific conditions and eligible persons (for example only named oil companies are eligible for equipment for upstream oil and gas operations).

For the Service Tax, no exemptions were offered except the exclusion of certain taxable services within a group of companies, provided conditions were met.

Under the SST system, it is critical to be able to identify relevant exemption and develop a robust procedure to ensure that benefits can be enjoyed and maintained in a sustainable manner. For businesses that operate in dynamic environments, this can be a real challenge as the criteria or conditions for some exemptions may be rigid. Weak internal controls, poorly trained personnel or outdated processes could easily lead to void exemptions, resulting in retrospective tax liabilities or worse.

Conclusion

At this juncture, the pending SST legislation remains the missing piece of the jigsaw. For most businesses, it will be necessary to make adjustments and modifications to their systems, processes and procedures as well as training of people.

Any system would be dysfunctional, however, if the quality of data is questionable. Error-free product classification, correct taxable values and the right utilisation of exemptions represent some of the most critical data in an SST system, and deserve top attention. E