MEMORANDUM ON ISSUES ARISING FROM LABUAN BUSINESS ACTIVITY TAX (AMENDMENT) BILL 2019

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Contents

1. Taxation of a Labuan entity which fails to comply with substance requirements

New Section 2B(1A) of the Labuan Business Activity Tax Act 1990 ("LBATA") with effect from the year of assessment ("YA") 2020: -

(1A) A Labuan entity carrying on a Labuan business activity which fails to comply with regulations made under subsection (1) for a basis period for a year of assessment shall be charged to tax at the rate of twenty four per cent upon its chargeable profits for that year of assessment.

Comments:

1.1 Section 2B(1A) appears to be conflicting as *"A Labuan entity carrying on a Labuan business activity"* may refer to a Labuan entity that undertakes a business activity which qualifies to be a Labuan business activity under Section 2B(1)(b) of the LBATA. That Labuan entity would have complied with the Labuan Business Activity Tax (Requirements for Labuan Business Activity) Regulations 2018 (P.U. (A) 392/2018) ("Regulations") made under Section 2(B(1)(b) and would not be taxed at 24% on its chargeable profits. In view of this, we would like to request the tax authorities to review the wording in Section 2B(1A).

IRBM's response:

Section 2B(1A) is not conflicting with section 2B(1) as this section has made it clear that any Labuan entities that do not comply with the Regulations are taxed at 24%. The word Labuan entity has been used as reference for those provisions under LBATA 1990. A Labuan entity that has made an election under Income Tax Act (ITA) 1967 is still referred to as a Labuan entity although it has not met the requirements under the Regulations.

1.2 As Section 2B(1A) and Section 2(3)(a) of the LBATA may be applied to a Labuan entity which does not meet the criteria to qualify as carrying on a Labuan business activity under Section 2B(1)(b), we would like to seek clarification on the following: -

a. Whether Section 2B(1A) only applies to Labuan entities undertaking Labuan business activities which are listed in the Regulations and which do not comply with the substance requirements listed in the Regulations.

IRBM's response:

Yes.

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b. Notwithstanding Section 2B(1A), whether Section 2(3)(a) applies to Labuan entities undertaking business activities which are not listed in the Regulations (please see the notes below).

IRBM's response:

Yes.

Note:

i. Examples of Labuan entities which are not listed in the Regulations are: -

- Labuan Trading Company e.g. a Labuan entity dealing with foreign entity trading in goods or immoveable properties outside Malaysia but the Labuan entity only derives brokerage fee income and commission income.

IRBM's response:

Awaiting for policy's decision from MOF.

- A Labuan entity providing funding and treasury services to its related companies.

IRBM's response:

Awaiting for policy's decision from MOF.

- A Labuan entity operating as an investment holding company but not operating as a holding company. (According to the Labuan Investment Committee ("LIC") Pronouncement 2/2019 dated 11 December 2019, the list of Labuan entities subjected to substance requirements will be expanded to include entities that undertake pure equity holding and carry on non-pure equity holding. It would be much appreciated if the Regulations could be updated accordingly).

IRBM's response:

The amendment of the Regulations has been submitted to MOF.

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ii. In item 2.1 on page 11 of the CTIM Memorandum On Issues Arising From Recent Tax Legislation In Relation To Labuan, the Inland Revenue Board ("IRB") had clarified that a Labuan business activity which is not listed in the Regulations will not be regarded as a Labuan business activity and will be taxed under the Income Tax Act 1967 ("ITA").

1.3 Section 2B(1A) appears to reverse the IRB's clarification in item 4.1(ii) on page 38 of the Joint Memorandum On Issues Arising From 2019 Budget Speech & Finance Bill 2018 that the provisions under the ITA shall apply if the Labuan entity fails to comply with the substance requirements as specified in the Regulations. This may have significant impact to those taxpayers who rely on the exemptions provided under the ITA.

Please clarify whether non-trading income such as dividends received by an investment holding company in Labuan from a foreign subsidiary is exempted from tax (Schedule 6 exemption if it is taxed under the ITA or Section 9 exemption under the LBATA) or would it be taxed at 24% under the LBATA? If the intention of the government is to tax the non-trading income at 24% under the LBATA, "chargeable profits" has to be redefined. The current definition of "chargeable profits" in Section 4(2) of the LBATA only covers net profits of trading activity.

