EC Trust (Labuan) Bhd
License : LT0024
Wisma EC Trust, U0195, Jalan Merdeka,
87007 Federal Territory of Labuan,Malaysia
Tel: +6 087 453 858 / 452 858 / 453618
Fax: +6 087 453 616
http://www.ectrustco.com

WHY LABUAN, MALAYSIA? (from an Australian perspective)

Peter K Searle and Robert Gordon
Barristers-at-law
www.ectrustco.com

INDEX

1. INTRODUCTION
2. TAXATION OF LABUAN COMPANIES
3. FRAMEWORK OF INTERNATIONAL TAXATION
4. RESIDENCE
5. SOURCE OF INCOME
6. PERMANENT ESTABLISHMENTS
7. HIGH TAX COUNTRIES' USE OF CFC LEGISLATION
8. DIVIDENDS FROM LABUAN
9. USE OF LABUAN COMPANIES
10. COMPARISON WITH HONG KONG AND SINGAPORE
11. GENERAL ANTI-AVOIDANCE PROVISION

1. INTRODUCTION

This paper focuses on corporate tax residence and compares the advantages and disadvantages of using a double tax treaty country such as Malaysia, with a non-double tax treaty country, in relation to investment from Australia.

Malaysia has an extensive double tax treaty network with 60 or so countries including the UK, Canada, Australia, New Zealand, other Commonwealth countries, ASEAN countries and many EU and Arab countries (Appendix A).

Double tax treaty countries have significant advantages including the following:-

(a) a residence tie breaking Article which deems dual resident companies to be a resident solely of the Contracting State in which its place of effective management is situated. Without treaty protection, the company is at risk of being a tax resident, and therefore taxable in both, or numerous, States, whereas dual residence companies are protected from taxation in the other Contracting State.

(b) Provided the non-resident does not have a “permanent establishment” in the other Contracting State:

(i) “business profits” sourced in the other Contracting State are protected from source country tax;
(ii) Interest, dividends and royalties are subject to a reduced rate of withholding tax.

Dividends distributed from a double tax treaty country are sometimes exempt from tax in the hands of corporate shareholders in the Other Contracting State i.e. a “participation exemption” dependent on a minimum level of tax in the source country[1], which is more likely be accepted due to the existence of a treaty.

By way of contrast, income which is properly subject to tax in non-double tax treaty countries may also be taxable in high tax countries. The absence of a double tax treaty has the consequence that numerous tax laws are capable of applying without necessarily the benefit of any double tax treaty relief. Unilateral credits may be available in the country of residence, but may be inferior to treaty relief[2].

2. TAXATION OF LABUAN COMPANIES

The International Business and Financial Centre (“IBFC”) Island of Labuan, a Federal Territory of Malaysia, is strategically located in the South China Sea close to the Kingdom of Brunei. It was proclaimed a Federal Territory of Malaysia in 1984 by the Prime Minister, who said Labuan would be developed not only as a tourist port but as an important Freeport in ASEAN. The domestic law of Labuan remains the law of Sabah, the State of Malaysia situated in Borneo of which it formed part.

The Island of Labuan is an established IBFC and Freeport by laws passed by the Malaysian Parliament since 1990 and as such, offers unparalleled advantages as a trading, investment, asset protection and/or e-commerce centre.

[1] Belgium, Luxembourg, Netherlands
[2] Treaty relief is usually superior because a treaty will ensure that the country with the right to tax the income will be deemed to be the source of the income, so that the country of residence will have to accept that the foreign tax was on foreign source income, whereas under the domestic law, the income might be regarded as sourced in the country of residence, and therefore not have to provide a tax credit

The Offshore Companies Act, 1990 provides for the incorporation of Labuan Offshore Companies ("LOC's"), which are required to have a registered office in Labuan, at least one director and a resident secretary. Unless exempted, Labuan offshore companies may only trade with non-residents of Malaysia or with other Labuan companies, and in a currency other than Malaysian ringgit.

The Labuan Offshore Business Activity Tax Act, 1990 ("LOBATA"), taxes offshore trading activities (excluding shipping and petroleum activities) carried on by an offshore company[3] at the rate of 3% on its audited offshore trading profits or, upon election, at a fixed rate of MR20,000 (Approximately US$5,250).

Offshore non-trading activity relating to investments in securities, stock, shares, deposits and immovable properties is not chargeable to tax on LOC's.

The Director General of Inland Revenue may require a person to furnish information for the purposes of LOBATA but such information under current legislation, shall be regarded as confidential, and shall not be communicated or disclosed to any person except for the purpose of the Act only. However, under pressure from the OECD and G20 forums, in April 2009 Malaysia agreed to amend its law to comply with new international standards of transparency.

The Income Tax Act, 1967 (Malaysia) provides an election for income derived by an offshore company from its offshore business activity to be taxable in Malaysia under either the Income Tax Act, 1967 or LOBATA.

Interest, royalties and management fees paid by an offshore company to a non-resident or another offshore company are not subject to withholding tax. An offshore company is not subject to stamp duty under the Stamp Duty Act, 1949. There is no Malaysian tax on dividends paid by a Labuan company in respect of dividends distributed out of income derived from offshore business activities or income exempt from income tax[4].

