Tax e-Alert

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Advance Ruling Susceptible To Judicial Review

Under Section 138B of the Income Tax Act 1967 ("**ITA**"), any person can apply to the Director General of Inland Revenue Board ("**Director General**") for an Advance Ruling on how the provision of the ITA would apply to a proposed arrangement.

Before the case of *IM Sdn Bhd v Ketua Pengarah Hasil Dalam Negeri*, taxpayers and tax practitioners were unsure whether an Advance Ruling was a mere opinion of the Director General on the issues sought in an application. Questions also lingered as to the taxpayer's recourse if an Advance Ruling was not in his favour.

These pressing questions were answered by the High Court in the recent landmark case of *IM Sdn Bhd*. We successfully represented the taxpayer in setting aside an Advance Ruling that was not in the taxpayer's favour. This case is the first matter concerning an Advance Ruling to have been challenged in the High Court.

Facts

The taxpayer wanted to enter into a software distribution agreement with a non-resident company. Before executing the agreement, the taxpayer sought an Advance Ruling on whether the payment to be made to the non-resident company under the agreement would be deemed royalty, and hence subject to withholding tax.

The Director General issued an Advance Ruling affirming the payment as royalty and, thus, would be subject to withholding tax. Being aggrieved by the Advance Ruling, the taxpayer appealed by way of judicial review.

In responding to the judicial review commenced by the taxpayer, counsel for the Director General argued, among others, that:

i. The Advance Ruling is merely an opinion of the Director General and hence not a decision amenable to judicial review;

ii. There is domestic remedy under the ITA available to the taxpayer; and

iii. The payment to be made under the software distribution agreement is royalty and is subject to withholding tax.

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Advance Ruling is a 'decision' and not merely an opinion

It was held by the High Court that an Advance Ruling issued by the Director General is a binding decision which is susceptible to judicial review. In *R v Worthing Borough Council and Another* (1985) 50 P&CR 53, the English High Court had held that the opinion of the Secretary of State could be subject to judicial review because it would be unreal to suppose that one would do otherwise than to accept the opinion as decisive. In *IM Sdn Bhd*, it was held that the Explanatory Note to Clause 26 of the Finance Bill 2006 and the Income Tax (Advance Ruling) Rules 2008 ("**Rules**") make it clear that the Advance Ruling is final and binding on the Director General and the taxpayer.

The Director General also argued that the taxpayer has not been adversely affected by the Advance Ruling because no assessment has been made as such. The High Court rejected the Director General's argument and held that the "adversely affected" test is the single test for all the remedies under judicial review. In order to pass the test, the taxpayer has to show a real and genuine interest in the subject matter (see *Malaysian Trade Union Congress v Menteri Tenaga, Air dan Komunikasi* [2014] 3 MLJ 145). It has also been held by the Federal Court in *Members of the Commission of Enquiry on the Video Clip Recording of Images of a Person Purported to be an Advocate and Solicitor Speaking on Telephone on Matters of Appointment of Judge v Tun Dato' Seri Ahmad Dairuz bin Dato' Sheikh Abdul Halim* [2011] 6 MLJ 490 that the decision must affect the aggrieved party, either by altering his rights or obligations, or depriving him of the benefits that he has been permitted to enjoy.

In *IM Sdn Bhd*, the High Court agreed that the taxpayer's rights had been deprived by the Advance Ruling since the taxpayer would suffer financial detriment and also have to pay a tax as a result of the Advance Ruling.

No domestic remedy under ITA to taxpayer

The High Court also rejected the Director General's argument that there is an alternative remedy available to the taxpayer under Section 99(1) or 109H(1) of the ITA. The right to appeal to the Special Commissioners of Income Tax does not arise in the case of Advance Ruling. The right to appeal under Section 99 only arises when an assessment or a notice of assessment has been issued. In this case, there was no assessment or notice of assessment raised by the Director General. In *Malayan United Industries Bhd v Ketua Pengarah Hasil Dalam Negeri & Anor* [2006] 5 CLJ 240, the High Court held that in cases where no assessment has been made, judicial review is the most appropriate, convenient and suitable

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procedure to challenge the Director General's decision. Additionally, the High Court also held that no right of appeal could arise under Section 109H(1) because no amount was due from the taxpayer to the Director General under Sections 109, 109B or 109F of the ITA at the time when the Advance Ruling was made.

The only subject matter in question is an Advance Ruling for which no special appeal procedure has been provided in the ITA or other written law. Consequently, there is no right of appeal provided for under the statute and there is no recourse for the taxpayer under the ITA or otherwise. As a result, the only remedy available to the taxpayer is by way of judicial review under the inherent powers of the High Court. The High Court added that the "no appeal against any Advance Ruling" rule under the Rules does not operate to estop the court from judicially reviewing a decision (see *Tenaga Nasional Bhd v Bandar Nusajaya Development Sdn Bhd* [2016] MLJU 1387).

Payment under software distribution agreement not royalty

The Director General argued that Sections 2 and 109(1) of the ITA should apply in determining whether the payment in question is royalty. The High Court reiterated the position taken by our superior courts in *Damco Logistic Malaysia Sdn Bhd v Ketua Pengarah Hasil Dalam Negeri* (2011) MSTC 30-033 that the definition of "royalty" provided under Article 13(6) of the Double Taxation Agreement between Malaysia and Netherlands ("**DTA**") and supplemented by the OECD Commentary on Article 12 shall prevail over the ITA in determining whether a payment is royalty. Since the payments to be made by the taxpayer are not for the right to reproduce the software programs or the use of any copyright but only for the costs of purchasing the products to be distributed, the High Court held that the payments are not royalty. Hence, the court held that the decision taken by the Director General in the form of Advance Ruling is *ultra vires*, illegal, void, unlawful and in excess of its authority.

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Observations

The advantage of getting an Advance Ruling is the certainty it offers to taxpayers. Before *IM Sdn Bhd*, the advantage of such certainty was counteracted by the finality clause under paragraph 16 of the Rules, which states that any Advance Ruling issued for the purpose of any arrangement shall be final and no appeal shall be lodged against it. With this High Court decision, taxpayers who are cautious of the tax implications of any major arrangement can use the device of Advance Ruling to get the view of the Director General on such arrangement. If the application for an Advance Ruling returns an unfavourable result from the Director General, the taxpayers can then choose to challenge the decision through judicial review. Obtaining a decision from the court early is certainly better than appealing against an assessment or a notice of assessment issued by the Director General because taxpayers will need to pay the amount (including any penalty) within 30 days from the date of the assessment made.

Please contact us at tax@lh-ag.com if you have any queries on tax matters.

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