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Client Alert

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Malaysia: The Refined Labuan Tax Regime

In brief

The introduction of the economic substance requirements under the Labuan tax regime in 2019 came hand in hand with a myriad of ambiguities and uncertainties, which subsequent legislation and guidelines aimed to clarify.

This alert discusses Labuan tax developments such as the updated substance requirements for equity holding companies, the taxation of Labuan entities who carry out "other trading" activities, stamp duty implications for instruments relating to a Labuan entity, and also the latest amendments to legislation, via the Labuan Business Activity Tax (Requirements for Labuan Business Activity) Regulations 2021 ("**2021 Regulations**")[1] and Income Tax (Exemption) (No. 11) Order 2021 ("**Exemption Order**").

In this issue

Updates related to the economic substance requirements for Labuan pure equity holding companies

The new 2021 Regulations further revise the rules pertaining to the economic substance requirements for Labuan entities, thus effectively revoking and replacing the Labuan Business Activity Tax (Requirements for Labuan Business Activity) Regulations 2018 ("**2018 Regulations**"). We set out the key updates under the 2021 Regulations below:

1. **Reduced economic substance requirements for Labuan entities undertaking pure equity holding ("PEH") activities ("Labuan PEH Entities")**[2]

   Previously, the 2018 Regulations had required all Labuan holding companies, which arguably includes all Labuan PEH Entities, to have a minimum of two (2) full time employees in Labuan and an annual operating expenditure ("**OPEX**") of RM 50,000 in Labuan.

   Under the 2021 Regulations, all Labuan PEH Entities are exempted from the requirement to have full time employees in Labuan[3]. Additionally, the amount of minimum OPEX required in Labuan is reduced from RM 50,000 to RM 20,000[4].

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[1] The Labuan Business Activity Tax (Requirements for Labuan Business Activity) Regulations was gazetted on 22 November 2021.

[2] A company undertaking PEH activities has been defined by the Labuan Investment Committee as a company that only holds equity participation and earn only dividends and capital gains. The receipt of interest from financial institutions arising from the placing of dividend monies or proceeds of disposal of shares, will not disqualify a company of its PEH status.

[3] This was also legislated under the Labuan Business Activity Tax (Exemption) Order 2020 which was gazetted on 2 June 2020 and had retrospective effect from 1 January 2019.

[4] This was also legislated pursuant to the Labuan Business Activity Tax (Requirements for Labuan Business Activity) 2018 (Amendment) Regulations 2020 (gazetted 24 December 2020).

2. New management and control requirements for Labuan PEH Entities with effect from 1 January 2021

Although Labuan PEH Entities are no longer required to have full time employees in Labuan, the Labuan Financial Services Authority ("**LFSA**") had released a directive requiring all such entities to ensure management and control is exercised in Labuan[5].

The new 2021 Regulations set out the specific criteria to demonstrate management and control in Labuan. The requirements as listed below (which mirror the LFSA's past directives and circulars) are deemed to have come into operation on 1 January 2021:

i. meeting of the board of directors is convened in Labuan at least once a year ("**Board Meeting Requirement**");

ii. the registered office of the Labuan entity shall be situated in Labuan;

iii. the secretary of the Labuan entity appointed under the Labuan Companies Act 1990 shall be resident in Labuan; and

iv. the accounting and business records including the minutes of meeting of the Labuan entity's board of directors shall be kept in Labuan.

In view of the travel restrictions due to the COVID-19 pandemic, the LFSA had allowed a concession to the Board Meeting Requirement, where board meetings could be held virtually in view of the extension of Malaysia's recovery movement control order at the time up to 31 December 2020, provided that the hosting of such meetings is arranged by the resident secretary in Labuan. The Inland Revenue Board ("**IRB**") has recently clarified[6] that the Board Meeting Requirement may continue to be satisfied virtually if the directors of the Labuan entity are unable to convene a physical meeting in Labuan due to Covid-19 pandemic restrictions to enter Labuan or imposed by their respective countries of origin.

Clearer taxation of Labuan entities carrying on "other trading" activities under the LBATA

Previously, the LFSA had issued a circular announcing that the Ministry of Finance had approved Labuan entities undertaking "other trading" activities to be eligible for the preferential tax regime under the Labuan Business Activity Tax Act ("**LBATA**"), provided such entities comply with the requirement to have two (2) full time employees in Labuan, and an annual OPEX of RM 50,000[7]. Such "other trading" activities included administrative, accounting and legal services.

However, the IRB had subsequently issued a letter[8] requiring all Labuan entities that carried out such "other trading" activities to be taxed under the Income Tax Act ("**ITA**") instead of the LBATA ("**IRB Letter**").

In another turn of events, the 2021 Regulations have now included these "other trading" activities as a Labuan trading entity under item 20 of its First Schedule. Consistent with LFSA's earlier circular, Labuan entities carrying out the following "other trading" activities may still be taxed under the LBATA, provided such entities have a minimum of two (2) full time employees in Labuan and incur a minimum OPEX in Labuan of RM 50,000. The specific Labuan entities which qualify for the preferential tax treatment under the LBATA are those which are undertaking the following activities:

i. Administrative services;

ii. Accounting services;

iii. Legal services;

[5] Directive on Management and Control Requirements for Labuan Entities That Undertake PEH Activities ("Directive") issued by the LFSA on 10 August 2020 and Clarification on Board Meeting Requirement issued by the LFSA on 10 September 2020.