IRBM's response:

The new amendment is the reverse of the IRB's clarification in item 4.1(ii) on page 38 of the Joint Memorandum On Issues Arising From 2019 Budget Speech & Finance Bill 2018 as there were a lot of operational issues such as the difference in submission of income tax returns base on preceding year and current year and the compliance of instalments under CP204B.

This amendment will ease the burden of Labuan entities to comply with all the provisions under ITA 1967.

Non-trading income that is listed in the P.U.(A)392/2018 covers only holding company which will also cover investment holding company which receives dividend income. If the holding company complies with the substance requirement under the Regulations, it will be charged under Section 9 of LBATA 1990. If the investment holding company do not fall under the definition of holding company as provided in the regulation, the income is taxable under ITA 1967 and any exemptions including those given under paragraph 28 Schedule 6 of ITA 1967 maybe applicable.

If the Labuan entity could not fulfil the substance requirement under the Regulations, the entity will now be taxed at 24% of the chargeable profits. IRBM takes note that the word chargeable profits only appear in section 4 of LBATA 1990 under trading activity but the new provision under section 2B mentions Labuan entity carrying on a Labuan business activity which include trading and non-trading activity.

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New definition of chargeable profit will be determined through practice note regarding this matter.

1.4 The implications of taxing Labuan entities which do not meet the substance requirements at 24% under the LBATA based on accounting profits include the following: -

- There is no distinction between foreign and local sourced income. Foreign sourced income is effectively taxed at 24% under the LBATA.
- Accounting gains such as capital gains, fair value gains, exchange translation gains etc. which may not be taxable under the ITA would be taxed at 24% under the LBATA.

It is also noted that there is no foreign tax credit provision under the LBATA as compared to the ITA.

We would request the tax authorities to consider and review the above matters so that Labuan entities would not be worse off under the LBATA compared to the ITA.

IRBM's response:

As explained in the paragraph above, the amendment was made to address the operational issues of the Labuan entities and this was the request from LFSA.

1.5 A Labuan entity may elect to be taxed under the ITA but the deadline for submission of the election for YA 2020 would have lapsed (an election must be made within three months after the beginning of the basis period for a YA i.e. by 31 March 2019 if the year-end is 31 December).

We hope a concession can be granted by the IRB to allow those taxpayers that may be impacted under item 1.3 above to make an election to be taxed under the ITA for YA 2020.

IRBM's response:

Under subsection 3A(2) of LBATA 1990, the DG has not been given the powers to give any extension period. Therefore, no extension can be given.

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1.6 A Labuan entity (filed Form LE 5 up to YA 2019) which is carrying on a non-trading business activity e.g. investment holding, is currently exempted from having its accounts audited. As that Labuan entity is not listed in the Regulations made under Section 2B(1)(b) of the LBATA, kindly clarify whether that Labuan entity's accounts are required to be audited for YA 2020?

IRBM's response:

Yes, as these entities are not listed in the Regulations it will be taxed under ITA 1967 of which all the provisions in that Act has to be complied with.

1.7 Would the withholding tax payment exemption under the *Income Tax (Exemption) (No. 2) Order 1998* (P.U. (A) 69/1998) still be applicable for those Labuan entities which do not fulfil the substance requirements in the Regulations and thus, will be charged to tax at the rate of 24% on its chargeable profits under the LBATA?

IRBM's response:

No. The *Income Tax (Exemption) (No. 2) Order 1998* (P.U. (A) 69/1998) will not be applicable to the Labuan entities that do not comply with the Regulations, as those entities do not fulfil the definition of Labuan business activity as provided under Section 2B(1) LBATA 1990. The P.U.(A) 69/1998 will be amended accordingly to reflect this policy change.

1.8 Following the amendment of Section 8 of the LBATA by the Finance Act 2018 in respect of the absence of basis period, we would like to seek clarification on the following: -

a. Will the definition of "basis period" in Section 2 of the LBATA be amended or retained?

IRBM's response:

No. The definition provided under Section 2 of LBATA 1990 will be retained.

b. When will the IRB's directive on determination of basis period for a Labuan entity which changes its accounting period be issued?

IRBM's response:

First quarter of 2020.

