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Revisiting the Public Ruling Relating to Withholding Tax for Better Compliance

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Abstract

This study examines the clarity of the public ruling on the interpretation of section 4A of the Income Tax Act 1967 (ITA) in respect of withholding tax for better compliance. Section 4A of the ITA imposes the statutory obligation of withholding tax on income derived from Malaysia by the non-resident. Section 4A of the ITA is a peculiar provision and classified as a "special classes of income". Despite having the law, the Director General of Inland Revenue (DGIR) could not successfully enforce it as there have been challenges made by taxpayer questioning the clarity of the law. Uncertainty and ambiguity of the law lead to non-compliance of the law. So, how is the ambiguity of the law is resolved? Thus, this study is necessary as it contributes not only to the international literature but also to the policy maker.

Keywords: Non-resident, withholding tax, ambiguity, complexity, clarity, compliance

1. INTRODUCTION

There are various types of income that are subject to withholding tax (WHT) under the Income Tax Act, 1967 (ITA). However, for the purpose of this study, focus is centered especially on the types of income that are classified as 'special classes of income' under the ITA. No other country in the world has a similar provision like Malaysia. Thus, this so-called 'special classes of income' provision is peculiar in the context of Malaysia tax. It empowers the Government to tax the income of the non-resident even though the non-residents have no physical presence in Malaysia.

1.1 History

The provision of section 4A was introduced into the ITA during the 1983 Budget announcement (*Budget Report*, 1983). One of the tax measures made by the Government which was facing the economic challenges as a result of recession at that material time, was to introduce a law to tax non-residents who derived income from Malaysia. This tax measure was also made to circumvent the adverse impact of a Federal Court decision in *Director-General of Inland Revenue v. Euromedical Industries Ltd* (Malaysian Law Journal,1983). Malaysia being a developing country sees that there is a need to tax non-resident as the flow of capital and technology moves from the developed to developing countries (Subramaniam, 2014b). Such flows of income in the cross-border transaction are subject to tax in certain tax jurisdiction. Thus, withholding taxes are the important enforcement tools to ensure that the tax of the non-resident are withheld. Malaysia, like any other tax jurisdictions imposes withholding taxes (WHT) on certain payments made to non-residents where the WHT is the best mechanism to collect the tax of the non-residents.

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As such, effective from the year 1983, WHT is imposed on any payments made to non-resident in respect of income from services and rental of movable property. However, since the law was introduced in 1983, it appears that there have been non-compliance issues with the statutory obligation of WHT under section 109B of the ITA. This can be seen from the audit cases carried out by the non-resident branch of the Inland Revenue Board of Malaysia (IRBM) on resident payers.

Not only that there is noncompliance of the WHT provisions discovered during the audit, but there have also been cases filed in Courts by taxpayer challenging the Director General of Inland Revenue's treatment to tax non-resident income under section 4A of the ITA. Most of the court's decisions have also been decided in favor of the taxpayer. Hence, it has been decided by the Courts that the provision of section 4A of the ITA is ambiguous. The ambiguity of the law allows taxpayers to interpret the laws creatively, rationalizing non-compliance (Krause, 1996). Therefore, tax simplicity appears to be a desirable feature of a tax system (Isa, n.d.).

In order to clarify the application of section 4A of the ITA, the Director General had also issued Public Rulings (*Public Ruling No. 4/2005*, 2005) ("Addendum to Public Ruling No. 4/2005," 2007)(*Addendum to Public Ruling No. 4/2005*, n.d.)(*Public Ruling No. 1/2014*, 2014) by virtue of the Director General's power (*Income Tax Act 1967*, n.d.-a) under the ITA. Notwithstanding that, the Public Rulings have failed to provide clarification and certainty to the taxpayer on the application of section 4A of the ITA. Furthermore, the public ruling is only a guideline and not binding on taxpayer ("Ketua Pengarah Hasil Dalam Negeri v Success Electronic and Manufacturer Sdn Bhd," 2011).

