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TRICOR INSIGHTS

REGULATORY TAX UPDATES ON LABUAN

Opening

On 22 November 2021, the Labuan Business Activity Tax (Requirements For Labuan Business Activity) Regulations 2021 was gazetted to replace the Labuan Business Activity Tax (Requirements for Labuan Business Activity) Regulations 2018 issued on 31 December 2018. Two main changes to the Regulations are discussed below.

Subsequently on 23 November 2021, the Income Tax (Exemption) (No.11) Order 2021 was issued to provide exemption from the application of Section 39(1)(r) of the Income Tax Act 1967 (ITA) which restricts the deductibility of payments made to Labuan entities.

This Issue of Tricolor Insights highlights the recent key changes affecting Labuan entities and entities transacting with Labuan entities in the course of their business operations.

Labuan Business Activity Tax (Requirements For Labuan Business Activity) Regulations 2021 [P.U.(A) 423/2021] [“Substance Regulations 2021”]

1) Introduction of new Labuan business activities under Item 20 in the First Schedule of the Substance Regulations 2021

The Substance Regulations 2021 introduces an additional category of Labuan business activities via item 20 as set out in the First Schedule of the said Regulations. The Substance Regulations 2021 take effect retrospectively from 1 January 2019 except for Regulation 3 (as discussed below) which is deemed to be effective from 1 January 2021.

Item 20 essentially comprises “other trading” Labuan business activities, as announced previously by the Labuan FSA via its circular dated 21 January 2020. In connection with this, the Labuan FSA issued an FAQ dated 14 December 2021 providing details of the Labuan business activities under Item 20, as outlined in the table below.

Item 20, First Schedule	Details of Labuan business activities
Administrative services	<ul style="list-style-type: none"> • Employee management • Payroll management • Property management • Human resource management • Financial planning • Contract or subcontract management • Facilities management • Proposal management
Accounting services	Services pertaining to recording, analysing, summarising or classifying financial, commercial and business transactions and information of a person or business
Legal services	<ul style="list-style-type: none"> • Conveyancing services • Legal advisory services • Litigation or legal representation services in any proceedings before any court, tribunal or other authority • Legal dispute resolution services including alternative dispute resolution

Backroom processing services	<ul style="list-style-type: none"> • Settlement of receivables and payables • Records maintenance • Regulatory compliance • Information technology related services <p>which are usually performed by administrative and support personnel who do not deal directly with clients</p>
Payroll services	<ul style="list-style-type: none"> • Processing, calculation, payment and deduction of remuneration, benefits, tax and statutory payment • Issuance of payslip and tax statement
Talent management services	Provision of human resource services to attract, onboard, develop, motivate and retain employees
Agency services	Provision of specific services on behalf of another pursuant to an agency agreement
Insolvency related services	Provision of services related to administering company liquidations, winding up or personal bankruptcy
Management services excluding Labuan Company Management services	Services provided to organize and coordinate activities of a business and usually consists of organizing, supervising, monitoring, planning, controlling and directing business' resources such as people, finance and technology

Labuan entities carrying on Labuan business activities under Item 20 are required to meet substance requirements to be eligible for the preferential tax rate of 3% on net audited profits under the Labuan Business Activity Tax Act 1990 (LBATA). The substance requirements are as follows:

- Incur a minimum annual operating expenditure in Labuan of RM50,000; and
- Employ at least two (2) full time employees in Labuan.

These substance requirements must be complied with throughout the basis period for a year of assessment. If this condition is not met, the Labuan entity will be subject to tax at 24% on net audited profits for that year.

2) Introduction of control and management conditions for Labuan entities carrying on pure equity holding activities

Labuan entities carrying on pure equity holding activities shall comply with the following substance requirements:

- Incur a minimum annual operating expenditure in Labuan of RM20,000; and
- Exercise control and management in Labuan

Regulation 3 of the Substance Regulations 2021 provides the conditions relating to “control and management in Labuan” as follows:

- At least one (1) board of directors meeting is convened in Labuan;
- The registered office of the Labuan entity shall be situated in Labuan;
- The secretary of the Labuan entity appointed under the Labuan Companies Act 1990 shall be resident in Labuan; and
- The accounting and business records including minutes of Board meetings shall be kept in Labuan

If the operational expenditure and control and management requirements are not met throughout the year, the Labuan entity will be subject to tax at 24% on net audited profits for that year.

Income Tax (Exemption) (No. 11) Order 2021 [P.U.(A) 425/2021]

With effect from 1 January 2019, Section 39(1)(r) of the ITA was enacted to restrict a deduction for payments made by resident taxpayers to Labuan entities as follows:

Types of payments	% not deductible
Interest payment	25%
Lease rental	25%
Other payments	97%

The above Exemption Order provides that payments made to Labuan entities under the following circumstances will **not be subject to the restriction** on deductibility of expenses, subject to meeting the general deductibility test in Section 33(1) of the ITA:

Payer	Payee	Effective period
Tax resident	Labuan company which has made an irrevocable election to be taxed under the ITA	1 January 2019 onwards
Tax resident	Labuan company undertaking a qualifying activity under the Global Incentives for Trading Programme (GIFT)	Years of assessment 2019 to 2025
Labuan tax resident not carrying on: <ul style="list-style-type: none"> A Labuan business activity specified in the Schedule to the Substance Regulations 2021; or A Labuan business activity under the LBATA 	Labuan Company carrying on a Labuan business activity under Section 2B of the LBATA	Years of assessment 2019 to 2025

Tricolor Taxand's take

- After much lobbying by the various stakeholders, the “non-regulated” business activities as promoted by the LFSA have finally been listed in the legislation with the inclusion of Item 20 in the First Schedule of the Substance Regulations 2021. With this amendment, more Labuan entities would be eligible for the preferential tax rate of 3% under the LBATA, subject to meeting the substance requirements.
- Labuan entities that fall within Item 20 are now required to re-submit their tax returns under the LBATA for financial years 2019 and 2020 respectively, and the deadline for the submission is 21 January 2022.
- However, such Labuan entities can continue to be taxed under the ITA by making an irrevocable election pursuant to Section 3A of the LBATA. The election must be done by 15 January 2022.
- Labuan entities carrying on pure equity holding activities should ensure both operational expenditure and control and management requirements are met in order to enjoy the zero tax rate for the year.
- The exemption from the restriction on deductibility of payments made to Labuan entities provides a more equitable tax treatment to the payer who would otherwise have been greatly burdened by the restriction.
- However, the exemption from the restriction on deductibility does not cater to the scenario where the resident payer (including a Labuan resident entity) is subject to tax under the ITA whilst the payee is a Labuan entity that is subject to tax under the ITA by virtue of undertaking a non-Labuan business activity.

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