



MEMORANDUM ON ISSUES ARISING FROM RECENT TAX LEGISLATION IN RELATION TO LABUAN

Date: 18 January 2019

Prepared by:

Technical Committee – Direct Tax (II)

Chartered Tax Institute of Malaysia



MEMORANDUM ON ISSUES ARISING FROM RECENT TAX LEGISLATION IN RELATION TO LABUAN

Contents

	Issues	Page No.
1.	Labuan Business Activity Tax (Requirements for Labuan Business Activity) Regulations 2018 [P.U. (A) 392/2018]	3
2.	Amendment of S.2B of the Labuan Business Activity Tax Act 1990 (“LBATA”)	8
3.	3% mandatory tax rate for Labuan trading activity	10
4.	New definition of Labuan business activity	11
5.	Limitation of tax deductions on payments to Labuan companies	12
	APPENDIX A	13

1. Labuan Business Activity Tax (Requirements for Labuan Business Activity) Regulations 2018 [P.U. (A) 392/2018]

A Labuan entity carrying on a Labuan business activity shall have the number of full time employees and an amount of annual operating expenditure as specified in the Regulations' Schedule. [Paragraph 2(1) of the P.U. (A) 392/2018]

1.1 Annual operating expenditure - Any expenditure excluded?

Comments:

What would be excluded from the annual operating expenditure?

LHDNM's Comment:

For the purposes of FHTP's criteria the operating expenditure must be the actual expenditure spent in the jurisdiction that offers the preferential regime to generate the core income generating activities. The operating expenditure shall exclude any expenditure which is capital in nature and any expenditure which involved estimation such as depreciation, provision of doubtful debt and impairment.

1.2 Expenditure in Malaysia outside Labuan

There may be certain supplies, services etc. which are not available in Labuan, and which need to be sourced from other parts of Malaysia.

Comments:

Can the words "*Minimum amount of annual operating expenditure in Labuan*" be interpreted to include the operating expenditure of the Labuan office which is paid anywhere in Malaysia, especially since Labuan entities are now allowed to deal with residents of Malaysia and in the Malaysian currency?

LHDNM's Comment:

Yes. The minimum amount of annual operating expenditure in Labuan must be incurred in Labuan. This is to ensure that Labuan benefits from the preferential tax rate provided to Labuan Entities. This requirement was made to adhere to international tax standard which require the entities given the tax benefit to have substantial activity in the jurisdiction providing the tax benefit. Since Labuan Entities are permitted to carry out the Labuan business activities with Malaysian residents and in Malaysian currency, the government has imposed necessary requirement to ensure Labuan will not be used as tax minimisation vehicle and to fulfil Malaysia's commitment in BEPS action plan.

1.3 Grace period

The Regulations came into operation on 1 January 2019.

The period between 2 November 2018 and 1 January 2019 is less than two months. In addition, The Regulations are dated 31 December 2018.

Comments:

It would be ideal for a Labuan entity to get its filing right in the first year, i.e. for the basis period ending in 2019 for the year of assessment 2020.

Can a grace period be granted to comply with the Regulations? For example, so long as a Labuan entity meets the specified requirements at any time before the end of 2019, it would be regarded as compliant and carrying on Labuan business activity for the year of assessment 2020.

LHDNM's Comment:

No grace period is granted. The substance requirement must be fulfilled by Labuan Entities starting from 1 January 2019. Since the tax filing for Labuan Entities are still according to preceding year (PY) basis, therefore, for basis period for year of assessment 2020 (starting from 1 January 2019), Labuan Entities shall fulfill the substantial requirement activities i.e having a number of fulltime employees and an a minimum amount of annual operating expenditure as provided under Labuan Business Activity Tax (Requirements for Labuan Business Activity) Regulations 2018 – P.U.(A) 392/2018. Failure to comply with the regulations may result in the activity not to be regarded as Labuan Business Activities and will be subjected to tax under ITA 1967.

1.4 Switching of filing jurisdiction

Comments:

If a Labuan entity is not compliant in 2019, but becomes compliant with effect from 1 January 2020, can the Labuan entity switch to filing under the LBATA for the basis period ending 31 December 2020 (after filing under the Income Tax Act 1967 ("ITA") for the basis period ending 31 December 2019)?

LHDNM's Comment:

Yes. The Labuan Entities will file its tax return under the LBATA 1990 once the substance requirement is met. This will be further explained in the Operational Guidelines.

1.5 Filing under both ITA and LBATA

Comments:

Where a the Labuan entity is compliant for part of a year, and not compliant for the other part, would the Labuan entity be required to file under both the ITA and the LBATA?

How should the cut-off date be determined?

Alternatively, to allow the entity to meet with the minimum number of full time employees within 3 years.