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1.9 The Regulations are restricted to certain types of businesses. Hence, Labuan Entities undertaking Labuan business activities which are not covered in the Regulations are in a dilemma and this has created uncertainty. This issue is further compounded for example when Labuan entities desiring to voluntarily wind-up due to various reasons are facing an acute problem in seeking a tax clearance from the IRB. Although the IRB has recently issued guidelines dated 12 November 2019 on procedures on the application for tax clearance for Labuan entities, uncertainty still exists on the treatment of taxation on income derived with effect from 1 January 2019 in the event that the Regulations are not complied with. We would like to request the IRB to ensure that all Labuan entities which are licensed by or registered with or approved by the Labuan Financial Services Authority are included in the Regulations which is to be amended.

IRBM's response:

The list of Labuan business activities provided in the Regulations was proposed by LFSA to MOF. IRBM is only implementing the policy's decision. LFSA has proposed the necessary amendments to MOF with the advice of the Labuan Investment Committee (LIC) to include some of the activities that were excluded in the existing Regulations.

1.10 We understand that some companies, because they do not meet the substance requirements, have registered with the IRB under the ITA and have lodged Form CP204s under which they are paying income tax instalments. Based on Section 2B(1A) of the LBATA, such companies should be taxed at 24% under the LBATA and not the ITA. Please therefore confirm the procedure to be used by such companies for cancelling their registration under the ITA and return them to be taxed under the LBATA. Also, please confirm that such companies can cease paying tax instalments under the ITA and that any instalments already paid will be available for direct offset against any tax payable under LBATA or refunded.

IRBM's response:

Yes, your understanding is correct. The companies have to cancel their registrations with the respective branches and to continue to file under LBATA. The Operations and Collections Department of IRBM have been informed accordingly on this matter.

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2. Determination of residence status for the purposes of a double taxation arrangement under Section 132 of the ITA

New Section 3B of the LBATA with effect from YA 2020: -

3B. For the purposes of the double taxation arrangements effected under section 132 of the Income Tax Act 1967—

(a) a Labuan entity carrying on a business or businesses is resident in Malaysia for the basis year for a year of assessment if at any time during that basis year the management and control of its business or of any one of its businesses, as the case may be, are exercised in Malaysia; and

(b) any other Labuan entity is resident in Malaysia for the basis year for a year of assessment if at any time during that basis year the management and control of its affairs are exercised in Malaysia by its directors, partners, trustees or other controlling authority.

Comments:

2.1 Please clarify if the words "any other Labuan entity" refer to a Labuan entity that is carrying on an activity other than a Labuan business activity to which Section 2(3)(a) of the LBATA applies.

IRBM's response:

As this provision is meant for the purpose of double taxation arrangement under Section 132 of the ITA, "any other Labuan entity" means Labuan entities which do not fall under subsection 3B(a) LBATA 1990.

2.2 According to the Schedule under Section 2B(1)(a) of the LBATA, a Labuan entity includes a Labuan Trust. As the residence of a Trust Body under Section 61(3) of the ITA is ascertained by establishing whether any trustee member of that body is resident for that basis year and not whether its management and control is exercised in Malaysia, we would like to request the tax authorities to review the wording in Section 3B.

IRBM's response:

There is no need to put in the provision on the residence similar to subsection 61(3) because a reference has been made to subsection 7(5) Part 11(Creation & Recognition of Labuan Trusts of Labuan Trust Act [Act 554]) as follows:

"Where the trust property includes Malaysian property, any income derived from the trust property shall be subject to ITA 1967"

From 17/01/2017, the amendment to the definition of non-trading has been amended to properties situated in Labuan, therefore the trust companies shall be subject to ITA 1967.

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2.3 Can a Labuan entity which qualifies to be a tax resident under the LBATA be treated as tax resident for withholding tax purposes?

IRBM's response:

As stipulated in Section 3B, the residence determination is only for the purposes of double taxation arrangements effected under section 132, ITA 1967 and not for other purposes.

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3. Tax due and payable

New Section 13A of the LBATA with effect from YA 2020: -

13A. (1) Where an assessment is made under section 6, the tax payable under the assessment shall, on the service of the notice of assessment under section 6B, be due and payable on the person assessed at the place specified in that notice whether or not that person appeals against the assessment.

