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DTA vs ITA: Is it Royalty? High Court allows Taxpayers' Application for Leave to commence Judicial Review and Stay

Section 109 of the Income Tax Act 1967 (**ITA**) imposes withholding tax on royalties paid to non-residents. However, certain royalties are not taxable under various *Double Taxation Agreements*[1] (**DTAs**), which Malaysia has signed. DTAs prevent taxpayers who carry out cross-border business from being taxed twice on the same transaction or income source, i.e., both in its country of residence and in another country in which it has business dealings.

A recurrent issue that crops up is whether it is the definition of royalty in the ITA or a DTA that should prevail in the event of a conflict. This issue has arisen because the Director General of Inland Revenue (**DGIR**) insists on applying the ITA, despite the primacy given by Parliament to DTAs in *Section 132 ITA*. Recently, the High Court confirmed the availability of judicial review as a mechanism to resolve such disputes, when 2 separate judges of the Kuala Lumpur High Court (**KLHC**) granted leave for judicial review to the applicants to challenge decisions by the tax authorities involving a DTA matter.

Brief Facts

A1 is a Malaysian company and a reseller of services belonging to A2, which is a non-resident company. A1 makes annual payments to A2 to market and resell A2's services in Malaysia (**the Payments**).

[1] Agreements for the Avoidance of Double Taxation; Malaysia has effective DTAs with 74 countries as of August 2022; See https://www.hasil.gov.my/en/international/double-taxation-agreement/

As the Payments did not fall within the definition of "*royalty*" in the relevant DTA, withholding tax under *Section 109 ITA* was not deducted by A1 from Payments made to A2.

As a matter of prudence, A2 applied to the DGIR for a ruling to confirm the situation (**Ruling Application**).

However, the DGIR decided to:

a) Raise tax assessments by invoking *Section 39(1)(f) ITA* to disallow the deductions claimed by A1 for the Payments on the basis that taxes were not withheld; and

b) Reject A2's Ruling Application.

Both decisions by the DGIR were made on the basis that the Payments by A1 to A2 were royalties **solely by reference to the definition of "*royalty*" in *Section 2 ITA***. Aggrieved, A1 and A2 commenced judicial review applications in the High Court to challenge these decisions.

A1's & A2's Grounds for Judicial Review

Amongst others, the following grounds were advanced at the High Court:

1. Jurisprudence by the superior courts from the past 40 years has confirmed that pursuant to *Section 132 ITA*, the definition of "*royalty*" in a DTA must apply and will override the definition of "*royalty*" under *Section 2 ITA*.[2]

The DGIR's decision which is premised solely upon the definition of "royalty" in *Section 2 ITA* is clearly erroneous and was made in excess of jurisdiction. This is a pure question of law which is suitable for judicial review.

2. A1 has no right to an alternative remedy of an appeal to the Special Commissioners of Income Tax ("**SCIT**"). The specific provision governing an appeal in a withholding tax matter lies in *Section 109H ITA*. However, *Section 109H(2)(b)* precludes this right where *Section 39* has been invoked by the DGIR to disallow the deduction claimed.

3. Similarly, A2 has no right to an alternative remedy of a SCIT appeal. An appeal under *Section 99 ITA* can only be made against an assessment. The assessment here were issued against A1, and not A2. Nevertheless, A2 has legal standing to file the judicial review application as it is an aggrieved party.

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[2] *DGIR v Euromedical Industries Ltd* [1983] CLJ Rep 128; *Damco Logistic Malaysia Sdn Bhd v KPHDN* (2011) MSTC 30-033; *Wira Swire Sdn Bhd v KPHDN* [2018] 1 LNS 722; *KPHDN v Thomson Reuters Global Resources* (2016) MSTC 30-124

High Court granted Leave and Stay

Despite strenuous objection by the DGIR, two separate judges of the KLHC decided to grant leave and stayed the assessments.

Concluding Thoughts

The term "*royalty*" originates in ancient Britain when gold and silver mines were owned by the Crown, to whom a payment of "*royalty*" had to be made before these "*royal*" metals could be mined. Since then, royalties have grown in sophistication and magnitude, and disputes on their scope and meaning in the 21st century have grown correspondingly complex.

Foreign companies intending to do business in Malaysia would thus be understandably concerned over the efficacy of tax dispute resolution in a country where they have no presence, and the possibility of being embroiled in lengthy and expensive appeal proceedings. The High Court's recent decisions are thus to be lauded for confirming that judicial review remains a viable mechanism for taxpayers and other aggrieved parties to challenge decisions by the Malaysian tax authorities, especially where such decisions appear to have been made in defiance of the DTAs and case laws.

The taxpayer was successfully represented by Dato' Nitin Nadkarni, Jason Tan Jia Xin and Chris Toh Pei Roo from Lee Hishammuddin Allen & Gledhill's Tax, Customs & Trade Practice.

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If you have any queries pertaining to tax assessments which have been issued by the DGIR, please do not hesitate to contact the author or his team partners, Dato Nitin Nadkarni, Jason Tan Jia Xin and Ivy Ling Yieng Ping, at tax@lh-ag.com.

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