

Client Alert

February 2019

The New Labuan – Understanding the Changes

The Budget 2019 announcement by the Minister of Finance on 2 November 2018 has brought about significant changes to the Labuan tax regime. These changes are in line with Malaysia's commitments as a member of the Inclusive Framework on Base Erosion and Profit Shifting ("**BEPS**") to address tax evasion and harmful tax practices, including the elevation of substantial activities requirements in Labuan.

In this alert, we will take a closer look at the legal implications of the following changes, all of which came into effect on 1 January 2019:

- (i) amendments to the Labuan Business Activity Tax Act 1990 ("**LBATA Amendments**");
- (ii) introduction of the new Labuan Business Activity Tax (Requirements for Labuan Business Activity) Regulations 2018 ("**Economic Substance Regulations**"); and
- (iii) introduction of the new Income Tax (Deductions Not Allowed for Payment Made to Labuan Company by Resident) Rules 2018 ("**Disallowed Deductions Rules**").

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A. No restriction on dealing with Malaysian Ringgit or Malaysian residents

Previously, a Labuan entity may be said to be carrying on a "Labuan business activity" only if that activity is carried on in, from or through Labuan in a foreign currency with a non-resident or another Labuan entity.

The LBATA Amendments have removed these restrictions. A Labuan entity may carry on a "Labuan business activity" in Malaysian Ringgit and with a Malaysian resident, so long as such activity does not constitute an offence under any other written law.


B. Abolishment of election to pay tax at the flat rate of RM 20,000 per year

A Labuan entity carrying on a "Labuan trading activity"¹ previously enjoyed the ability to elect to pay tax: (i) at the rate of 3% on its net profits per year as reflected in its audited accounts; or (ii) at the flat rate of RM 20,000 per year.

However, following the LBATA Amendments, a Labuan entity performing a "Labuan trading activity" is automatically subject to tax at the rate of 3% on its net profits² as reflected in its audited accounts. Consequently, all Labuan entities are now required to have audited accounts for the purpose of tax filings.

¹ "Labuan trading activity" is defined to include banking, insurance, trading, management, licensing, shipping operations or any other activity which is not a "Labuan non-trading activity".

² This excludes any income derived from royalty or an intellectual property right if it is receivable as consideration for the commercial exploitation of that right.



That said, a Labuan entity performing a "Labuan non-trading activity"³ continues to be exempt from tax under the LBATA. There is presently no requirement for such a Labuan entity to maintain audited accounts.

C. Income from intellectual property no longer taxed under LBATA

Pursuant to the LBATA Amendments, income derived from royalty or an intellectual property right⁴ if it is receivable as consideration for the commercial exploitation of that right is now taxed under the Income Tax Act 1967 ("ITA") instead of the preferential tax regime of the LBATA. The prevailing corporate income tax rate under the ITA is 24%.

D. New economic substance requirements for Labuan entities

Previously, the LBATA did not specifically require a Labuan entity to have economic substance. However, the new Section 2B(1)(b) of the LBATA now requires all Labuan entities undertaking a "Labuan business activity" to have:

- (i) an adequate number of full time employees in Labuan; and
- (ii) an adequate amount of annual operating expenditure in Labuan.

The Economic Substance Regulations seek to specify what is (i) the minimum number of full time employees required in Labuan; and (ii) the minimum amount of annual operating expenditure required in Labuan. The minimum requirements vary depending on the type of Labuan entity. For example, a Labuan "holding company" is required to have a minimum of two (2) full time employees in Labuan and an annual operating expenditure of RM50,000 in Labuan. A Labuan "leasing company" is required to have a minimum of two (2) full time employees in Labuan and an annual operating expenditure of RM100,000 in Labuan.

The Economic Substance Regulations reflect the Malaysian Government's constructive response to the Forum on Harmful Tax Practices' ("FHTP") recommendations, and have resulted in the FHTP's latest assessment⁵ of some Labuan regimes as not harmful. Nonetheless, Wong & Partners have been engaging in discussions with the authorities to voice our concerns on a few issues that remain uncertain, including the following:

- (i) Given the Economic Substance Regulations set out minimum compliance requirements, does compliance with the Economic Substance Regulations automatically satisfy the obligations of a Labuan entity to meet "adequate" requirements under Section 2B(1)(b) of the LBATA regardless of the size of the operations and assets of the Labuan entity?
- (ii) Does the Economic Substance Regulations apply to Labuan entities which are not specifically listed in the Economic Substance Regulations, and if so, to what extent?

³ "Labuan non-trading activity" is defined to mean an activity relating to the holding of investments in securities, stock, shares, loans, deposits or any other properties situated in Labuan by a Labuan entity on its own behalf.

⁴ An "intellectual property right" means a right arising from any patent, utility, innovation and discovery, copyright, trade mark and service mark, industrial design, layout-design of integrated circuit, secret processes or formulae and know-how, geographical indication and the grant of protection of a plant variety, and other like rights, whether or not registered or registrable.

⁵ See the Harmful Tax Practices – 2018 Progress Report on Preferential Regimes released by the OECD on 29 January 2019.



- (iii) How does the economic substance requirements apply to non-operating investment holding companies or pure equity holding companies (which only hold equity participations and earn only dividends and capital gains, and as such, are perceived to pose less BEPS risk)? Why would pure holding companies be required to have "full time employees" and incur annual operating expenditure?
- (iv) The term "full time employees" is undefined. Are non-traditional or alternative employment arrangements acceptable?
- (v) To what extent, if at all, can outsourcing arrangements be taken into account for the purpose of complying with the economic substance requirements?

Following an industry briefing with the Labuan Financial Services Authority ("LFSA") on 17 January 2019 in relation to issues faced by various industries as a result of the Economic Substance Regulations, the LFSA has issued a set of frequently asked questions on 25 January 2019 to further explain some of the requirements under the Economic Substance Requirements. However, as some of the issues discussed above have yet to be fully addressed, we are hopeful that clearer guidance will be issued by the authorities soon.

E. Restrictions on tax deductions for payments made to Labuan company

Previously, a person may claim a full tax deduction under Section 33 of the ITA, when ascertaining his adjusted income to be taxed under the ITA, in respect of expenses which are wholly and exclusively incurred in the production of gross income.

With the introduction of the Disallowed Deductions Rules, a person may now claim a partial tax deduction only under Section 33 of the ITA in respect of certain payments made to a Labuan company. The maximum deductions permitted are outlined below:

Type of payment to a Labuan company	Maximum deduction permitted
Interest payment	67%
Lease rental	67%
Other payments	3%

What this means for taxpayers

The Malaysian Government has clearly put in much effort to enact legislative amendments and introduce additional requirements to the Labuan regime to ensure that Labuan structures are not used for tax evasion purposes in compliance with Malaysia's BEPS commitments. These changes are intended to comply with prevailing international standards while being responsive to the needs and circumstances of taxpayers. Although the changes are still new and further clarification is expected soon, businesses and individuals should carry out a detailed review of their existing structures with their advisors to understand the potential impact of the new requirements, and reconsider their strategy and plans.

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