(2) Where any tax due and payable under subsection (1) has not been paid within thirty days after the service of the notice, so much of the tax as is unpaid upon the expiration of that period shall without any further notice being served be increased by a sum equal to ten per cent of the tax so unpaid, and that sum shall be recoverable as if it were tax due and payable under this Act.

Comments:

3.1 We understand from the new Section 13A that tax payable is due within 30 days from the date of service of the notice. However an existing Section 11 of the LBATA also requires tax to be paid in full on filing of the statutory declaration and return of its profits for a YA under Section 5. It appears that these two provisions are contradictory.

We wish to seek clarification if the words "assessment made under Section 6" in the new Section 13A refer to "assessment / additional assessment raised by the IRB where it appears to him that no or no sufficient assessment has been made on a person chargeable to tax for any YA.

IRBM's response:

Section 11, LBATA 1990 is to address the assessments raised by the DG on returns filed in by Labuan entities under subsection 6(1) LBATA 1990.

The new section 13A is to address on the assessment or additional assessments raised under subsection 6(2), LBATA 1990 which the assessment or additional assessments is raised by the DG due to no or no sufficient assessment has been made to that person.

Therefore, there is no contradiction between the both sections.

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4. Power of the Director General to substitute the price in a related transaction if the transaction was not made at arm's length

New Section 17D of the LBATA with effect from YA 2020: -

17D. (1) This section shall apply notwithstanding section 17C and subject to any regulations prescribed under this Act.

(2) Subject to subsection (3), where a person in the basis period for a year of assessment enters into a transaction with an associated person for that year for the acquisition or supply of property or services, then, for all purposes of this Act, that person shall determine and apply the arm's length price for such acquisition or supply.

(3) Where the Director General has reason to believe that any property or services referred to in subsection (2) is acquired or supplied at a price which is either less than or greater than the price which it might have been expected to fetch if the parties to the transaction had been independent persons dealing at arm's length, the Director General may in determination of the chargeable profit of the person, substitute the price in respect of the transaction to reflect an arm's length price for the transaction.

(4) The transactions referred to in subsection (2) shall be construed as a transaction between—

(a) persons one of whom has control over the other; or

(b) persons both of whom are controlled by some other person, in this section referred to as "third person".

(5) Without prejudice to the generality of paragraph 17C(6)(a), for the purpose of subsection (4), "control" refers to persons one of whom owns shares of the other person, or a third person who owns shares of both persons, where the percentage of the share capital held in either situation is twenty per cent or more and—

(a) the business operations of that person depends on the proprietary rights, such as patents, non-patented technological know-how, trademarks or copyrights, provided by the other person or a third person;

(b) the business activities, such as purchases, sales, receipt of services, provision of services, of that person are specified by the other person, and the prices and other conditions relating to the supply are influenced by such other person or a third person; or

(c) where one or more of the directors or members of the board of directors of a person are appointed by the other person or a third person.

(6) In this section, "transaction" has the same meaning assigned to it under paragraph 17C(6)(b).

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Comments:

4.1 Is the intention of this new Section 17D to require all Labuan entities to prepare transfer pricing (TP) documentation?

IRBM's response:
A separate transfer pricing Rules and Guidelines will be issued to address this.

4.2 To what extent would the IRB TP Guidelines 2012 (Updated Version) apply to Labuan entities?

IRBM's response:
Refer to the answer above.

4.3 Let's take a scenario – there is a Labuan company whose only customer is a Malaysian company. In the past, it was understood that the Malaysian company is required to prepare TP documentation to ensure arm's length, i.e. it did not enter into overpriced acquisitions. So, there would be no TP adjustment if the outcome of the TP documentation for the Malaysian company shows that it is within the interquartile range / above median of the comparable companies.

Now, if the Labuan company is required to prepare TP documentation, what would be consequences if:

- the Labuan Co is below the interquartile range or median?

- the Labuan Co is above the interquartile range or median?

IRBM's response:
Refer to the answer above.

4.4 Is Section 17D meant to apply when the Labuan company pays tax at 24% ?

IRBM's response:
Section 17D LBATA 1990 is applicable to Labuan entities that is pays tax at 3% or 24% and also applicable to Labuan entities which carry on Labuan non-trading activity where its income is charged under Section 9 of LBATA 1990.

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