Labuan has excellent internet, IT, cable and telecommunications infrastructure. The local presence of many of the world's leading banks' offshore offices, as well as leading insurance and international accounting firms, means that issues pertaining to accounts, taxation and money movements can be securely arranged in cooperation with the client's preferred international financial institutions.

---

[3] or foreign companies registering under the Labuan Offshore Companies Act 1990
[4] Income Tax (Exemption)(No 22) Order 2007

3. FRAMEWORK OF INTERNATIONAL TAXATION

3.1 Double Tax Agreements

Whilst each country has its own rulings concerning the taxation of international business, there are a number of "norms". These "norms" are also reflected in the various model double tax agreements. Those are the OECD model conventions (1963, 1977, 1992 and 2005), the UN model, the US model, the Andean model, and the ASEAN model.

Taxation treaties seek to achieve their purpose of avoiding double taxation by allocating the right to tax various types of income (and in some cases capital gain) to the country of residence only, or partly to the country of source with residual taxation to the country of residence. A country by its taxation treaties, limits its right to tax certain sources of income in the hands of the resident of the other country with which it has entered into the taxation treaty.

3.2 Elimination of Double Tax

Where both countries' domestic law subjects the income to tax it is necessary to prescribe a method for relieving double taxation in the taxation treaty. The UK's taxation treaties provide a credit basis for the relief of double taxation to be applied by the UK and, in the other country, relief variously by credit and sometimes by deduction.

The "method for elimination of double taxation" article of Malaysian and the UK treaties generally provides that a resident shall be entitled to a credit for treaty country tax paid in accordance with the treaty, whether directly or by deduction, in respect of income derived by that person from sources in the treaty country.

3.3 Malaysia/Australia DTA

The Malaysia/ Australia DTA contains "tie breaker" provisions in Article 4 where a person (including a company) is a dual resident. In the case of a company, Article 4(4) provides that the person –

> *"shall be deemed to be a resident solely of the Contracting State in which its place of effective management is situated*".

The Malaysia/United Kingdom DTA contains an identical provision. After the decision in ***Smallwood v Revenue and Customs*** [2009] EWHC 777 (Ch) (08 April 2009), it is likely that "effective management" will continue to be equated with "central management & control".

3.4 Exclusion of LOC's taxed under LOBATA from Treaty Benefits

Generally Malaysia's double tax treaties do not exclude Labuan offshore companies from status as Malaysian residents for the purposes of those agreements. At present, of 60 or so Malaysian double tax treaties, only ten exclude LOC's carrying on offshore trading business subject to LOBATA.

Accordingly, Labuan companies are extremely useful for doing treaty protected business. It should also be noted that Malaysia's treaties do not contain "mutual assistance" provisions requiring Malaysia to enforce tax judgments obtained in treaty countries[5].

Since 1997, several of Malaysia's double tax treaty partners have moved to exclude entities taxed under LOBATA, from the benefit of those treaties: Australia, UK, Japan, Netherlands, Sweden, Norway, Finland, Indonesia, South Korea and Luxembourg.

LOBATA entities were not generally subject to the Malaysian Income Tax Act 1967 on their "offshore" income until the September 2007 Malaysian Budget.

This treaty exclusion only generally affected in-bound investment into those source countries, that is, to prevent access by the LOBATA entity to the exemption from source country tax on business profits derived without a PE in the source country, and to prevent access to reduce rates of withholding tax on dividends, interest, and royalties from the source country.

The exclusion was usually achieved by Protocols to the relevant treaties, specifying that by exchange of diplomatic notes, tax privileged entities could be identified, and thereby excluded from the benefit of the treaty. On 28 July, 2002 Malaysia and Australia signed a Second Protocol to their DTA.

Amongst other things, the 2002 Protocol denies Labuan offshore companies, with effect from 1 July, 2003, the benefit of protection from Australian tax on income sourced in Australia. The denial of protection by the double tax treaty means the Labuan company would become assessable in Australia on its Australian "business profits" even though it does not have a "permanent establishment" in Australia, and denial of the lower rates of withholding tax on Australian unfranked dividends, interest and royalties provided by the treaty.

---

[5] as is required between EU countries

However, none of Malaysia's double tax treaties (including under the Second Protocol with Australia) exclude all residents of the territory of Labuan (corporate or otherwise) from status as Malaysian residents for the purposes of those agreements.

A response by clients affected by such exclusions was for the LOC to form an ordinary Malaysian subsidiary, though which to earn income sourced in treaty countries with the exclusion: the so-called "Malay satay".

This was possible as ordinary Malaysian companies are not taxed on foreign source income, even if remitted into Malaysia (other than companies carrying on a business of banking, insurance, shipping or air transport), and an exclusion from tax applied to dividends paid by the ordinary Malaysian company to its shareholders .

The downside is that ordinary Malaysian companies are subject to Malaysian exchange control, whereas LOBATA entities are not.

