KPMG Insights

Relooking at Labuan Entities

Following Malaysia's participation in the Forum of Harmful Tax Practices, Malaysia has enacted a major tax reform in the Labuan tax regime. Several tax changes have been initiated in line with the Base Erosion & Profit Shifting Action 5. Amongst others are the introduction of substance requirements for Labuan entities, the abolishment of the election to pay tax at a fixed amount of RM20,000, the lifting of restriction on Labuan entities to deal with local currency and local residents and the imposition of restriction on tax deduction for payments made to Labuan entities.

Needless to say, these changes in the Labuan tax regime have posed many challenges and uncertainties to Labuan entities.

Key considerations

With the changes in the Labuan tax regime, there are a few key areas which Labuan entities should consider.

Following the introduction of substance requirements, Labuan entities which are unable to comply with the substance requirements under the Labuan Business Activity Tax (Requirements for Labuan Business Activity) Regulations 2018 ("Substance Regulations") are now taxed at a rate of 24% of its chargeable profits (e.g. net audited profits).

In addition, Labuan entities which are carrying on a business activity which is not listed in the Substance Regulations may be subject to tax under the Malaysian Income Tax Act, 1967 ("MITA") and not the Labuan Business Activity Tax Act 1990 ("LBATA").

In this regard, where a Labuan entity does not have substance in Labuan or is carrying on a business activity not listed in the Substance Regulations, it is certainly worth considering whether there is a need to maintain the Labuan entity and/or whether it would be more tax efficient to be taxed under MITA.

This is especially so for Labuan entities which receive foreign sourced income as the said income is exempted under the MITA (except for resident company carrying on the business of banking, insurance or sea or air transport), while under Labuan tax regime, there is no distinction of foreign sourced income and the entire net audited profits would be taxed at 24% (for Labuan entities which do not have substance in Labuan).

Moreover, under MITA, companies can carry forward any unutilized capital allowances and business losses for future utilization. This may be beneficial where businesses incur losses in certain Years of Assessment which can be carried forward for future utilization. We have summarized the tax features of the Labuan tax regime and MITA in the following table:-

Comparison Table of the Tax Features of Labuan tax regime and MITA

Legislation / Highlights	Labuan tax regime	MITA
Tax Rate	Exempted[1] / 3%[1] / 24%[2]	24%
Tax Base	Net audited profits	Chargeable income[3]
Tax Attributes	N/A	Utilisation of capital allowances, business losses, etc.
Withholding Tax ("WHT") Exemptions	WHT exemptions (e.g. interest, royalty, rental of moveable property, etc.) will apply, subject to meeting the substantive requirements. Some countries do not recognize Labuan, hence Labuan entity may not enjoy a reduced WHT rate under a double taxation agreement.	There may be certain WHT exemptions available based on Gazette Orders
Filing Obligations	Submission of Form LE and statutory declaration	Filing of estimate of tax payable for a Year of Assessment, payment of tax estimates, etc.

[1] Where the Labuan entity is carrying on a Labuan business activity listed in the Substance Regulations and has complied with the substantive requirements, the Labuan entity will be taxed at the preferential tax rate of 3% or be exempted from tax under the LBATA.
[2] Where the Labuan entity is carrying on a Labuan business activity listed in the Substance Regulations but is unable to comply with the substantive requirements, the Labuan entity will be taxed at 24% of its chargeable profits under the LBATA.
[3] Foreign sourced income is exempted under the MITA, except where the recipient is a Malaysian resident company carrying on the business of banking, insurance or sea or air transport.

Other Changes to the Labuan Tax Regime

Definition of "Holding Company" under the Labuan Regulations	Audit Exemption	Revised Non-Deductibility Rates for Payments Made to Labuan Companies
• Pure-equity holding company - companies that hold equity participations and earn only dividends and capital gains • Non-pure equity holding company - companies that hold a variety of assets and earn different types of income (e.g. interest, rents and royalties) • The substantive requirements vary for the above	• Labuan entities which are dormant, struck off, under winding up proceeding or under the liquidation process are not subject to the Substance Regulations and will enjoy the audit exemption provided the Labuan entities do not derive any source of income • Labuan entities under the run-off process[4] are subject to the Substance Regulations and will not be able to enjoy the audit exemption	• Interest payments - 25% (previously 33%) (including all payments relating to financing, e.g. commission, facility and upfront fee) • Lease rental - 25% (previously 33%) • Other payments - 97% (remains unchanged) • The changes above have yet to be gazetted

[4] Run-off insurance is an insurance policy that covers claims made against companies that have been acquired, merged or have ceased operations. It is purchased by the company being acquired and indemnifies the acquiring company from lawsuits against the directors and officers of the acquired company.

Given the changes in Labuan Tax regime and the number of differences in the tax treatment of an entity under the Labuan tax regime and the MITA, a tax risk assessment should be conducted to compare the Labuan entity's tax exposure under both legislation and to determine what would be most tax efficient for the business.

Businesses should also carry out a detailed review of its existing structure where Labuan entities are involved. Where there is interest in setting up a new Labuan structure, an analysis of the potential transactions would also be beneficial in arriving at an optimal tax efficient structure.

How KPMG can help

In view of the above, our services include advising clients on, amongst others, the following:

Tax Risk Assessment

Our advice encompasses a review of whether a Labuan business is listed in the Substance Regulations and subsequent Circular, whether the business is compliant with the substance requirements and the tax exposure for non-compliance.

Labuan Structure Analysis

Our assistance includes assisting clients to review their business operations and structure to facilitate tax efficiency.

Our services include conducting an analysis on whether there is a need to maintain a Labuan entity within an existing group structure, computer projections of tax exposure under the Labuan tax regime and the MITA and compare the advantages and disadvantages of being taxed under the Labuan tax regime and the MITA respectively.

We have access to a global network of tax professionals in relevant affiliated KPMG offices, enabling us to give our clients a comprehensive perspective of the relevant tax issues in relation to an existing Labuan structure or the setting up of a new one.

Submission of an Irrevocable Election to be taxed under the MITA

Our assistance includes advising on, drafting and submitting an irrevocable election to be taxed under the MITA to the Labuan Branch of the Malaysian Inland Revenue Board.

Ad Hoc Advice

We also provide tax advisory services of a general nature relating to various Labuan tax matters such as tax deductibility of expenses, WHT and tax compliance obligations under the Labuan tax regime.

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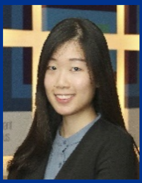

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