[6] Via a letter dated 28 December 2021 issued by the IRB.

[7] Addition to the Revised Substance Regulations issued by the LFSA on 21 January 2020.

[8] Letter dated 5 February 2021.

iv. Backroom processing services;

v. Payroll services;

vi. Talent management services;

vii. Agency services;

viii. Insolvency related services; and / or

ix. Management services other than Labuan company management.

Given the change in position, the IRB had indicated[9] that Labuan entities carrying out "other trading" activities who had previously filed their tax returns under the ITA in reliance of the IRB Letter, may now inform the IRB of their (a) intention to file their taxes under the LBATA; or (b) make an irrevocable election to be taxed under the ITA moving forward.

Availability of stamp duty exemption subject to fulfilment of the substance requirements

Presently, stamp duty exemption[10] is available in respect of the following instruments:

i. all instruments which are executed by a Labuan entity in connection with a Labuan business activity[11];

ii. all Memorandum and Articles of Association, statute, charter, rules, by-laws, partnership agreement or other instrument, under or by which a Labuan entity is established and the scope of that entity's function, business, powers and duties are set out, whether contained in one or more documents; and

iii. all instruments of transfer of shares in a Labuan entity.

In a letter dated 29 January 2021, the IRB stipulated that any person who wished to avail themselves of the stamp duty exemption above will need to ensure that the relevant Labuan entity has satisfied the relevant substance requirements under the 2018 Regulations.

In the same vein, the IRB also instructed that the stamping of all instruments relating to Labuan entities has to be done via the online STAMPS portal from 1 February 2021 onwards. Such stamping applications would need to be accompanied by supporting documents to evidence compliance with the relevant substance requirements. This includes, amongst others, employment letters, EPF / SOCSO contribution documents, employer tax returns for the employees (Form EA), utility bills and documents evidencing expenditure on rental of office space. With the release of the 2021 Regulations, the IRB will likely require evidence of compliance with the relevant requirements under the new 2021 Regulations instead of the revoked 2018 Regulations.

Updates related to deductions for payment made to Labuan company by residents

Briefly, Section 39(1)(r) of the ITA states that subject to any rules as may be prescribed by the Minister of Finance, any person who is a Malaysian resident is disallowed from taking deductions for any amount in respect of a payment made to any Labuan entity[12]. In this regard, the Income Tax (Deductions Not Allowed for Payment Made to Labuan Company by a Resident) Rules 2018 prescribed the following deduction limits as below[13].

[9] Via a letter dated 29 November 2021 issued by the IRB.

[10] Stamp Duty (Exemption) (No. 3) Order 2012.

[11] "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.

[12] References to "Labuan entity" means a "Labuan entity" referred to in paragraph 2B(1)(a) of the LBATA.

[13] The Income Tax (Deductions Not Allowed for Payment Made to Labuan Company by a Resident) Rules 2018 were amended by the Income Tax (Deductions Not Allowed for Payment Made to Labuan Company by a Resident) Rules 2018 (Amendment) 2020.

No.	Type of payment	Amount not allowed for deduction by resident
1.	Interest payment	25% of the amount of payment (including payment in connection with financing in respect of commission, facility fee and advance fee)
2.	Lease rental	25% of the amount of payment
3.	Other payments	97% of the amount of payment

However, the availability of the Exemption Order now means that Malaysian residents will be able to take a deduction for the full amount of certain payments. Specifically, the Exemption Order now exempts any Malaysian resident from the provision of Section 39(1)(r) of the ITA in respect of the amount of payment made by the resident:

i. to a Labuan company which undertakes a qualifying activity under the Global Incentives for Trading programme;

ii. to a Labuan company which has made an election to be taxed under the ITA under section 3A of the LBATA; and

iii. to a Labuan company which carries on a Labuan business activity under section 2B of the LBATA[14].

The Exemption Order is deemed to have come into operation on 1 January 2019, however the exemptions under points (i) and (iii) above are deemed to have effect from the years of assessment 2019 to 2025.

Key takeaways

Given the continuous changes in legislation and policies relating to the Labuan tax regime, it is important for Labuan entities to consistently review their activities against the corresponding requirements from time to time. A thorough assessment of their existing holding structures and transactions is encouraged, to ensure that the structure remains compliant with the current laws and to reduce any adverse Malaysian tax consequences.

We are well-placed to assist you in navigating the complex Labuan tax landscape. For further information and to discuss what these developments might mean for you, please get in touch with the contacts below.

[14] Subparagraph 3(2) of the Exemption Order clarifies that the exemption in part (iii) is only applicable where the resident making payment is a Labuan company which carries on a business activity which is not specified in the Schedule to the 2021 Regulations or an activity other than a Labuan business activity under the LBATA.

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