LHDNM's Comment:

Labuan Entities must comply with the substantial requirement as provided in the regulations throughout the basis period. Partial compliance will result in the activity not to be regarded as Labuan Business Activities and will be subjected to ITA 1967.

There is no flexibility provided by FHTP for Labuan Entities to fulfil the substantial requirement. Malaysia has provided its commitment that all Labuan Entities enjoying the tax benefit will comply to the regulation. Malaysia will deny the Labuan Entities benefiting from the Labuan regime if they fail to comply with substance requirement. This is the denial of benefits that shall be conducted in the monitoring process of FHTP.

1.6 Labuan banks and insurance companies (co-located office in Malaysia)

There are Labuan banks and insurance companies which have established co-located offices in Malaysia outside of Labuan under guidelines issued by Labuan FSA.

Comments:

Can the Labuan bank/ insurance company retain this office and still be regarded as carrying on a Labuan business activity, if it complies with the "full time employees" and "annual operating expenditure" requirements at this office?

If it is required to maintain an office in Labuan as well, can the employees travel between these two offices, and the employees and expenditure at both offices be taken into account to arrive at the minimum required?

LHDNM's Comment:

As provided in 1.2, the substantial activities requirement must be undertaken in Labuan. Therefore, employees and operating expenditure incurred in any co-located offices outside Labuan shall be excluded in assessing the compliance on substantial activity for Labuan Regime.

The fulltime employees shall be separated from the entity outside Labuan where the Labuan bank or insurance company must maintain its own employees.

The expenditure to be taken into account by the Labuan entity shall be expenditure spent by that entity and not a combination of the entity outside Labuan.

1.7 Labuan international commodity trading companies ("LITCs") under the GIFT programme (operational office in Malaysia outside Labuan)

LITCs are permitted to establish an operational office anywhere in Malaysia pursuant to the guidelines on the establishment of LITCs under the GIFT programme dated 8 March 2018.

Comments:

Can the LITC retain this office and still be regarded as carrying on a Labuan business activity, if it complies with the "full time employees" and "annual operating expenditure" requirements at this office?

If it is required to maintain an office in Labuan as well, can the employees travel between these two offices, and the number of full time employees and annual operating expenditure at both offices be taken into account to arrive at the minimum required?

LHDNM's Comment:

The LITC shall comply with requirements that have been addressed in the Labuan Business Activity Tax (Exemption) 2013 (Amendment) Order 2017 and Labuan Business Activity Tax (Exemption) (No.2) 2013 (Amendment) Order 2017 respectively. Those exemption orders will be amended accordingly to follow the FHTP criteria once the Minister of Finance decides on the policy of GIFT programme.

1.8 Sharing of office in Labuan

Comments:

If a group has two or more subsidiaries which are Labuan entities, can the Labuan entities share one office in Labuan together with the employees, and all are regarded as compliant if that one office complies with the “full time employees” and “annual operating expenditure” requirements?

LHDNM’s Comment:

No. Each of Labuan Entities must comply with substantial activity requirement in order to enjoy the tax benefit. The fulltime employees shall be separated from the entity outside Labuan and must maintain its own employees.

The expenditure to be taken into account by the Labuan entity shall be expenditure spent only by that entity and not a combination of the entity outside Labuan.

1.9 A second office in Malaysia

Labuan entities are now allowed to deal with residents of Malaysia and in the Malaysian currency.

Comments:

If a Labuan entity is compliant in Labuan with the “full time employees” and “annual operating expenditure” requirements, would it be permitted to set up a second office in another part of Malaysia, and still be regarded as carrying on a Labuan business activity?

LHDNM’s Comment:

No. Labuan Entities must be established in Labuan. Each of Labuan Entities must maintain its own employees and must incur the annual operating expenditure as provided in the regulation.

1.10 Labuan Holding Company

(1) No.	(2) <i>Labuan entity carrying on a Labuan business activity</i>	(3) <i>Minimum number of full time employees in Labuan</i>	(4) <i>Minimum amount of annual operating expenditure in Labuan (RM)</i>
21.	Holding Company	2	50,000

[Item No. 21 of the Schedule in the P.U. (A) 392/2018]

Comments:

Does this “Holding Company” refer to the Labuan Holding Company pursuant to the “Guideline On Co-location of Labuan Holding Company” issued by the Labuan Financial Services Authority (“FSA”) dated 1 June 2009 (updated on 18 December 2015)?

Under the said guideline, the Labuan Holding Company must make an irrevocable election to be taxed under the ITA pursuant to S.3A of the LBATA. As such, the “full time employees” and “annual operating expenditure” requirements do not seem relevant for such Labuan entities.

