LHAG Insights

Special Alert!

Tax, Customs & Trade

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DTA vs ITA: Is it Royalty?
High Court issues Grounds of Judgement for Decisions to Grant Leave to Commence Judicial Review and Stay

Double Taxation Agreements[1] (**DTAs**) have become increasingly important in regulating taxation matters when cross-border businesses are involved. DTAs safeguard taxpayers by preventing them from being taxed twice on the same transaction or income source, i.e., both in their country of residence and in another country in which they have business dealings.

In our previous LHAG Insights of 1 September 2022, we discussed the decisions made by 2 separate judges at the Kuala Lumpur High Court (**KLHC**) to grant leave for judicial review in applications by taxpayers involving a DTA dispute. The dispute pertains to a recurring issue in DTA matters i.e., whether it is the definition of royalty in the Income Tax Act 1967 (**ITA**) or a DTA that should prevail in the event of a conflict. This issue arises 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*.

Grounds of Judgment have since been issued by the KLHC in both cases, providing useful guidance on principles in judicial review and DTA matters.

[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/

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**).

As the Payments did not fall within the definition of "*royalty*" in the relevant DTA, withholding tax under *s.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.

High Court's Decisions to Grant Leave and Stay

Judicial Review against the Tax Assessments[2]

The salient points from the grounds of judgment (available here) can be summarised as follows.

1. The DGIR's decision arises from an error of law amounting to a clear lack of jurisdiction. This is due to the DGIR's failure to recognise that the Payments made by A1 to A2 are not royalty within the meaning of the applicable DTA. There is therefore no basis for the DGIR to disallow the Payments for deduction pursuant to *Section 39(1)(f) ITA*.

2. The DGIR has failed to abide by binding decisions of the superior courts despite being referred repeatedly to them. These decisions have confirmed that pursuant to *Section 132 ITA*, in the event of a conflict, the provisions of a double taxation agreement or a relief order should prevail over the ITA.

[2] *Akamai Technologies Malaysia Sdn Bhd & Anor v Ketua Pengarah Hasil Dalam Negeri [2022] 1 LNS 2641*

3. The taxpayers have been consistent in their tax treatment and have disclosed this to the DGIR at an early stage (in 2014). However, the DGIR only issued the tax assessments 7 years later in 2021, without raising any allegations of fraud, wilful default or negligence to justify the imposition of the assessments for time-barred years.

4. The Court has the power to stay the tax assessments. In particular, there is no explicit ouster clause within the ITA which limits the Court's inherent powers to grant a stay. The Court also agreed that "there is a clear pattern of the IRB failing to refund or delaying in refunding taxes in general".

Judicial Review against the Decision on the Ruling Application[3]

The salient points from the grounds of judgment (available here) can be summarised as follows.

1. The DGIR and the IRB have not succeeded in showing that the application was frivolous. Examples of frivolous applications are those made out of time, filed by meddlesome busybodies with no interest in the dispute, or against non-justiciable matters. The applicant is clearly an "adversely affected" party by the tax authorities' decision to reject the Private Ruling Application.

2. The DGIR argued that there was no "decision" to be challenged, as it has used the word "berpandangan" in opining that the Payments comes within the definition of "royalty". This, according to the DGIR was a mere "opinion" and not a "decision". The Court rejected this argument, holding that the assertive nature of the statement comes within the meaning of "decision" within the meaning of Order 53, Rule 2(4) of the Rules of Court 2012 (**ROC**).

3. The Court agreed that there was no alternative remedy of an appeal to the Special Commissioners of Income Tax (**SCIT**) by A2, as the non-resident recipient of the Payments. This was because *Section 109H ITA* is only available for the payer of the Payments i.e., A1.

Conclusion

The DGIR and IRB have previously filed appeals to the Court of Appeal against the High Court's decisions above. These have since however been withdrawn.

It must be noted of course that these decisions are only for leave to commence judicial review, and not the substantive application itself. However, in light of the unambiguous decision by the KLHC

[3] *Akamai Technologies International AG v Ketua Pengarah Hasil Dalam Negeri & Anor* [2022] 1 LNS 2261

that "the Respondent's Decision arises from an error of law amounting to a clear lack of jurisdiction" and that the Payments "are clearly not royalty, and hence not subject to withholding tax", it would be interesting to observe what arguments, if any, that the DGIR could raise to counter such findings at the substantive stage.

Further, the High Court's decisions again confirm that judicial review remains available for taxpayers to challenge decisions by the Malaysian tax authorities, especially where such decisions appear to have been made in defiance of 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 consultant, **Dato Nitin Nadkarni** and his team partners, **Jason Tan Jia Xin** and **Ivy Ling Yieng Ping**, at tax@lh-ag.com.

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