The September, 2007 Malaysian Budget announced that LOBATA entities would be entitled to irrevocably elect to become subject to the Income Tax Act 1967. This has now been legislated for, effective from 1 January, 2009. As the treaty exclusions were cast generally to catch entities benefiting from LOBATA, the LOC's which make the election should no longer be excluded from the benefit of the relevant treaties, and as they derive only foreign source income, will be no worse off as they won't pay Malaysian tax on that foreign source income. Nor will they become subject to Malaysian exchange control.

4. RESIDENCE

The determination of residence of taxpayers is fundamental to the concept of relief of double taxation pursuant to a treaty. The "residence" article generally defines "persons" as a resident of either treaty partner. "Person" is defined in the majority of treaties in the "general definitions" article as, "includes individual, a company and any other body of persons".

The "residence" article normally provides that a "person" who is a resident in one country for the purposes of the tax law of that country will be a resident of that country.

The test of residence for companies often depends upon the place of management of the company and/or the place of incorporation of the company.

Whilst clearly the place of incorporation of a company provides certainty for corporate taxpayers it has been described as arbitrary and unrelated to economic reality. However, the

concept of placement of management or control as a test for residence of companies has been described as almost as susceptible to manipulation as the place of incorporation test. Most countries that use the place of management as a test of residence for companies consider central management to be located at the head office or corporate seat, for example, France, Germany and Japan, or in the place where the directors usually meet, for example, Canada and the United Kingdom. Only in exceptional circumstances will a foreign subsidiary corporation be considered to have its place of management or control in the country where its controlling shareholders reside.

The cases dealing with "central management and control" in the United Kingdom referred to below demonstrate the importance of the board of directors of the foreign subsidiary carrying out their duties properly in order that the foreign subsidiary be treated as a resident of the country where the board meets. Professor Arnold has said:

> *"If the foreign corporation is properly organised and its affairs are conducted by its own properly constituted board of directors, even though they simply act in accordance with the instructions of the controlling shareholder, corporation will be treated as a non-resident corporation. In effect, the place of management test is largely formal; it looks to de juri control of the foreign corporation. Consequently, the test can be easily avoided and is not effective in dealing with tax haven abuse.*
>
> *"Moreover, even if the place of management test is applied to treat every tax haven corporation as resident where its controlling shareholders are resident, there are serious difficulties in enforcing any domestic tax against the tax haven corporation. Assuming, as is quite likely, that the tax haven corporation does not have any assets within domestic jurisdiction, it will be necessary for the domestic tax authorities to collect the tax from the controlling shareholders".*

It is an international "norm" that the fact that a company resident in a particular country has a subsidiary in another country will not of itself make the subsidiary a permanent establishment of the parent company, in the country of residence of the subsidiary. See article 5(7) of the OECD model (1997), which was adopted as article 5(7) of the Malaysia/Australia double tax agreement.

The classic general law central management and control test, which until 1988 was the sole test of company residence in the United Kingdom6, was set out in the speech of Lord Loreburn in ***De Beers Consolidated Mines Ltd v Howe*** [1906] AC 455. Also see ***Unit Construction Co Ltd v. Bullock*** [1959] 3 All ER 831.

[6] see SP 1/90

As can be seen from ***Swedish Central Railway Co v. Thompson*** [1925] AC 495, the central management and control of a company can be shared between two countries, such that the company can under the test, be a dual resident.

More recently, both ***Untelrab Ltd v McGregor (Inspector of Taxes)*** [1996] STC(SCD) 1 and ***R v Dimsey; R v Allen*** [2000] QB 744 referred to below, highlight the need to be fastidious in ensuring that the majority of the board of a Malaysia company is resident in Malaysia, and do in fact meet for the purpose of considering resolutions, rather than that an individual, for example, in the UK, whether a director or not, conduct the Malaysian company's board level decisions, on their own.

Malaysia determines corporate residence solely on the basis of "central management and control".

The United Kingdom and Australia are examples (there are many) of countries which now determine corporate tax residence on the alternative bases of:

(a) place of incorporation; or
(b) place of central management and control.

In contrast, the United States simply looks to the place of incorporation.

In ***Wood v Holden (HMIT)*** [2006] EWCA Civ 26, the principle was confirmed, that the place where a board of directors exercises its duties (properly), will be the place of its "central management and control" (in that case, The Netherlands), even where the controlling shareholders, or advisers recommend or even expect the board to reach certain decisions, and those persons are elsewhere (UK). After reviewing the authorities such as the Australian High Court decision in ***Esquire Nominees Ltd v FC of T*** (1973) 129 CLR 177, Lord Justice Chadwick, with whom the other two members of the court, so held.

The High Court of Australia in *Esquire Nominees* held that a company incorporated on Norfolk Island (then part of Australia but then only taxable on income sourced from the mainland), and all of whose board resided on Norfolk Island, indeed had its central management and control on Norfolk Island, notwithstanding the resolutions for board meetings were prepared in Melbourne by the ultimate shareholders' accountants. This was on the basis that the board meet to consider such resolutions, and it would not have passed them, had they been illegal or not in the best interests of the company.

