

Taxation in Labuan

Then and Now!

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The Federal Territory of Labuan is a group of seven islands located off the coast of Sabah. While part of Malaysia, Labuan provides a separate tax regime for qualifying entities. This article seeks to outline the separate tax regime together with recent changes.



THEN

Labuan Business Activity Tax Act 1990 (LBATA)

The LBATA was originally named the Labuan Offshore Business Activity Tax Act 1990 (LOBATA). However, during 2008 with Labuan's move to that of an intermediate jurisdiction, the word "offshore" was deleted and LOBATA became LBATA. Notwithstanding this change, the systems of taxation under LOBATA and LBATA were until recently substantially the same, with tax being either nil or 3%, but with an option to elect to pay tax of RM20,000.

Section 3 of LBATA is the main charging provision and provides that "... a Labuan entity carrying on a Labuan business activity shall be charged to tax in accordance with this Act for each year of assessment in respect of that Labuan business activity". Particular regard must be had to the underlined words.

Labuan Entity

A "Labuan entity" is defined in Section 2B and the Schedule to the LBATA. The definition of "Labuan entity" in the LBATA is not exhaustive as regard may need to be had to the associated provisions/legislation. For instance, a Labuan company includes not only

companies incorporated under the Labuan Companies Act 1990 (LCA), but also foreign incorporated companies registered under the LCA.

The Minister of Finance is empowered to amend the Schedule for the purposes of declaring any other person to be a Labuan entity.

Labuan Business Activity

A key concept is that of a "Labuan business activity" which until recently was defined as:

"... a Labuan trading or a Labuan non-trading activity carried on in, from or through Labuan in a currency other than Malaysian currency, by a Labuan entity with non-resident or with another Labuan entity..." (Section 2(1) of the LBATA).

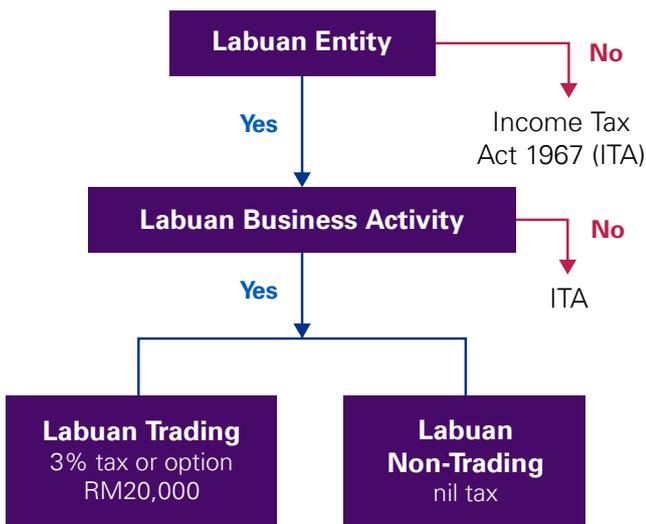
A Labuan trading activity includes banking, insurance, trading, management, licensing, shipping operations or any other activity which is not a Labuan non-trading activity. In turn, a Labuan non-trading activity is defined to mean an activity relating to the holding of investments in securities, stocks, shares, loans, deposits or any other properties situated in Labuan by a Labuan entity on its own behalf.

Year of Assessment (YA)

The LBATA adopts a similar definition of YA to that used in the Income Tax Act 1967 (ITA), namely the calendar year. However, it is important to note that LBATA uses a preceding year basis period. Therefore, for YA 2020 the basis period is the financial year ending in the 2019 calendar year.

Charged to Tax

The distinction between a Labuan trading and a Labuan non-trading activity is important as this determines the tax rate. A Labuan trading activity is taxed at 3% of the net profits as reflected in the audited accounts. There was an option to pay a fixed amount of tax of RM20,000 for a YA but this has been abolished with effect from 1 January 2019. A Labuan entity carrying on a Labuan non-trading activity is not charged to tax for that YA. The position, pre-2019 amendments, can be summarized as follows:



As will be discussed later in this article, significant changes to the rates of tax as well as the introduction of substance requirements are effective from 1 January 2019.

The LBATA also provides Labuan entities with an irrevocable election to be taxed under the ITA. This election was introduced primarily with the intention of enabling Labuan entities holding overseas investments to access treaty benefits as some countries have specifically excluded Labuan entities from accessing treaty benefits in their double tax agreements with Malaysia.



Ring-Fencing

To enjoy the favourable rates of tax under the LBATA, there was a general requirement that the Labuan entity must be dealing with either a non-resident or another Labuan entity. To this extent the activities of a Labuan entity were ring-fenced.

There are a number of relaxations to this general requirement whereby businesses can be undertaken by a Labuan entity with a Malaysian resident and in the Malaysian currency including:

- a Labuan entity carrying on business under Parts VI and VII of the Labuan Financial Services and Securities Act 2010 and parts VI and VII of the Labuan Islamic Financial Services and Securities Act 2010 [e.g. banking, insurance and leasing];
- a Labuan entity may hold investments in domestic companies;
- subject to approval, a Labuan entity may hold debt obligations in a domestic company; and
- such transactions as may be approved by the Minister of Finance.

