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The Relationship Between Double Taxation Agreements And The Income Tax Act 1967

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Double Taxation Agreement (DTA) or double tax treaty is an agreement or a contract drawn up between two states which are designed to:

(i) protect against the risk of double taxation where the same income is taxable in two states.

(ii) provide certainty of treatment for cross-border trade and investment.

(iii) prevent excessive foreign taxation and other form of discrimination against local business interests abroad.

The Need For DTA

When tax residents (individual, corporations, or enterprises) of any two given countries trade or transact commercially with each other, it gives rise to international trade or, in other words, cross-border transactions. DTA is important as the likelihood of double taxation discourages international trade. There is a need for states to bilaterally and mutually agree to specific terms and rules on how income or profits of international trade or cross-border transactions are to be treated. Every DTA is culminated through rounds of negotiations, compromises and trade-offs between two states in coming to a consensus on the articles and clauses to be included in DTA.

In Malaysia, the Minister of Finance is empowered under Section 132 of the Income Tax Act 1967 (ITA) to make arrangements with the governments of any territory outside Malaysia with a view to avoid the occurrence of double taxation vide DTA. So long as the DTA remains in force, such arrangements shall have effect in relation to tax implications notwithstanding the provisions of the ITA or any written law in Malaysia. Presently, Malaysia has entered into DTA with 74 countries.

REIMAGINING TAX SOLUTIONS

The Conflict Between DTA And Domestic Law

A conundrum may arise where there is conflict in the tax treatment of a particular subject matter between the ITA and a DTA. The question then arises as to whether the DTA or the ITA will prevail in the event of a conflict. Section 132(1)(b) of the ITA has settled the law that in the event of a conflict, the DTA will prevail. Further, there have been a myriad number of cases in Malaysia on this issue whereby it is noticeable that our judiciary affirms that the provisions of the DTA supersedes the provisions of the ITA in line with the provision of the law.

The law in this regard has been settled by the Federal Court in *Director General of Inland Revenue v Euromedical Industries Ltd* [1983] CLJ (Rep) 128 where it was found that the payments received by the taxpayer, a company incorporated in the United Kingdom, from a company with its registered office in Malaysia, was subjected to the definition of royalty under the DTA and not Section 2 of the ITA. In deliberating upon the conflict between the definition of the word royalty between the DTA and the ITA, the Federal Court held that:

> *"It appears to us that the learned Judge never intended it to be understood that he had found the management fees to be royalty under Section 2 of the Act. What he obviously means is that whilst the parties agree that the fee does appear to come under the definition of "royalty" under that section, it does not come within the definition of that term in the Relief Order, and that because under Section 132(1) of the Act in the event of conflict the provisions of the Relief Order should prevail, the fees should be treated as income or profit and not as royalty. This provision is not peculiar to our tax law. Counsel for the respondent drew our attention to a similar provision in the United Kingdom Income Tax Act, 1918 where in the event of any inconsistency between the provision of the Act on one hand and a Double Taxation Relief Agreement on the other, the Agreement must prevail over the Act."*

The decision of the Federal Court in *Euromedical Industries Ltd* was subsequently applied in the High Court case of

Damco Logistic Malaysia Sdn Bhd v Ketua Pengarah Hasil Dalam Negeri [2011] MSTC 30 - 033, involving similar facts of whether the Electronic Data Processing (EDP) charges paid by the taxpayer to a Danish company were in fact royalty, and if it is so the taxpayer should have withheld tax from the EDP charges paid. The High Court held as follows:

> *"However, in treating EDP charges as royalty, I agree with the submission of learned counsel for the Applicant that the definition of 'royalty' under the DTA applies and not the ITA. It is difficult to come to terms with the contention of the learned counsel for the Respondent that the definition in the ITA applies, in light of the clear authority that the DTA takes precedence over ITA as decided in the Federal Court case of Director General of Inland Revenue v Euromedical Industries Ltd [1983] 3 CLJ (Rep) 128"*

In *Ketua Pengarah Hasil Dalam Negeri v Thomson Reuters Global Resources* [2016] 10 MLJ 1, a Swiss company was successful in obtaining tax refunds from the Inland Revenue Board in respect of distribution fees paid by a Malaysian company which was erroneously subjected to withholding tax. Following *Euromedical Industries Ltd* and *Damco Logistic Malaysia Sdn Bhd*, the High Court dismissed the IRB's appeal on the basis that the definition of the word 'royalty' as in the DTA should be preferred over the same definition in the ITA and hence the income of the taxpayer derived from the distribution fee should only be subject to tax in Switzerland where the taxpayer operates.

Having considered the abovementioned authorities and the Commentary of the Organisation for Economic Co-operation and Development (OECD) Model Convention in determining the relevant articles under the DTA with regards to the definition of royalty, the courts held that the provisions of the DTA prevails over the ITA and subsequently deliberated on whether the payments made by the taxpayers fell under the definition of royalties under the respective DTA with Denmark and Switzerland.

It is notable that the taxpayers in *Damco Logistics* and *Thomson Reuters* were successfully represented by the

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firm's Senior Partner, Datuk D.P. Naban and Tax, SST & Customs Partner, S. Saravana Kumar up to the Court of Appeal, where the IRB's further appeals were also dismissed.

Commentary

The international principle of a DTA provision overriding the provision of the ITA is well settled, as mirrored in the novel English case of *Ostime (H.M. Inspector of Taxes) v. Australian Mutual Provident Society 38 TC 492.* It is notable that Section 132 of the ITA reinforces this position as it expressly provides protection against the occurrence of double taxation. Taxpayers must always be mindful that a DTA exists to avoid double taxation, and not to be used by the Revenue as an instrument to impose tax. Essentially, our domestic law in the form of the ITA is the only authority which provides for the imposition of a tax liability. In this regard, a DTA can only act as a shield against double taxation; it cannot by itself give rise to tax liabilities.

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