In *Untelrab*, the United Kingdom Inland Revenue asserted that the company incorporated in Jersey, with two Bermudian resident directors, and one director resident in Jersey, was nonetheless resident in the UK, where the parent company was resident. The Special Commissioners held that the company was resident in Bermuda and applied *Esquire Nominees*. What is interesting about the case is the depth of analysis of the evidence of the activities of the company over a six year period, including cross examination of the offshore directors.

The Inland Revenue had more success in criminal proceedings in *R v Dimsey*; *R v Allen* where the defendants unsuccessfully appealed their gaol sentences for "conspiracy to cheat the public revenue" and "cheating the public revenue" respectively.

The central allegation in those cases was that companies incorporated in Jersey and other havens, and of which Mr Dimsey was a Jersey resident director, were in fact centrally managed and controlled in the UK, such that the companies were liable to UK corporations tax. The evidence accepted by the jury was that Mr Dimsey's client in the UK (Mr Allen), who was not an actual director, was a shadow director, and was in fact actually managing and controlling the companies in respect of board level decisions. The result for the companies was that they were resident in the UK rather than Jersey.

The established principles were recently applied in UK Tribunal decision in ***Laerstate BV v Revenue & Customs*** [2009] UKFTT 209 (TC) (11 August 2009), where a Dutch company was found to be a tax resident of the UK. Again, the case demonstrated the detailed enquiry into the decision making process of directors (and for a period, a "shadow" director). *Esquire Nominees* was again referred to with approval. A somewhat more detailed emphasis was on whether the director who did now own the company had sufficient information before him to be able to make an informed decision.

The most relevant principles to be gleaned from the authorities are:-

(a) Effective management should be where the board of directors regularly meets to decide the policy, conduct and manage the strategic ("high level") decisions necessary for the business, and that each of them have sufficient information for that purpose; and
(b) A majority of the board should be residents of the jurisdiction the company is or purports to be resident of.

The Australian Taxation Office has issued a tax ruling TR2004/15 which confirms these principles, and in addition, confirms (at ¶ 50) that if an Australian resident director

participates by telephone or electronically, in a majority foreign board meeting overseas, the fact that the Australian resident is in Australia at the time does not upset the outcome.

5. SOURCE OF INCOME

There is a "source of income" article appearing in most of the UK's taxation treaties. Most of those articles provide that income derived by a resident of one country which is permitted to be taxed in the other country in accordance with the taxation treaty, is deemed for all purposes of the treaty to be income arising from sources in the other country. This empowers each country to exercise taxing rights allocated to it by the treaty. Almost all treaties specify this to be the case for the purposes of providing tax credits, which ensures double taxation relief as intended.

Taxation treaties which do not contain a "source of income" article, other than one which is only for the purposes of the "relief from double taxation" article, invariably have limited source rules for particular types of income.

In contrast to the international norms concerning residence, there is more variation concerning what is regarded as domestic source income by various countries. Generally, for businesses carried on within a country, the income from the business will be considered to be domestic source income. Similarly, income from sources located within a country, such as real estate, is usually taxed as domestic source income. Whilst few countries have sophisticated source rules, the United States is a major exception. Often, questions concerning the source of income are resolved by tax treaties. For example, under most tax treaties, income is allocated to a taxpayer's foreign permanent establishment on the principle that it is treated as a separate entity dealing at arm's length with the taxpayer.

In relation to the domestic source of income generally, for the Common Law countries, the Privy Council on appeal from the Hong Kong Court of Appeal in ***Commissioner of Inland Revenue v. Hang Seng Bank Limited*** [1991] 1 A.C. 306 said :

> *"But the question whether the gross profit resulting from a particular transaction arose in or derived from one place or another is always in the last analysis a question of fact depending on the nature of the transaction. It is impossible to lay down precise rules of law by which the answer to that question is to be determined. The broad guiding principle, attested by many authorities is that one looks to see what the taxpayer has done to earn the profit in question. If he has rendered a service or engaged in an activity such as the manufacture of goods, the profit will have arisen or derived from the place where the service was rendered or the profit making activity carried on. But if the profit was*

> *earned by the exploitation of property assets as by letting property, lending money or dealing in commodities or securities by buying and reselling at a profit, the profit will have arisen in or derived from the place where the property was let, the money was lent or the contracts of purchase and sale were effected."* (per Lord Bridge at 322)

That case concerned whether for Hong Kong tax purposes, profits from dealing in certificates of deposit were derived in Hong Kong, but the principles are equally applicable to whether a trade is carried on in the UK[7], or Australia[8].

5.1 Source of Trading Income

In Anglo-Australian jurisprudence the source of income from the sale of trading stock by a simple merchant is the place where the contract of sale was entered into.[9] The source of income where the taxpayer's business involves a range of activities, such as extraction, manufacture/processing and sale is apportioned between the places at which the various activities are carried out.[10] For example, that part of the trade which is manufacturing is carried on where the manufacturing takes place[11].

For UK purposes, two forms of activity do not amount to trading in the UK, and the position in Australia should be no different:

(a) Purchasing goods or services in the UK for use in the business abroad[12];
(b) Representative offices, sales promotion, or after-sale services provided the contracts of sale and other trading activities are make or carried on abroad[13].