As a result of the above concessions, a number of activities were transacted between Labuan entities and domestic businesses. Of particular note was the growth of leasing transactions where approved Labuan leasing companies undertook leasing arrangements between overseas lessors and domestic lessees. Such leasing structures are complemented by the Income Tax (Exemption) (No. 2) Order 1998 [PU(A) 69/1998] which provides an exemption from the 10% withholding tax that would otherwise be due on equipment lease rentals paid to a non-resident lessor.

Substance

Over the years, questions have been raised as to what substance is required in Labuan. LBATA requires that the Labuan Business Activity must be "... carried on in, from or through Labuan...". These terms are not further defined. However, they are capable of wide interpretation and appear not to be difficult to satisfy in practice.



2019 AND NOW

With the introduction of the Base Erosion and Profit Shifting (BEPS) initiative, the work of the Forum on Harmful Tax Practice (FHTP) has gained prominence in relation to preferential tax regimes. The work of the FHTP comprises three main areas:

1. The assessment of preferential tax regimes to identify features of such regimes that can facilitate base erosion and profit shifting.
2. Review substantial activities requirements in no or nominal tax jurisdictions.
3. Peer reviews and monitoring of tax transparency frameworks.

In line with FHTP practices, with effect from 1 January 2019, the following notable amendments have been made to the LBATA.

1. Introducing substantial activity requirements.
2. Introduction of 24% rate of tax under the LBATA.
3. Removing the option to pay tax of RM20,000.

4. Removing the ring-fenced features namely, the restrictions on dealing with residents and in the Malaysian currency, in order to introduce a level playing field.
5. Excluding income from an “intellectual property right” from the LBATA and instead taxing such income under the the ITA. This change is to combat transactions in what are sometimes referred to as “patent box” companies.

A complementary amendment was made to the ITA to limit the tax deductions that can be claimed by persons taxable under the ITA in respect of payments to Labuan entities.

The IRBM has also introduced a requirement for a Labuan entity to apportion its income if it carries out more than one approved Labuan business activity (i.e. if there is more than one business activity code).

The amendments introducing the substantial activity requirements and the changes to the tax rates have attracted the most attention.

Substantial Activity Requirements

The Labuan Business Activity Tax (Requirements for Labuan Business Activity) Regulations 2018 (“the Regulations”), read with Section 2B of the LBATA, introduced substance requirements in terms of the minimum number of full-time employees and annual operating expenditure, that a Labuan entity must have. The substance requirements, as amended by subsequent orders and proposals, depend on the particular Labuan business activity as follows:

No.	Labuan entity carrying on a Labuan Business Activity	Minimum number of full time employees in Labuan	Minimum amount of annual operating expenditure in Labuan (RM)
1. ^	Labuan insurer or Labuan takaful operator	3	200,000
2. ^	Labuan reinsurer or Labuan retakaful operator	3	200,000
3.	Labuan underwriting manager or Labuan underwriting takaful manager	4	100,000
4.	Labuan insurance manager or Labuan takaful manager	4	100,000
5. ^	Labuan insurance broker or Labuan takaful broker	2	100,000
6. ^	Labuan captive insurer or Labuan captive takaful		
	i. 1 st party captive	2	100,000
	ii. 3 rd party captive	3	100,000

No.	Labuan entity carrying on a Labuan Business Activity	Minimum number of full time employees in Labuan	Minimum amount of annual operating expenditure in Labuan (RM)
7. ~	Labuan International Commodity Trading Company (LITC)		
	i. 5 or less related LITC companies	2 per group	3,000,000 per entity in Malaysia (including minimum of RM100,000 in Labuan)
ii. Every incremental of 5 related LITC companies	Increase of 1 employee for every additional 5 LITC companies		
8. ^	Labuan bank, Labuan investment bank, Labuan Islamic bank or Labuan Islamic Investment bank	3	200,000
9.	Labuan trust company	3	120,000
10. ^	Labuan leasing company or Labuan Islamic leasing company	2 + *	100,000 per entity
11.	Labuan credit token company or Labuan Islamic credit token company	2	100,000
12.	Labuan development finance company or Labuan Islamic development finance company	2	100,000
13.	Labuan building credit company or Labuan Islamic building credit company	2	100,000
14.	Labuan factoring company or Labuan Islamic factoring company	2	100,000
15.	Labuan money broker or Labuan Islamic money broker	2	100,000
16.	Labuan fund manager	2	100,000
17.	Labuan securities licensee or Labuan Islamic securities licensee	2	100,000
18.	Labuan fund administrator	2	100,000
19.	Labuan company management	2	100,000
20.	Labuan International Financial Exchange	2	120,000
21.	Self-regulatory organisation or Islamic self-regulatory organisation	2	120,000
22. ^	Holding company:	1	20,000
	<ul style="list-style-type: none"> • Labuan entity that undertakes other than pure equity holding activities • Labuan entity that undertakes pure equity holding activities 	Not required, instead to comply with management and control requirements	20,000
23. #	<u>Other trading entity</u> Labuan entity that carries out administrative, accounting and legal services including backroom processing, payroll services, talent management, agency services, insolvency related services and management services	2	50,000

* Depends on the number of related leasing companies.

