

# Tax e-Alert

18 JANUARY 2019

## FHTP Membership & Impact of BEPS 5 On Labuan Entities

On 17.8.2018, the Ministry of Finance (**MoF**) announced its commitment to implement the Base Erosion and Profit Shifting (BEPS) Action 5, titled “Countering Harmful Tax Practices More Effectively, Taking into Account Transparency and Substance”. BEPS 5 and its impact on MSC companies have previously been discussed in our Tax e-Alert dated 16.11.2018 (click [here](#)).

## BEPS Action 5 and Labuan

In short, BEPS Action 5 identifies no or low preferential corporate tax rate (preferential regimes) that can be categorised as harmful tax practices. Evaluation will be carried out by the Forum on Harmful Tax Practices (**FHTP**) on whether tax incentives available in member countries result in “harmful” tax practices, and how these could be curbed. In this regard, with its low tax rate and reputation as an attractive tax jurisdiction, it is inevitable that the Labuan tax regime will draw scrutiny for FHTP evaluation.

## Proposed changes to Labuan incentives

### *(a) Removal of ring-fencing on Labuan business activity*

With effect from 1.1.2019, Section 2(1) of the Labuan Business Activity Tax Act 1990 (**LBATA**) has been amended to remove ring-fencing on Labuan business activity. The new proposed definition is to read as follows:

“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.”

Labuan business activity has previously been ring-fenced by excluding transactions between a Labuan entity and a resident (Malaysian natural person or business) and transactions in Malaysian currency.

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This amendment is meant to bring Labuan closer in line with one of the FHTP's criteria on evaluation for non-IP incentives, i.e. ring-fencing, which requires no distinction on tax treatment including transaction and currency restrictions between residents and non-residents.

*(b) Requirement for adequate number of full-time employees and annual operating expenditure amount*

The definition of a Labuan entity was amended where under the new definition, a Labuan entity is required to have "an adequate number of full-time employees in Labuan" and "an adequate amount of annual operating expenditure in Labuan".

Similarly, this amendment is clearly meant to achieve compliance with the FHTP's substantial activities requirement. Ambiguity would continue to persist, however, until and unless the MoF stipulates what exactly would be an adequate number or adequate amount for the purpose of compliance with the LBATA.

*(c) Abolishment of option to elect for fixed amount of tax at RM20,000*

A Labuan taxpayer could previously either pay tax at a fixed amount of RM20,000 for each year of assessment (see Section 7 of the LBATA) or be taxed at the rate of 3% (see Section 4 of the LBATA). As an added incentive, taxpayers who opted for the former would also not be required to prepare audited accounts.

Pursuant to the Finance Act 2019, a Labuan taxpayer would now be taxed at a rate of 3% without the option of being taxed at a fixed rate of RM20,000. The retention of the 3% tax rate is perhaps a recognition that a balance has to be struck between compliance with international tax standards and ensuring that Labuan remains an attractive jurisdiction for businesses.

*(d) Carving out of IP income*

The Finance Act 2019 has also amended Section 4 of the LBATA to the effect that income from exploitation of intellectual property (**IP**) would now be subject to tax under the Income Tax Act 1967 (**ITA**). In other words, the 3% tax rate is not applicable to the IP income of a Labuan entity.

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The FHTP nexus approach for IP income requires that only expenditure incurred in a particular jurisdiction be eligible for incentives in that jurisdiction. To ensure compliance with international standards, excluding IP income entirely from the Labuan regime is not unprecedented. In May 2018, for instance, Singapore legislated to remove IP income entirely from the scope of its pioneer incentives (subject to a transitional period allowed by the FHTP).

It is hoped, however, that this is only a short-term measure as BEPS does not require IP income to be excluded entirely from incentives so long as there is a sufficient nexus with the particular jurisdiction in question.

*(e) Disallowance of payments made to Labuan company by Malaysian taxpayers for deductibility*

By virtue of the insertion of the new Section 39(1)(r) to the ITA, payments made to a Labuan company by a Malaysian taxpayer would now be disallowed for deductibility under Section 33(1) unless otherwise prescribed by the MoF.

On 31.12.2018, the Income Tax (Deductions Not Allowed for Payment Made to Labuan Company By Resident) Rules 2018 PU(A) 375/2018 was gazetted. Effective from 1.1.2019, the prescribed amount prohibited from deduction for the following types of payments to Labuan companies is as follows:

Type of payment	Amount not allowed for deduction
Interest payment	33%
Lease rental	33%
Other payments	97%

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## Conclusion

It remains to be seen whether these amendments have taken away the attractiveness of Labuan as an international business and financial centre. The good thing is that the 3% tax rate for a Labuan entity remains far more attractive than the 24% corporate tax rate applicable under the ITA. The 21% tax rate difference should still be more than sufficient for Labuan to remain an attractive jurisdiction for businesses, provided that a Labuan entity now maintains an “annual number of full-time employees” and “adequate amount of annual operating expenditure”, though these new requirements are rather vague.

If you have queries on how these amendments may affect your Labuan tax liability, please contact our tax partners **Datuk D P Naban** or **S Saravana Kumar** at [tax@lh-ag.com](mailto:tax@lh-ag.com)

Published by the Tax, SST & Customs Practice,  
Lee Hishammuddin Allen & Gledhill

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