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TECHNICAL

Direct Taxation

TAX CASE UPDATE

Appeal to the Federal Court against grant of judicial review – payments to a non-resident treated as royalty subject to withholding tax.

KPHDN v ALCATEL-LUCENT MALAYSIA SDN BHD & ALCANET INTERNATIONAL ASIA PACIFIC PTE LTD. (Judgment & Supporting Judgment)

Federal Court of Malaysia
Civil Appeal No: 01(f)-18-08/2012(W)
Date of Judgment: 29 November 2016

(The appeal to the Court of Appeal in this case was reported in our e-CTIM TECH-DT 43/2016 dated 10 June 2016.)

Facts and Issues:

(*Please also read the facts in our report of the case before the Court of Appeal. The following is a recapitulation.)*

The 1st respondent, Alcatel-Lucent Malaysia Sdn Bhd (ALM), a Malaysian company, entered into an agreement dated 1.1.2003 ("the Service Agreement") with the 2nd respondent, Alcanet International Asia Pacific Pte. Ltd. (AIAP), a non-resident. Under the Service Agreement, AIAP was to provide services to ALM from overseas relating to the provision of global network for voice, data and video communication. The rates to be paid were fixed.

As a result of a tax audit conducted by the appellant, ALM was informed in a letter from the appellant dated 31.10.2007 that withholding tax (WHT) was required to be paid on payments made to AIAP for the years of assessment 2001 – 2005, such payments being regarded as royalty payments by the appellant. After negotiations between ALM and the appellant, the amount to be paid was finally confirmed to be RM 1,507,674 by the appellant in a letter to ALM dated 28.3.2008. This was reconfirmed in a letter to ALM's tax agent dated 14.4.2008, which also made reference to sections 109 and 109B of the Income Tax Act 1967 (ITA). (All sections cited hereinafter refer to sections of the ITA unless otherwise stated.)

Despite lengthy negotiations, exchanges and correspondences culminating in the reduction of the WHT, it was alleged that the appellant did not furnish the reason for subjecting the payments to WHT. ALM eventually paid the amount payable under protest on 28.4.2008, but registered its dissatisfaction to the appellant in a letter of the same date. However, the taxpayer never filed any appeal to the Special Commissioners of Income Tax (SCIT) as provided under the ITA.

The respondents then filed for judicial review to the High Court, which allowed the application for judicial review on 15.6.2010. Being dissatisfied with that decision, the appellant appealed to the Court of Appeal, which affirmed the High Court's decision.

Hence, this present appeal to the Federal Court ("the Court") against the decision of the Court of Appeal. The questions for the determination of the Court are:

(a) whether the letter from the DGIR dated 14.4.2008 referring to both sections 109 and 109B of

the ITA is bad in law; and

(b) if the answer to the question is in the negative, whether the payments for services under the Service Agreement are royalties under S109 of the ITA.

Decision:

Appeal allowed. The grounds of decision are summarized below (*from the main Judgment*):

1. **Submissions**

1.1 Among the submissions of the **appellant** are the following:

- The High Court had wrongly agreed with the respondents that they **first** became aware that the payments were royalties subject to WHT through the appellant's affidavit in reply as affirmed on 15.6.2009. The High Court had also failed to take into account the material facts of the case.
- Based on the correspondences and meetings between ALM and the appellant, it could be gleaned that ALM and its tax agent ("*a reputable tax agent*") were aware of the issues at hand, i.e. issues arising from non-compliance of WHT provisions right from the beginning of the audit exercise.
- On the complaint that no reason was given by the appellant for its treatment of Leased Equipment Facilities payments as royalty, the appellant rebutted that the DGIR is not statutorily bound to give reasons for its decision to impose WHT.
- The appellant's conduct was in compliance with the principles of natural justice. The fact that several meetings were held between the appellant and the taxpayer and its tax agent (which culminated in reduction of the WHT charged) showed that the respondents were accorded their fundamental rights to be heard and given fair and reasonable opportunities to put their case before the appellant.
- The reference to both sections 109 and 109B in the letter dated 14.4.2008 was not unreasonable as there are only 2 WHT provisions involved and the respondents were not in the dark when they received that letter.
- The payments made under the Service Agreement "*as consideration for the use of the software*" were "royalty" as defined under S2, being payment to AIAP for the use of intellectual property. There could not be any outright sale as ALM was only given a non-exclusive, non-transferable right to use the software and the copyright remained with AIAP. The right to use the software was given to ALM, otherwise ALM would have infringed a copyright under S36 of the Copyright Act 1987.