1.2 Studies

Several empirical studies have been done on the complexity of taxation laws and compliance of the ITA. Certain aspects of tax law complexity had been done by some researchers which includes the area on the complexity in the tax returns (Mock, 1985). By using the FRES and F-KGL analysis, a previous study done on the complexity of the ITA revealed that the ITA was indeed a complex law and the researcher suggested that the ITA should be rewritten. Thus, this study is relevant in respond to the survey findings that it is worth to address the issues of readability based on a specific provision in the Act (Saad, Udin, & Derashid, 2014).

We are also not aware of any prior research done on this area. Thus, this warrants a research that can provide an insight as to whether redrafting the section 4A of the ITA would make the law clear and increase the WHT compliance amongst taxpayers.

2. LITERATURE REVIEW

2.1 Income Tax Act 1967

Prior work on tax compliance revealed that the main factors affecting non-compliance include high tax rates, probability of detection, complexity of the law and the methods employed to collect taxes (Sapiei, Kasipillai, & Eze, 2014). It is also revealed from prior research that the ITA is indeed complex. The most recent research done on the complexity of the Malaysian ITA found that the level of readability of Malaysian tax legislations and supplementary materials is low (Saad et al., 2014).

Thus, the ITA must be explicit when taxing a subject matter. Studies have shown that withholding taxes generates more revenues for the Government (Parker-Fleming, 1995). In the case of Malaysia, the Government relies on the revenue collection from direct taxes by the Inland Revenue Board of Malaysia (IRBM) being the only agency entrusted to collect direct taxes on behalf of the Government. Generally, IRBM contributes more than 50% of the Federal revenue collection and only about 1.3-1.9% came from the withholding taxes as shown in Table 1. Thus, with this study, it is hoped that the revenue collection from WHT is increased as a result of better compliance of the law.

The general principle of taxation is every income derived from Malaysia is taxable in Malaysia regardless of whether or not a taxpayer is present in Malaysia (*Income Tax Act 1967*, n.d.-b). The type of income that is taxable includes gains or profits from business. Thus, any business income made by a resident or non-resident is taxable under the ITA.

Table 1. Collection of WHT

Years	Total WHT collected under section 109B		Total WHT	Percentage of WHT collection from total tax collected	Total tax collected
	No. transactions	Amount (RM million)	Amount (RM million)	%	Amount (RM million)
2011	52,161	630.23	1,525.10	1.39	109,609.86
2012	56,300	770.81	2,097.07	1.68	124,890.80
2013	63,188	847.74	2,012.57	1.56	128,932.69
2014	68,177	900.17	2,205.56	1.65	133,694.97
2015	68,005	902.18	2,310.00	1.91	121,205.00

The issue on the imposition of tax becomes more complex especially if it involved non-resident taxpayer. This is especially so where the income of a non-resident taxpayer may be taxed twice which resulted to a double taxation. In other words, the income of a non-resident company may be taxed by the source country and at the same time is taxed by the resident state in which the non-resident company is incorporated. Thus, the issue of double taxation arises.

Hence, in order to avoid the issue on double taxation, an avoidance of double taxation convention or agreement is entered into between Malaysia with other countries outside Malaysia. A Double Taxation Agreement (DTA) is an agreement that is concluded between two States in order to prevent a person who is fully liable to tax in one of the States (or sometimes in both States) from being taxed on the same income (or capital) in both States. To date, Malaysia has entered into seventy two effective (72) DTAs ("www.hasil.gov.my," n.d.).

The substance of a DTA varies between countries. It is drafted based on the object and purpose of a country. In formulating such agreement, guidance is also made to the Organization for Economic Co-operation and Development (OECD) Model (Model Tax Convention on Income and on Capital) and United Nation (UN) Model (United Nations Model Double Taxation Convention Between Developed and Developing Countries). The Malaysia's Model of DTA is based on the combination of both OECD and UN Models.