LHDNM’s Comment:

If the Labuan Entities have made irrevocable election to be taxed under ITA 1967, there is no need for that Labuan Entities to fulfil the substantial activity requirement. The “holding company” as stated in the regulation P.U.(A) 392/2018 refers to Labuan Business Activity which core income generating activity relates to holding of investment and to be taxed as non-trading activity under LBATA 1990.

1.11 Labuan entities which do not wish to comply and prefer to liquidate as soon as possible (grace period/ tax clearance/ liquidation)

Comments:

Can such Labuan entities be given a grace period, of say 12 months, to wrap up their affairs, seek tax clearance under the old Labuan tax regime, and thereafter be liquidated?

An example is a Labuan entity which has always paid the flat tax of RM20,000 annually, and has never had its annual accounts audited. Commencing the audit of the 2019 accounts of such an entity is likely to be challenging for both auditor and client.

LHDNM's Comment:

No grace period will be given to the Labuan Entities.

1.12 Dormant Labuan entities

We understand that a Labuan entity which is dormant means that it has either ceased its business operations, or it has not commenced business operations, for a year of assessment.

Comments:

- i. As the Labuan entity does not carry on any business activity, please confirm :
 - that the “full time employees” and “annual operating expenditure” requirements do not apply to it; and
 - that it can continue to file in accordance with item 2.4 of the letter issued by the IRB dated 21 July 2016 (please refer to the **attached Appendix A**).
- ii. What is “dormant”? Could a definition be provided for “dormant” as guidance for LBATA tax filing purposes?

LHDNM's Comment:

Since Labuan Entities need to fulfil the substance requirement to enjoy the tax benefit, there should not be any dormant company to be regarded as Labuan Entities. If the dormant company does not fulfilled the substance requirement, the dormant company will then be subjected to tax under ITA 1967. For Labuan Entities to enjoy the preferential tax regime, it must undertake the core income generating activities. If there is no income generated from the core income generating activities, no income is eligible for the preferential tax rate.

2. Amendment of S.2B of the Labuan Business Activity Tax Act 1990 ("LBATA")

S.2B of the LBATA is amended by substituting for subsection (1) the following subsection:

"(1) The Labuan entities—

- (a) shall be as specified in the Schedule *; and*
- (b) shall, for the purpose of the Labuan business activity, have— (i) an adequate number of full time employees in Labuan; and*
 - (ii) an adequate amount of annual operating expenditure in Labuan, as prescribed by the Minister by regulations made under this Act."*

* The LBATA's Schedule is as follows:

***"SCHEDULE
[Section 2B]
LABUAN ENTITY***

- 1. A Labuan company.*
- 2. A Labuan foundation established and registered under the Labuan Foundations Act 2010 [Act 706].*
- 3. A Labuan Islamic foundation established and registered under the Labuan Islamic Financial Services and Securities Act 2010.*
- 4. A Labuan Islamic partnership as defined in the Labuan Islamic Financial Services and Securities Act 2010.*
- 5. A Labuan limited partnership established and registered under the Labuan Limited Partnerships and Limited Liability Partnerships Act 2010.*
- 6. A Labuan limited liability partnership established and registered under the Labuan Limited Partnerships and Limited Liability Partnerships Act 2010.*
- 7. A Labuan Islamic trust as defined in the Labuan Islamic Financial Services and Securities Act 2010.*
- 8. A Labuan trust as defined in the Labuan Trusts Act 1996 [Act 554].*
- 9. A Malaysian Islamic bank licensee as defined in the Labuan Islamic Financial Services and Securities Act 2010.*
- 10. A Malaysian bank licensee as defined in the Labuan Financial Services and Securities Act 2010.*
- 11. Any Labuan financial institutions as defined in the Labuan Financial Services Authority Act 1996 [Act 545].*
- 12. Any person declared by the Minister to be a Labuan entity under subsection 2B(2)."*

(please turn over)

2.1 Are unlisted Labuan entities exempted?

Comments:

Are those Labuan entities which are **not listed** in the Regulations' Schedule **exempted from complying** with the "full time employees" and "annual operating expenditure" requirements?

Examples of Labuan entities which are **not listed** in the Regulations' Schedule are:

- A family trust.
- A charitable foundation.

LHDNM's Comment:

No. Labuan Business Activity which are not listed in the regulation will not be regarded as Labuan Business Activity and to be taxed under ITA 1967.

3. 3% mandatory tax rate for Labuan trading activity

With the abolition of the RM20,000 tax election, Labuan entities which carry on a Labuan trading activity will be taxed at 3% of net audited profits.

The effective date is 1 January 2019.

There are Labuan entities whose financial year does not end on 31 December each year.

3.1 When does the 3% mandatory tax rate commence?

Comments:

Can it be confirmed that the first year for the mandatory 3% tax rate will affect only those Labuan entities whose basis period begins on or after 1 January 2019?

