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Labuan International Business Financial Centre – the mid-shore jurisdiction

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Labuan is a financial centre located in Malaysia. The following article discusses its role and features, including tax and trusts regimes.

I. Introduction

Labuan is a mid-shore jurisdiction. It possesses a robust regulatory framework and the flexibility and competitiveness of an international financial centre. The jurisdiction provides a wide range of business and investment structures for cross-border transactions, international business dealings and wealth management demands. The Labuan Financial Services Authority ("Labuan FSA") regulates its financial services industry.

II. Labuan as an Asian business hub

Labuan, located in East Malaysia, lies in the heart of the Asia-Pacific region and shares a common time zone with major Asian cities. Malaysia is a member of ASEAN. As such, Labuan provides a convenient business environment for companies looking to expand into Asia. This includes the advantages of extensive trade links that Malaysia has with other ASEAN member countries and beyond. Furthermore, the business language of Labuan is English.

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III. Exchange controls

Unlike the rest of Malaysia, Labuan has no exchange controls. As such, all transactions can be carried out in foreign currencies through Labuan's efficient banking system. Labuan entities are not permitted to conduct business in Malaysian Ringgit (MYR).

IV. Principal legal structures

One of the key advantages of Labuan as a jurisdiction is its strong legal system, based on English common law. Labuan's legal framework empowers the Labuan FSA to administer, license and provide for the setting up of all Labuan entities participating in the international business and financial centre. The jurisdiction's tax provisions are contained within the Labuan Business Activity Tax Act 1990 ("LBATA").

V. Company law framework

In Labuan, 100 percent foreign ownership is permitted. A company can be formed by one or more shareholders, which can be corporate entities or

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individuals, of any nationality or residency. The company may have one or more directors appointed (either natural or corporate persons) and there are no requirements as to their nationality or residency.

All Labuan companies must employ a Labuan trust company providing the registered address and resident secretary service. Companies must also keep their books and records at their registered office.

VI. Tax framework

Labuan has a simple tax framework that covers Labuan business activity carried on by a Labuan entity in, from or through Labuan. Tax is charged at a rate of 3 percent for a year of assessment on the net audited profits of a Labuan entity carrying on a Labuan business activity which is a Labuan trading activity. However, a Labuan entity carrying on a Labuan trading activity may elect, pursuant to LBATA section 7(1), to be charged at a flat rate of MYR20,000 ($6,000) annually.

There is no capital duty or stamp duty, which contribute to making transaction costs lower.

The LBATA also provides that a Labuan entity carrying on a Labuan business activity that is a Labuan non-trading activity will be exempt from tax in Labuan. A Labuan non-trading activity includes an activity relating to the holding of investments in securities, stock, shares, loans, deposits or any other properties by a Labuan entity on its own behalf.

A. Payments to non-residents

Labuan does not impose any applicable withholding taxes on payments to non-resident persons. This includes payments of dividends, interest, royalties and directors' fees.

B. Access to tax treaties

It is currently unclear as to whether Labuan entities, which are taxed under the LBATA, have access to Malaysia's tax treaties network. Certain tax treaties such as the Malaysia-Japan tax treaty specifically exclude entities that are taxed under the LBATA from treaty benefits. However, for treaties that are silent on this matter, Labuan entities may be able to obtain treaty benefits.

C. Irrevocable election to be taxed under ITA

A Labuan entity can make an irrevocable election for its profits to be taxed under the Malaysian Income Tax Act 1967 ("ITA"). As a consequence, the Labuan entity will be subject to the provisions of the ITA for its tax matters instead of the LBATA.

There is no significant difference in the taxation of foreign sourced passive income (dividends, interest, royalties) and capital gains, as the ITA does not tax foreign sourced income and capital gains. The only notable difference relates to the taxation of substantive business activities in Malaysia. Under the ITA, income is taxed at 25 percent instead of at the lower rate under the LBATA. It is therefore likely that only non-trading entities will make this election.

The main advantage of doing so would be to gain access to the majority of Malaysia's double taxation agreement network. Malaysian tax residents have access to an extensive DTA network, which contributes to a dynamic and conducive business environment. Labuan entities which elect to be taxed under the ITA and obtain residency under the Act, generally should have access to the majority of Malaysia's DTA network. However, there are specific exclusions in certain tax treaties. It is therefore imperative that an in-depth analysis is carried out on a case-by-case basis.