An intending purchaser may inspect sample goods in, for example, the Australian warehouse of an agent for an overseas manufacturer. However, if the purchaser then orders goods from the overseas manufacturer the place of the contract of sale is where the manufacturer posts a letter of acceptance: for an exposition of the rules which determine where a contract is made

[7] See *Yates v GCA International Ltd* [1992] STC 723 at 729; source of profit on the sale of shares can be complicated: see *Australian Machinery and Investment Co Ltd v DCT* (1946) 8 ATD 81
[8] In Australia, the question of source has been referred to as "a practical, hard matter of fact": *Nathan v FC of T* (1918) 25 CCLR 183; *Thorpe Nominees Pty Ltd v FC of T* (1988) 19 ATR 1834
[9] *Grainger & Son v Gough* [1896] AC 325; *Lovell & Christmas Ltd v C of T* [1908] AC 46; *C of T (WA) v D & W Murray Ltd* (1929) 42 CLR 332
[10] *C of T v Meeks* (1915) 19 CLR 568; *C of T v Kirk* [1900] AC 588
[11] *Firestone Tyre and Rubber Co Ltd v Llewellin* (1957) 37 TC 111
[12] *Sulley v A-G* (1860) 2 TC 149
[13] *Greenwood v FL Smidth & Co* (1922) 8 TC 193 HL

see the judgment of Denning LJ in ***Entores Ltd v Miles Far Eastern Corporation*** [1955] 2 QB 327 at 332-4.

The precise mechanism which brings a contract into existence may be significant. Sending a catalogue from overseas to potential buyers, for example, in Australia is not a legal offer, it is an invitation to treat: ***Granger & Son v. Gough*** [1896] AC 325. As a result, an order from a purchaser is an offer and the contract will be made where the acceptance is received. In *Entores Ltd v. Miles Far Eastern Corporation* Denning LJ stated that where the offeror and the offeree are located in different countries and communication is not by post, but telephone, telegram, telex or some instantaneous means of communication, acceptance will only be effective when it is received – not at the moment of transmission – "and the contract is made at the place where the acceptance is received".

The decision in *Entores v Miles Far Eastern Corporation* was applied by the New South Wales Supreme Court in ***Mendelson-Zeller Co Inc v T & C Providores Ltd*** [1981] 1 NSWLR 366.

As the place the contract is made is where the offeror receives notice of the acceptance of the offer, an Australian purchaser from a Labuan resident communicating electronically, is entering into the contract in Labuan if the Labuan resident's e-commerce server is in Labuan. That is, Labuan is the place of receipt of acceptance. For a general overview of income source considerations in electronic commerce, see Gary D. Sprague and Michael P. Boyle, "Taxation of income derived from electronic commerce", General Report – in 2001 IFA Cahiers, Vol. A, pp 21-63. For a more Australian specific discussion, see Bill Cannon, "A Practical Look at E-Commerce & Source Rules", 4th World Tax Conference, Sydney 25-27 February, 2004.

Where the law of the contract is specified to be that of Malaysia, and any dispute concerning the contract is to be litigated in Malaysian, it is likely that the contract will be made in Malaysia. It follows that the source of the income arising from the contract will often be Malaysia. For Australian purposes, the Electronic Transactions Act 1999 (C'wth) provides that if the parties to the contract agree that the contract is accepted in a particular place (s 14(5)), that will bind the parties for the purposes of Australian federal law e.g. Australian income tax.

The observation has been made that the significance of the *Entores v Miles Far East Corporation* and *Mendelson-Zeller Co Inc v T & C Providores Ltd* cases is limited to determining the source of income where the place of the contract is the most important factor in determining the source. However, the place of entry into of the contract is always a factor in determining source, even though its significance may depend upon other factors.

The "common law" source rules in any particular country may be modified by statute. For instance, in Australia, under the domestic law the source of income from the sale of goods was dependent upon goods being sold in Australia, or where any person in Australia was instrumental in bringing about the sale of goods to an Australian resident party: ss38-43 ITAA 1936 repealed in September, 2006. These specific rules were considered effectively inoperative due to the over-arching discretion to determine source under the anti-transfer pricing provisions of Div 13 ITAA 1936 (specifically s136AE(7)).

Notwithstanding the domestic source rules, a relevant double taxation agreement precludes the source country from subjecting the vendor of the goods to source country taxation unless the vendor has a "permanent establishment" in the source country with which the income is "effectively connected".

5.2 Source of services income

The source of services income derived by a company will take into account:

1. where the work is performed[14];
2. where the contract to perform the work is negotiated and executed; and
3. where payment is made[15].

Were the work is performed, is often the most important factor in determining source of services income.

However, consultancy source income may not be where the work is performed, if the work can largely, be performed anywhere[16], at least in cases where it is the provision of, for example, a written legal report, accounting statement, or architectural drawings, which is what the client ultimately pays for. In those cases, the place of entry into of the contact will be perhaps, more important in determining source.

