Executive summary
In a recent case involving a Malaysian subsidiary (the Taxpayer) of a large technology company, the High Court (HC) delivered a judgment in favor of the Taxpayer and ruled that a software distribution fee is not a royalty. Consequently, the software distribution fee payment is not subject to Malaysian withholding tax. This Alert summarizes the key judgment of the case.

Detailed discussion
The Taxpayer, incorporated in Malaysia, is a software distributor. In 2016, the Taxpayer applied for an advance ruling (Advance Ruling) to Malaysia’s Inland Revenue Board (IRB) to determine the nature of the software distribution fee and whether the fee specified in the Software Distribution Agreement (SDA) with a Dutch affiliate (the Dutch Affiliate) was subject to Malaysian withholding tax. The SDA would grant the Taxpayer the right to distribute in Malaysia the software program developed and owned by the Dutch Affiliate. However, the SDA does not grant the Taxpayer any proprietary right, copyright or know-how of any nature in relation to the Dutch Affiliate’s products. Further, the Taxpayer is not granted the right to reproduce the software programs or exploit any of the proprietary rights of the products.

The Advance Ruling issued by the IRB stated that the distribution fee is a royalty and thus, subject to withholding tax.
Dissatisfied with the Advance Ruling issued by the IRB, the Taxpayer filed a judicial review with the HC. The HC agreed with the Taxpayer that, if payments are made to acquire and distribute software copies (without the right to reproduce the software), these payments would be dealt with as business profits under Article 8 of the Malaysia-Netherlands Income Tax Treaty (the Treaty). If the distribution fee was a business profit of the Dutch Affiliate, the fee would only be taxable in the Netherlands.

The HC held that the distribution fee would not fall under the definition of royalty pursuant to Article 13(6) of the Treaty, given that the SDA only granted the taxpayer the right to distribute software programs in Malaysia, and there was no element of proprietary rights or know-how being granted or transferred to the taxpayer. Accordingly, the distribution fee paid under the SDA would not be subject to royalty withholding tax.

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