In general, based on the DTA, no tax is levied on a non-resident person's business if there is no permanent establishment in Malaysia. Gains or profits from a business of a foreign enterprise are taxed in Malaysia only if the foreign enterprise operates in Malaysia by way of a permanent establishment. The definition of a permanent establishment is more or less standard in most DTA concluded by Malaysia. Permanent establishment basically means a fixed place of business in which the business of the enterprise is wholly or partly carried on.

In accordance with the Article on Business Profits under a DTA, profits of an enterprise of one of the treaty partner countries from the provision of services will be taxable unless the profits are attributable to a permanent establishment situated in the other treaty partner country. This is the argument advanced by the non-resident taxpayer that Malaysia can only tax the income of a non-resident taxpayer if there is a permanent establishment in Malaysia. Hence, disregarding the provision of section 4A of the ITA. To further support the non-resident taxpayer's argument is the reliance of section 132 of the ITA, which provides that the DTA should prevail in the event that there is any inconsistency between the DTA and the ITA. The issue on double taxation does not arise in country where there is no tax treaty signed by Malaysia with any foreign country.

2.2 Historical Background on the Introduction of Section 4A

Prior to 1983, income from services and rental of movable property from non-resident were taxed as royalty under the DTA. However, the definition of royalty under the DTA and the ITA was different. In other words, there is a conflict on the interpretation of the DTA against the domestic law provision, i.e. the ITA. It was held by a Federal Court in (*Director-General of Inland Revenue v. Euromedical Industries Ltd*, 1983) that the law (prior to the introduction of section 4A) was not clear for the Director General of Inland Revenue (DGIR) to charge non-resident taxpayer on the cross-border services rendered by the non-residents taxpayer.

Briefly, based on the facts of the case, in 1983, a company incorporated in the United Kingdom which has no permanent establishment in Malaysia objected to the assessment raised by the DGIR in respect of the management fee paid by a Malaysian company which is a resident in Malaysia. The Federal Court decided in favor of the United Kingdom Company on the ground that the management services were income taxable only in the United Kingdom under Article VI of the Double Taxation Relief (United Kingdom) Order 1973. The Federal Court decision has a negative impact to the Government's revenue and also adverse impact on the development of the nation.

It is unfortunate that the Government could not tax the income made by the non-resident. On the other hand, the non-resident derived income in Malaysia without incurring any cost by having a permanent establishment in Malaysia i.e. office, staff, company, etc. To circumvent similar loss to the Government of Malaysia following from the Federal Court's decision, a step was taken to enact a provision into the ITA. Thus, section 4A and other provisions related to WHT on the special classes of income were enacted in 1983 by virtue of the Finance Act 1983 (Act 293). It was to cover a potential loophole in the aftermath of the *Euromedical* case.

2.3 Introduction of Section 4A into the ITA

With effect from 21 October 1983, the Government of Malaysia decided to introduce a law to overcome the economic challenges of recession faced by the Government and also to address the issue of law on the imposition of tax under the ITA. Consequently, the Government of Malaysia introduced section 4A, which imposes tax on the income derived by a non-resident. The income is called special classes of income that covers installation fees, technical and non-technical fees and rental on moveable property. Prior to October 21 1983, rental income derived from Malaysia was taxable. However, since there was no deeming provision such as now in s. 15A of the ITA, there was considerable difficulty and dispute in taxing rental income of non-residents before October 21 1983.

Section 4A read together with section 109B of the ITA provides the statutory obligation on the Malaysian payer to withhold tax on behalf of the non-resident at source and remits the tax to the Inland Revenue Board of Malaysia (IRBM) within a specified time. If no tax is withheld, the tax arising shall be increased by an amount equal to 10% of the payments liable to deduction and will become a debt due to the Director General and payable forthwith by the payer. Alternatively, the Director General of Inland Revenue may disallow the whole amount in computing the tax liability of the payer. The most pertinent principle regarding section 4A is receipts under section 4A are not to be considered as business income and the permanent establishment concepts under the DTA is therefore inapplicable.