5.3 Source of interest

HMRC in the UK, having considered the so-called "Greek" case (***National Bank of Greece v Westminster Bank Executor and Trustee Co (Channnel Islands) Ltd*** (1970) 46 TC 472,

[14] *IRC v Brackett* [1986] STC 521; *C of T (NSW) v Cam & Sons Ltd* (1936) 4 ATD 32 at 34; *FC of T v French* (1957) 98 CLR 398; *FC of T v Efstathaskis* (1979) 9 ATR 867
[15] *Evans v FC of T* 81 ATC 4512
[16] *FC of T v Mitchum* (1965) 113 CLR 401; (1965) 9 AITR 559

conclude that four factors must all be considered[17] to decide the source of interest income, none of which alone will be decisive:

(a) The residence of the debtor;
(b) the source from which the interest is paid;
(c) where the interest is paid; and
(d) the nature and location of any security.

In Australia, the place where the loan contract was entered into, and the place where the funds where advanced were considered important in concluding that the source of the interest was the Cook Islands: ***FC of T v Spotless Services Ltd*** 95 ATC 4775 (Full Federal Court – that issue was not appealed to the High Court).

Since the repeal of s25(2) there is no Australian deemed source rule for interest, outside the withholding tax provisions.

Section 128B(2) is to the effect that interest withholding tax applies to interest derived by non-residents from Australian residents (other than outgoing of a foreign PE), or from outgoings of the Australian PE of a non-resident. Thus that interest is taxed as a proxy to being sourced in Australia.

In addition, s128B(2A) is to the effect that interest withholding tax also applies to interest derived by a foreign PE of an Australia resident, from an Australian payer or from an outgoing of the Australian PE of a non-resident.

Section128B(3)(h) specifies that s128B does not apply to interest derived by the Australian PE of a non-resident, so such interest is subject to tax in full by assessment.

5.4 Source of royalties

In the UK, the place of registration, or the forum for protection of the rights, determines source. In ***Curtis Brown Ltd (as agents for Stella Brown) v Jarvis*** (1929) 14 TC 744 the source of the copyright royalty was held to be the UK, as that is where the literary work “subsisted”, even though the authors lived and worked abroad.

In relation to know-how, the High Court of Australia has held that royalties were sourced in the USA were the contract to supply the know-how had been entered into and the know-how was to be used: ***FC of T v United Aircraft Corporation*** (1943) 68 CLR 525.

[17] Tax Bulletin 9 (1993)

Section 6C is to the effect that royalties derived by non-residents from Australian residents (other than outgoing of a foreign PE of the Australian resident), or from outgoings of the Australian PE of a non-resident, are deemed to be sourced in Australia.

Section 128B(2B) is to the effect that royalty withholding tax applies to non-residents on royalties deemed to be sourced in Australia by s6C.

In addition, s128B(2C) is to the effect that royalty withholding tax also applies to royalties derived by a foreign PE of an Australia resident, from an Australian payer or from an outgoing of the Australian PE of a non-resident.

There is no equivalent to s128B(3)(h) in relation to interest, and so the Australian PE of a non-resident which derives royalties is subject to royalty withholding tax, but will still have a liability by assessment on the income effectively connected with the Australia PE. As in the non-DTA case, the withholding for royalties is 30%, this is an effective double tax. It is not known whether the Commissioner will informally give credit for the withholding tax paid, but the payer could ask for a variation of the amount to be withheld before payment is made, under s15-15 of Sch 1 of TAA. This problem does not arise under a DTA.

6. PERMANENT ESTABLISHMENTS

The "business profits" article of most Double Tax Treaties provide that the business profits of a resident of one treaty country are taxable only in that country unless it carries on business in the other country through a permanent establishment. Under these circumstances, the profits of the enterprise which are "attributable" or "effectively connected" to the permanent establishment may be subject to tax in the treaty country in which the permanent establishment is located. The subject of attribution of profits to permanent establishments was comprehensively dealt with in IFA Cahiers Vol 91b (2006). It should be noted that it is also the subject of revised draft commentary to Article 7 of the OECD model treaty (2007).

Where a treaty country in which the permanent establishment exists subjects the permanent establishment's profits to tax, the country of residence of the enterprise is required to avoid double taxation by providing a credit against its tax payable or an exemption from tax on the permanent establishment's profits.

The term "permanent establishment" is defined in the "permanent establishment" article as a fixed place of business through which the business of an enterprise is wholly or partly carried on. Unlike the definition of "permanent establishment" in the Australian Acts 1936 & 1997,

the concept in taxation treaties requires that there be a “fixed” place of business, although the OECD commentary suggests that the concept requires a specific geographical place with some degree of permanence (even though it may have existed only for a short time e.g. because of investment failure). The concept of “permanent establishment” is of crucial importance for determining the taxation liability of an enterprise of one contracting state in the other contracting state. The concept was considered in Australia in ***Unysis Ltd v FC of T*** (2002) 51 ATR 386, under the US/Australia treaty[18]. Recently, it was considered by the Supreme Court of India in ***DIT (International Taxation) v Morgan Stanley & Co Inc*** [2007] 292 ITR 416 (SC), under the US/India treaty.

As the format of the “permanent establishment” article of the Australia’s taxation treaties is subject to significant variations, at least with developing countries, it is necessary to examine each particular taxation treaty carefully in this regard.