If not, is a Labuan entity permitted to change its financial year (say from 30 June) to end on or before 31 December 2018 in order to make the RM20,000 tax election for the last time (for the year of assessment 2019)?

LHDNM's Comment:

The 3% mandatory tax rate will commence for Labuan Entities in YA 2020 and IRBM's opinion is on those companies whose basis period begin on or after 1 January 2019. This is pending policy decision from the Ministry of Finance.

4. New definition of Labuan business activity

“Labuan business activity” means a Labuan trading or a Labuan non-trading activity carried on in, from or through Labuan, excluding any activity which is an offence under any written law. [S.2(1) of the LBATA]

4.1 Shipping operations

The previous definition of “Labuan business activity” includes the following proviso:

(d) in relation to the shipping operations, the operations may be carried out in Labuan or outside Malaysia

With the new definition for “Labuan business activity”, the above proviso will be no more.

Comments:

Please confirm that shipping operations can now be carried out in Malaysia and will qualify as a Labuan business activity.

LHDNM’s Comment:

No. Shipping operations are not listed in the regulation and is not regarded as Labuan Business Activity and to be taxed under ITA 1967.

5. Limitation of tax deductions on payments to Labuan companies

Based on the new S.39(1)(r) of the ITA read together with the Income Tax (Deductions Not Allowed for Payment Made to Labuan Company by Resident) Rules 2018 [P.U.(A) 375/2018], payments by Malaysian residents to any Labuan company would only qualify for a limited tax deduction.

Comments:

- i. Based on a reading of the law, this appears to be the case even if the Labuan company is not carrying on a Labuan business activity or has elected to be taxed under the ITA. This does not appear to be an equitable result. If the Labuan company is taxed under the ITA on income received from a Malaysian resident, the Malaysian resident should obtain a full tax deduction on the payment to the Labuan company.
- ii. S.39(1)(r) is effective from 1 January 2019. For expenses incurred/ accrued before 1 January 2019 and paid after 1 January 2019, are such expenses subject to the disallowance under S.39(1)(r)?

LHDNM's Comment:

Yes, your understanding is correct. The payment restriction under Section 39(1)(r) of the ITA will not be applicable if the payment was made to Labuan Entities that have elected to be taxed under ITA 1967.

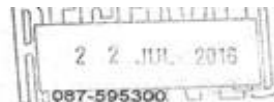
The Section 39(1)(r) of the ITA is effective from payment incurred/accrued after 1 January 2019

APPENDIX A

Letter issued by the IRB dated 21 July 2016 (see item 1.13 on page 7 of this memorandum)



LEMBAGA HASIL DALAM NEGERI MALAYSIA
(INLAND REVENUE BOARD),
UNIT E004 & E005, FIRST FLOOR,
PODIUM LEVEL,
FINANCIAL PARK LABUAN,
JALAN MERDEKA,
87000 W.P. LABUAN.



Tel : 087-595300
Fax : 087-415385
Homepage: <http://www.hasil.gov.my>

Our Ref : LHDN.L.01/262/3/1
Date : 21 July 2016

Attention to:
Labuan Trust Companies;
Labuan Entity; and
Tax Agents/ Advisory/ Auditors/ Liquidators.

Dear Sirs,

**LABUAN BUSINESS ACTIVITY TAX [FORMS] [REVOCATION] REGULATIONS 2016
(NEW TAX RETURN FORMS FOR LABUAN BUSINESS ACTIVITY)**

The above matter refers.

2. We are pleased to inform you on the following matters:-

- 2.1 With effect from 25 April 2016, the Labuan Business Activity Tax (Forms) Regulations 2013 [P.U. (A) 224/2013] has been revoked via new regulations cited as the Labuan Business Activity Tax [Forms] [revocation] Regulations 2016. Please refer Attachment A; and
- 2.2 In view of paragraph 2.1, the new tax return forms must be used with effect from 25 April 2016. However, **concession to use the previous (old) tax return forms up to 31 July 2016** has been granted by Inland Revenue Board of Malaysia (IRBM).

As such the new tax return forms will be used for tax filing purposes with effect from 1 August 2016;

- 2.3 The new tax return forms for Labuan business activity is available and can be downloaded at Inland Revenue Board of Malaysia (IRBM) website: <http://www.hasil.gov.my/>. Please refer to Attachment B for further clarification on the new tax return forms; and
- 2.4 **With effect from 1 August 2016**, Labuan entity which is dormant/ has not commence business for that particular year of assessment need to file Form LE1 and formal notification letter.

3. Cooperation from you will be much appreciated.

Thank you.

Yours faithfully,

(ZAMILA BINTI LIMJO)
Assistant Director
for Chief Executive Officer/Director General of Inland Revenue
Inland Revenue Board
Malaysia