2.4 Issues and Challenges in the Implementation of Section 4A

Notwithstanding the introduction of section 4A into the ITA, it appears that section 4A has not been able to tax non-resident on the special classes of income. In other words, the clarity on the interpretation of the law is disputed and challenged by taxpayers. This can be seen from the field audit findings carried out by the Non-Resident Branch of the IRBM and appeals filed by the taxpayer to the Special Commissioners of Income Tax or Judicial Review application in the High Court to set aside the DGIR's treatment of section 4A of the ITA. Not only that the taxpayer filed appeals but also the Courts affirmation of the non-resident taxpayer's contention that the law is not clear.

In (*Oil (Asia) Pte Ltd v Director General of Inland Revenue*, n.d.), the High Court decided that the income from the rental of ship is not taxable in Malaysia because it is a business source. Thus, as the non-resident has no permanent establishment in Malaysia, such income is not taxable in Malaysia. Again, the High Court in (*SGS Singapore (Pte) Ltd v. Director General of Inland Revenue*, 1988) decided that section 4A is irrelevant because the income of the Singapore enterprise is a business source of income. Hence, there must be a permanent establishment in Malaysia for the Director General of Inland Revenue to tax the income. In another related issue, the court applied the same principle and decided against the revenue in (*Teraju Sinar v Director General of Inland Revenue*, 2014).

In 2013, after almost three (3) decades of defending section 4A of the ITA, the Federal Court finally decided a landmark decision on the correct interpretation of section 4A in (*Lembaga Hasil Dalam Negeri Malaysia v Alam Maritim Sdn Bhd*, 2014). The case was originated from the High Court on a judicial review application filed by the taxpayer. The taxpayer, Alam Maritim Sdn. Bhd filed a judicial review application to set aside the decision of the Director General to impose a withholding tax on the charter hire payment made to non-residents.

Based on the facts of the case before the High Court, the taxpayer, Alam Maritim Sdn. Bhd. filed a judicial review application to quash the decision of the Director General of Inland Revenue to impose withholding tax on the charter hire payment. Under section 4A of the ITA, the applicant is obliged to deduct withholding tax on the payment of charter fees made by the applicant to Singaporean non-resident companies operating the business of the supply of ship and crew or "time charter" of the ship or crew. The applicant argued that that the "time charter" payment constitutes business income of the Singaporean non-resident companies and therefore Article IV of the Double Taxation Agreement applied.

The High Court decided that the "time charter" payment is business income of the Singaporean non-resident companies. Hence, as the Singaporean companies have no permanent establishment in Malaysia, the business income is not taxable in Malaysia. The Director General of Inland Revenue did not agree with the High Court's decision and later filed an appeal to the Court of Appeal. The appeal was dismissed. Subsequent to the Court of Appeal's decision, the DGIR filed an application for leave to appeal to the Federal Court and the application was granted.

The Federal Court decided unanimously in favour of the Revenue and decided that with the introduction of section 4A, the Government of Malaysia might tax a non-resident company's income, categorized as special classes of income. The Court further decided that there is nothing unjust or absurd in the purpose of the Parliament was found. Despite the Federal Court decision, taxpayers are still arguing that decision in Alam Maritim is not final. Based on a literature written by a renowned lawyer, he wrote that The *Alam Maritim* decision is not the final word on the position of s 4A against the background of double taxation agreements and *Alam Maritim* itself has severe limitations (Subramaniam, 2014a).

3. CONCLUSION

This study is needed to examine the effectiveness of the current provision of section 4A of the ITA. For that purpose, the public ruling, which explains the application and interpretation of section 4A, is analyzed using the focus group design in which an in-depth interview will be conducted that can provide an insight into the particular issue of clarity and complexity of section 4A through the means of qualitative research methods. It is expected that the study will recommend to the policy maker on whether to improve the ITA with the objective of making the law clearer for better compliance of WHT in Malaysia. Revenue plays a very pertinent role for the development of the nation. Thus, this study is very significant to the Government as better compliance of the WHT may contribute to the increase in the revenue collection.

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