The “permanent establishment” article in Australia’s taxation treaties often includes in the term; a place of management; a branch; an office; a factory; a workshop; a mine, an oil or gas well, a quarry or any other place of extraction of natural resources; a building site, a construction, assembly or installation project, or supervisory activities in connection therewith (but usually only where that site or project or those activities continue for a period or periods aggregating more than 183 days within any 12 month period); a warehouse in relation to a person providing storage facilities for others; and an agricultural, pastoral or forestry property.

If a person other than an independent agent acts in one country on behalf of an enterprise of the other country, that person is likely to be a permanent establishment if he or she has and habitually exercises an authority to conclude contracts on behalf of his or her principal. Independent agents, being brokers, general commission agents or any other type of agent acting in the ordinary course of the business which the agent carries on, do not constitute a permanent establishment of the principal.

Importantly, the ATO has ruled in TD2005/2 that a foreign resident enterprise does not have a PE in Australia solely by virtue of making sales of trading stock through a website hosted by an Australian resident internet service provider[19].

---

[18] also see TR2001/11
[19] This is consistent with the OECD Commentary on Art 5, at ¶ 42.1-42.10. The UK Inland Revenue by press release of 11 April 2000 specified that even a server in the UK will not of itself represent a UK PE. The advice concerning the US is generally more cautious i.e. for the non-resident selling into the US to use a foreign server if possible.

Sometimes the provisions of the "permanent establishment" article are applied for the purposes of determining the existence of a permanent establishment outside both countries, and whether an enterprise, not being an enterprise of one of the countries, has a permanent establishment in the other country.

7. HIGH TAX COUNTRIES' USE OF CFC LEGISLATION

A number of countries have a "territorial" system of taxation such that it is only income sourced in that country which is subject to tax there. Good examples in the Asia Pacific region are Malaysia and Hong Kong. Such countries are not concerned from a tax perspective about residents setting up offshore companies to derive foreign source income, as they don't tax such income anyway.

However, most countries tax residents on domestic and foreign source income, but non residents only on domestic source income, and so several high tax countries have complex rules designed to attribute to resident taxpayers, income derived by entities resident outside that country, but controlled by a resident. The rules are designed to prevent the deferral that would otherwise apply until the controlled entity paid a dividend to the resident. The control foreign corporation (CFC) and their related foreign investment fund (FIF) and transferor trust rules, are usually designed to attribute passive income, or income from transactions with associates ("tainted income"). Countries with CFC rules include USA, Canada, the UK, Germany, France, Sweden, Norway, Japan, Australia and New Zealand. For a general overview of the operation of such regimes, see Brian J Arnold and Patrick Dibout, "Limits on the Use of Low-Tax Regimes by Multinational Businesses: Current Measures and Emerging Treads", General Report – 2001 IFA Cahiers, vol.B, pp 21-89.

7.1 Investment from Australia

The CFC provisions of the Australia tax law are designed to deal with unacceptable deferral of Australian tax by Australian resident companies forming controlled companies in "non comparably taxed" countries, and not declaring dividends back to Australia. However, "non comparably taxed" is not defined, unlike the UK, where the concept is expressed as "low tax", and is defined as 75% of the UK company tax rate. The Australian anti-deferral rules are in the process of rationalisation, but the thrust of the government's acceptance in May 2009 of 9 out of 10 of the Board of Taxation's recommendations is for significant relaxation. None the less, as the specifics are not yet known, this paper deals with the current law.

Control

Whether the Australian CFC regime applies to attribute income to an Australian resident or not depends on –

(1) whether an Australian resident directly or indirectly controls a 40% or more interest in the company, unless a non resident actually has control; or 5 or fewer Australian residents directly or indirectly control a 50% or more interest in the company, or an Australian resident has actual control, by whatever means; (in which case the company is a "CFC"),

(2) the type of income derived by the CFC and

(3) whether the CFC is a resident of a comparable tax country (" listed") country or not .

From 1 July 1997 listed countries were either broad exemption or limited exemption. Malaysia was a limited exemption listed country. Labuan is a Federal Territory of Malaysia. From 1 July, 2004, the only listed countries are the former broad exemption listed countries, but a number of previously restrictive rules concerning the former unlisted countries, have been repealed.

CFC Attribution

Non-Australian sourced business profits derived by a CFC (say, in Labuan, Malaysia) will generally only be potentially attributable to its Australian controlling shareholders if the income derived by it is "tainted" and the company fails the "active income test" i.e. the ratio of tainted income to total turnover is greater than 5%.

Active Income Test

There are two further important aspects of the "active income test" which should not be overlooked, and they are is sub-s(1)(e):

That the company be a resident of a particular listed or unlisted country; and
That the company carries out business in that country through a "permanent establishment" ("PE") of the company in that country.

If the company is incorporated in Malaysia and has a majority of its directors who meet in Malaysia, it should be a resident of a particular unlisted country at all times during a year of income.

For the purposes of s432 it is the s6(1) ITAA 1936 definition of PE which is relevant, and which is in a different form to the OECD model definition used as the basis for all of Australia's DTAs[20].