1.2 Submissions by the **Respondent** include the following:

- The courts below were correct in law and in fact in holding that the appellant was unreasonable in applying both sections 109 and 109B on the payments, exacerbated by the failure to give reasons for his decision.
- Although there are only 2 WHT provisions, the appellant was unsure which one to apply, i.e. he had not come to a determination as to which section applied to the payments.
- The 2 sections cover different types of payments, and if the appellant himself was uncertain which one was applicable, it would fundamentally be unreasonable to require taxpayers to withhold the taxable portion.
- By alluding to both sections, the appellant had committed an error of law in numerous ways, including acting mechanically, omitting to give reasons for impugned decisions, taking into account irrelevant considerations, misconstructing the terms of the ITA, and

arriving at a decision which is evidently unreasonable.

- The appellant's failure to give reasons was a violation of the principles of procedural fairness and natural justice. By that failure, the respondents were deprived of the opportunity to present a case to effectively dispute the correctness of the appellant's decision.
- The payments in question were merely charges for services. There were no intellectual property rights provided by AIAP to ALM which could constitute royalty. What was provided by AIAP were services to facilitate ALM's access to the global network for voice, data and video communications.
- The appellant's decision should be quashed as it was ultra vires the law.

2. **The Court's Analysis**

2.1 The Court examined the provisions of the relevant sections of the ITA which are applicable to the case under consideration (S3 – Charge of income tax; S4(d) – Classes of income (income from royalty); S2 – Interpretation (definition of royalty); S4A – Special classes of income; S109 – Deduction of tax from interest or royalty in certain cases; S109B – Deduction of tax from special classes of income in certain cases derived from Malaysia;).

After considering the specific provisions of each section, the Court made the following remark relating to the WHT provisions of S109 and S109B:

> "*The duty to withhold tax on royalty income would invariably fall under section 109 whilst the special class of income that falls under section 4A will be catered to by the withholding provision of section 109B. ……be it section 109 or 109B, both are withholding provisions, and as the respondents have been informed that the income comes from royalty payment, by no figment of the imagination could the respondents' tax agent have been misled by the something so obvious."*

2.2 The Court pointed out that the respondents never filed any appeal to the SCIT.

> "*What comes out strikingly clear is that, despite being aware and aggrieved of the impugned decision, the respondents never filed any appeal to the Special Commissioners under section 99 against the determination by the appellant. And this despite protesting vide letter dated 28.4.2008 that the first respondent was aware of its rights to appeal….."*

2.3 By filing an appeal to the SCIT the respondents would have had the opportunity to challenge the decision of the DGIR as to whether the payments were indeed royalty, as well as rebut the "deeming provisions" of S15A of the ITA, under which certain income "*including the likes of services rendered (by AIAP to ALM) shall be deemed to be derived from Malaysia*." However, as there was no appeal, these issues are unresolved and the deeming provisions were left unrebutted. That being so, the requirements of S4(d) read together with S109 and S4A read together with S109B have been satisfied. In other words, there being no appeal to the SCIT, the Court has no option but to accept certain facts and conclusions as irreversible. It "*cannot alter the view that the payments* (under consideration) *were royalty, and* (then) *be heard to complain"*, since the respondents had failed to avail themselves *"of that remedy laid down by law*."

2.4 The Court noted that the central issue to the appeal was the DGIR's decision to subject the respondents to WHT. It is trite law that a judicial review is a court proceeding to challenge the decision of the relevant authority by challenging the lawfulness of the decision making process. The Court will not delve into the merits of the case, i.e. the evidence is not reassessed. Neither will it substitute the decision with what it thinks is the correct decision. However, in the case of *R.Rama Chandran v the Industrial Court of*

Malaysia [1997] 1 MLJ 145 it was decided (by the Federal Court) that the decision of an inferior tribunal may be reviewed on the grounds of "illegality", "irrationality" and possibly "proportionality", which not only permits the courts to scrutinize the decision making process but also the decision itself. "*In short, it allows the courts to delve into the merits of the matter*."

2.5 The grounds for judicial review set out by the respondents in their application are that the appellant had erred in law and/ or acted in excess of powers conferred by the ITA, and/ or without jurisdiction. These 3 grounds fall squarely on the term of "illegality" as propounded in the *R. Rama Chandran* case. To decide whether the respondents have succeeded in establishing their grounds, the Court proceeded to peruse the facts of the case. (See Para. 3.0 to Para. 18.0 of the written judgment).

2.6 The reason given by the respondent for the failure to appeal to the SCIT is that the issue of WHT is not an assessment, hence falls outside of S99. As such, the only remaining choice was a judicial review application. Therefore the question that must be asked is **whether the appellant made an "assessment**".