For Malaysian DTA purposes, one of the key requirements for enjoying treaty benefits is in the exercise of "management and control". Conducting other substantive activities in a particular jurisdiction in addition, generally will provide further evidence that "management and control" is being exercised in Malaysia. Labuan, with its financial labour force, can provide the necessary qualified manpower in order to carry on substantive business activities in Labuan. It is therefore possible to set up or move a global or regional operational headquarters to Labuan at a low cost.

VII. Islamic finance

Labuan's legislation on Islamic financial services provides the platform for the financial industry to create appropriate products for their clients. It supports the development of a more comprehensive range of Islamic financial structures, moving beyond banking, insurance and sukuk issuance to include protected cell companies, limited partnerships and limited liability partnerships, private trust companies, trusts and foundations.

VIII. Private wealth management

Labuan is a well-regulated location for trusts, foundations, limited partnerships and companies limited by guarantee. There is also no estate or inheritance tax in Labuan.

A. Trusts

A key feature of Labuan's trust laws is the Labuan Special Trust. The trust can be used to hold shares in a Labuan holding company which may in turn own assets including cash, real estate, art, securities, businesses and insurance policies as well as active trading businesses. This trust enables the shares of the holding company to be retained indefinitely and for the management of the company to be carried out by its directors without any intervention by the trustee. This is similar to a BVI VISTA trust.

Labuan also provides for the availability of private trust companies which appeal to individuals and families who wish to retain control of the management of assets and businesses, including the flexibility to be involved in the day-to-day administration of those assets.

B. Foundations

Foundations can also be established in Labuan.

A foundation is a corporate body with a separate legal entity, usually established by the founder to hold assets with the objective of managing these assets for the benefit of a class of persons on a contractual basis.

It is deemed a separate legal entity from its managers (i.e. its officers and its council) and is typically used for private wealth management and charitable purposes.

Labuan foundations set up under the Labuan Foundations Act 2010 enjoy the same taxation benefits bestowed upon other Labuan entities. However, income derived from Malaysian properties will be subject to the ITA.

IX. Labuan International Commodity Trading Company

The Labuan International Commodity Trading Company ("LITC") is promoted under the Global Incentives for Trading ("GIFT") programme. The GIFT programme is a framework of incentives to attract traders of specified commodities to use Malaysia as their international or regional trading base.

The LITC business is the trading of physical and related derivative instruments in any currency other than Malaysian Ringgit with non-Malaysian residents of the following specified commodities:

- petroleum and petroleum-related products including liquefied natural gas ("LNG");
- agriculture products;
- refined raw materials;
- chemicals; and
- base minerals.

A. GIFT incentives

- An LITC is allowed to set up its operational office(s) anywhere in Malaysia.
- A corporate tax rate of 3 percent on the LITC's chargeable profits arising from trading of the specified commodities as reflected in the audited accounts.
- Notwithstanding the above, a 100 percent tax exemption will be granted on its chargeable profits for the first three years of its operation if the LITC trades wholly in LNG and is licensed before December 31, 2014. Thereafter, the above tax rate of 3 percent applies.

B. Requirements

- Minimum annual revenue of $100 million;
- Minimum annual local expenditure of MYR3 million ($900,000);
- Employ a minimum of three professional traders;
- Encouraged to use and to engage local support services;
- All trades must be in currencies other than the Ringgit;
- Except for petroleum, petroleum related products, LNG and coal, all trades must be dealt with non-Malaysian residents.

The GIFT incentive provides a very attractive scheme which can attract global businesses to move their trading activities. Businesses can use a Labuan entity which qualifies for the incentive in order to take advantage of the scheme and Labuan's company law advantages.

X. Captive insurance and mutual funds industries

Captive insurance companies and mutual funds can use Labuan's protected cell company ("PCC") legislation to carry on their business in Labuan.

A PCC is a company that segregates the assets and liabilities of different classes (or sometimes series) of shares from each other and from the general assets of the PCC. Only the assets of each segregated portfolio are available to meet liabilities to creditors in respect of that segregated portfolio; where there are liabilities arising from a matter attributable to a particular segregated portfolio, the creditor may only have recourse to the assets attributable to that segregated portfolio.

A Labuan captive insurance PCC feature is that as the operating and sponsor core, one is not allowed to underwrite the risks of the cells. Only the cells are risk bearing; and not the core. This creates a prudent structure further supported by regulatory solvency capital to the core and to each individual cell. Apart from being a cost effective risk-financing vehicle, it offers other benefits, such as the optimisation of any kind of risk transfer and risk retention, statutory segregation and protection of various risks and flexibility in programme design.

XI. Conclusion

With the numerous advantages offered by Labuan, the jurisdiction is primed to be utilised as Asia's leading Islamic financial centre and is positioning itself as a key international business and financial centre in the region.

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