^ The above has been proposed in the Labuan Financial Services Authority (LFSA)'s Clarification to Labuan Investment Committee (LIC) Pronouncement 2-2019 dated 20 December 2019. The order has yet to be gazetted.

The above has been proposed in the LFSA's Addition to the Revised Substance Regulations dated 21 January 2020. The order has yet to be gazetted.

~ The above has been proposed in the LFSA's Revision to Substantial Activity Requirements for LITC under the Global Incentives for Trading (GIFT) Programme dated 29 April 2020. The order has yet to be gazetted.

For the purpose of the Regulations, the LFSA has clarified that “full time employees” shall include:

- a. At least an officer of a managerial capacity; and
- b. Other employees dedicated to serve the Labuan entities whom may be employed either on a permanent or contract basis by the Labuan entities which include non-managerial and clerical staff.

The view of the Inland Revenue appears to be that an activity which does not fall within the activities in the Regulations is not a Labuan business activity and will therefore, by default, fall under the ITA.

It is important to note that effective YA 2020, a Labuan entity carrying on a Labuan business activity which fails to meet the substance requirements in the Regulations, will be taxed at 24%.

24% Rate

When initially proposed, there was some concern that the 24% rate was a reference to the ITA. However, the Finance Act 2020 introduced a 24% rate of tax in the LBATA. The option to pay tax at the fixed amount of RM20,000 is abolished with effect from 1 January 2019. The relevant tax rates can be summarized as follows:

Labuan Business Activity carried on by a Labuan entity	Substance Requirements	LBATA Rate %
Trading	✓	3%
Trading	✗	24%
Non-trading	✓	Nil
Non-trading	✗	24%

Although both the ITA and the LBATA now impose tax at 24%, there is a key difference between the two. The 24% rate under ITA is levied on chargeable income, while the 24% rate under LBATA is on “... the net profits as reflected in the audited accounts”. The use of accounting profits as the base to which the 24% tax rate is applied, while simplistic, does not allow for any adjustments. This apparently simplistic approach can result in anomalies as accounting profits do not distinguish between capital and income gains nor between realised and unrealised amounts. Of particular note is that the exemptions contained in Schedule 6 of the ITA are not incorporated into the LBATA.

Holding Companies

There has been considerable debate about the substance requirement for holding companies. The Regulations initially required holding companies to have a minimum of two full time employees and annual operating expenditure of at least RM50,000. A distinction has now been drawn between a holding company which undertakes “pure equity holding activities” and a holding company which undertakes “other than pure equity holding activities”.

The holding company dichotomy is based on the distinction drawn in the Organisation for Economic Co-operation and Development (OECD)’s BEPS Report on Action 5 (“*Countering Harmful Tax Practices More Effectively, Taking Into Account Transparency and Substance*”). The OECD’s BEPS Report on Action 5 identifies “companies that hold equity participations and earn only dividends and capital gains” and for the purpose of the Regulations, these companies are viewed to be undertaking “pure equity holding activities”. In contrast, companies identified in the OECD’s Report that “hold a variety of assets and earn different types of income e.g. interest, rents and royalties” are viewed for the Regulations to be undertaking “other than pure equity holding activities”.

Pure equity holding entities do not require any full time employees but local management and control requirements apply and annual operating expenditure must be at least RM20,000. Given the significance between the two different types of holding activity, the definitions of “pure equity holding activities” and “other than pure equity holding activities” could be usefully included within the LBATA or at least the Regulations.



Concluding Remarks



The recent changes to the basis of taxation for Labuan entities are undoubtedly significant. The essence of the changes is the requirement to locate the economic activities which generate income in Labuan. This requirement for substance, as prescribed by the Regulation, to be in Labuan is a direct response to the “new normal” of international taxation. On the assumption that businesses adopt these requirements, this can only be good news for Malaysia.

It is submitted that further ‘fine tuning’ of the LBATA is required. The consequences of the apparently simplistic approach of using net accounting profits as the taxable base, may be unintended. Accounting profits may include capital gains both realised and unrealized, as well as dividends. The subjection of these profits/gains to tax is anathema to many tax professionals but appears to be the logical conclusion. The writer hopes that the authorities will relook at this, as failing which, more Labuan entities may need to explore exiting LBATA through the irrevocable election to be taxed under the ITA.

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1. “Management and control” is not defined in the LBATA but the LFSA has uploaded the ‘Directive on management and control requirements for Labuan entities that undertake pure equity holding activities (dated 10 August 2020)’ on its website.

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