2.7 Referring to the case of *Govt. of Malaysia v P. Corporation (M) Sdn Bhd (1950 – 1985) MSTC 426,* the Court indicated its approval of the view that –

> " *….section 99 refers to 'assessment' generally and not specifically to 'assessment to tax'. It is established law that …..notices of assessment…are not assessments. An assessment is the official administrative act of the appellant who determines the amount of tax to be paid by a taxpayer, after having taken into account all relevant circumstances. Notices of assessments will be sent out only after the ascertainment is complete."*

Based on this view, the Court held that "*without a doubt, the answer* (to the question stated in paragraph 2.6) *is in the affirmative*". Hence, the imposition of WHT in this case is subject to appeal to the SCIT.

2.8 Referring to the Court of Appeal's criticism of the appellant for failing to give reasons for its decision, which that court had accepted as providing justification for concluding that the appellant had no good reasons for making that decision, the Court proffered its own view that "*enforcing a blanket view that silence by a decision maker implies lack of good reasons may be too strong a stance, and must be treated with considerable reserve.*"

2.9 Citing some "persuasive cases"[1], the Court made the pronouncement that "*judicial interference should be on a case by case basis*" and declared that with regards to this appeal, the Court could "*also find no statutory provision that demands the appellant to supply reasons why the 1st respondent is duty bound to pay the withholding tax."* It added that the need to give an overt explanation was "superfluous" as there were ample documents and reasons surfacing in the course of negotiations between the parties which were self-explanatory.

2.10 After examining the decision making process, the Court found that the respondents had conducted negotiations with the appellant, which led to the reduction of the WHT amount to RM1,507,674. Reference was made to the letters dated 31.10.2007, 28.3.2008, 14.4.2008 and 28.4.2008. It was pointed out that S109 and S109B, mentioned in the letter 14.4.2008, had also been mentioned earlier, as far back as (the letter dated) 31.10.2007. It was the Court's view that "*by no account*" could the tax agent, "*a company that is world renowned for its tax expertise, have failed to know what these two sections referred to."* Based on its perusal of the evidence adduced, the Court found that no flaw was detectable in the decision making process and there was no illegality or irrationality in the decision.

2.11 Above all that has already been said, the Court found another "*disquieting factor*" which persuaded it that this appeal must be allowed, viz. the respondents had failed to satisfy some of the statutory requirements under Order 53 of the RHC 1980. The requirement was the time constraint for making an application, which is stipulated to be within 40 days when grounds for the application first rose, or when the decision was first communicated. The Court found that a clear decision regarding the WHT (final sum of RM1,507,674) which had to be paid, was already communicated in the letter dated 28.3.2008, addressed to ALM. The letter dated 14.4.2008 was merely a clarification, in response to the tax agent's query. On this finding of fact, that the decision was actually made in the letter dated 28.3.2008, the Court pronounced that "*the respondents were way out of time*" in filing for judicial review on 23.5.2008. Therefore the application for judicial review was incompetent.

2.12 (*From the Supporting Judgment*)

The letter dated 14.4.2008 ("the said letter") communicated the administration decision of the appellant pertaining to an **assessment** of WHT and was in fact, a notice of assessment of WHT (see para. 2.6 and 2.7 above). The crux of the appeal is whether that administrative decision was void when it relied on 2 provisions of law, namely Sections 109 and 109B. Based on the provisions of S143 (which is concerned with the validity of an assessment) it was posited that –

> "…*any error or mistake committed by the appellant in the exercise of its administrative function under the Act does not render an assessment void or voidable unless there is error in substance and is against the provisions of the Act. ……however, that defect in procedure cannot displace the underlying liability for tax imposed by statute."*

2.13 Sections 109 and 109B mentioned in the said letter apply to different types of income. It was observed that the error committed by the appellant lay in the description of income which was subject to WHT, but applying S143(2), the assessment contained in the said letter cannot be affected merely by reason of a mistake as to the "description of any income."

2.14 The liability to tax is directly imposed by statute itself, and not by the Revenue by assessment imposed on the taxpayer (which quantifies the amount due). [*Reckitt & Colman (New Zealand) Ltd v Taxation Board of Review [1996] NZLR 1032*] Applying S143(1), even if the appellant was uncertain as to the exact applicable provision, it did not render the assessment void for want of form. The allegation of procedural impropriety ought not to be permitted to vitiate the appellant's statutory duty to assess and collect the correct amount of tax.

Based on the above, it was held that question (a) was to be answered in the negative. The Court refrained from answering question (b).

Notes

(1) Cases cited:
Stefan v General Medical council (1999) 1 WLR 1293
ABC v The Comptroller of Income Tax of Singapore (1959) 25 MLJ 162/165

Members may read the full Grounds of Judgment and Supporting Judgment at the Institute's website (Judgment & Supporting Judgment) and the LHDNM website (Judgment & Supporting Judgment).