Importantly, the s6(1) definition does not express include an "office" or a "place of management" as examples of a PE, and does not refer to a "fixed" place of business, but rather only to a place of business. However, ¶ 19 of TR2002/5 says that the ATO does not consider it significant that the word "fixed" does not appear in s6(1), and says at ¶ 27 that the s6(1) definition will be broadly construed consistently with the meaning of PE in Australia's DTAs. Thus, ¶ 29 says that the s6(1) definition requires "geographic" permanence (expressly referring to an office, factory, farm, mine or market), and at ¶ 30, that the presence must not be temporary.

Accordingly, the Malaysia company will have a s6(1) PE if it conducts its business in Malaysia through an office there, which is in existence throughout the year of income. The office need not be exclusively for the use of the Malaysia company, but must be available for its occupation[21]: see Example 6 of the ruling, which deals with a party regularly being found at a market[22], even if the stall that is occupied is not the same stall on each market day. If the Malaysia company does not lease its own office, it will certainly have a registered office address at a trust company, lawyers or accountants offices, which will be where the directors hold their meetings, and transact the company's business in Malaysia. It is also where the company can be found in Malaysia by virtue of its "holding out" on stationary, advertising, and signage at that office[23].

---

[20] On the OECD definition, see generally, "Is there a permanent establishment?", IFA Cahiers Vol 94a (2009)

[21] Refer ¶ 4.1 OECD commentary on model DTA. The Canadian cases of *Sunbeam Corp. (Canada) Ltd v MNR* [1963] SCR 45, *Shanmoon v MNR* 75 DTC 275 (TRB), *Fiebert v MNR* 86 DTC 1017 (TCC), *American Income Life Insurance Company v The Queen* 2008 TCC 306, and *Knights of Columbus v The Queen* 2008 TCC 307, indicate that whether the space used in Canada by the non-resident can be a PE may depend on whether the space is paid for by the non-resident.

[22] Consistent with ¶ 4 OECD commentary reference to "pitch in a market place". This is certainly consistent with the Canadian Tax Court case of *Fowler v MNR* 90 DTC 1834. However, other Canadian authority might be regarded as contradictory e.g. *Toronto Blue Jays Baseball Club v Minister of Finance (Ontario)* 2005 DTC 5360 (Ont.CA). The UK case of *Dunlop Pneumatic Tyre Company, Limited v Actien-Gesellschaft Für Motor Und Motorfahrzeugbau Vorm. Cudell & Co* [1902] 1 KB 342 on presence in the jurisdiction for service (at a place of business of the company in the UK), where the employee of the defendant was at an exhibition for only nine days, also supports the OECD reference.

[23] TR2002/5 is referred to in *Unisys Corporation v FC of T* [2002] NSWSC 1115 at ¶ 40, but not on this issue. The case found that there was insufficient repetition of contractual activity for USI as the general partner of the UAL limited partnership, to constitute a PE in the US of UAL, as USI did not "habitually" enter into contracts on UAL's behalf (at ¶ 74). UAL only

Passive and Tainted Income

Section 384(2)(a) only applies to passive income and tainted income which is attributable back to the Australian controlling shareholders in the Labuan company. Passive income includes such things as interest. Income from the sale of goods or the provision of services is not passive income, but may be "tainted". It should be observed that sales income is not "tainted" provided it is not for the sale to or purchase from an Australian resident company with which the Labuan company is "associated" (broadly speaking, owned and controlled). From 1 July, 2004, services income is generally only "tainted" if the services are provided to an Australian resident.

Royalties will be "tainted royalty income" of a company except where all of the following conditions are satisfied:

(a) the royalties are derived in the course of a business carried on by the company;

---

did business with one associated company. It did not seek business from anyone else. In the current case, the company will be seeking business from the world at large, and will record its location for that purpose. The "holding out" of the office as a place where the taxpayer can be found was important in the Canadian Board case of *Panther Oil & Grease Manufacturing Co of Canada Limited v MNR* 57 DTC 494 (ITAB), aff'd 61 DTC 1222 (Ex. Ct. Can.). There, the sales manager amongst other things, used a letterhead identifying his residence as the address of the employer company. The use of a letterhead alone will not be enough to constitute a PE: see the US tax case of *Consolidated Premium Iron Ores Ltd v Commissioner of Internal Revenue* 57 DTC 1146 at 1162 (TC US), aff'd 59 DTC 1112 (US 6th Cir). However, where there is some business activity combined with the holding out that the company can be found at a particular place, the UK cases on presence in the jurisdiction for service (at a place of business of the company in the UK), support the holding out as sufficient: *Re Oriel Limited* [1985] 3 All ER 216, *A/S Dampskib "Hercules" v Grand Trunk Pacific Railway Company* [1912] 1 KB 222, *South India Shipping Corporation Limited v Export- Import Bank of Korea* [1985] 1 WLR 585, *Lord Advocate v Huron & Erie Loan & Savings Company* [1911] SC 612. As to whether a Delaware company "carried on business in Australia" for the purpose of s21 of the Corporations Act 2001, the use of an Australian PO box, telephone and fax number were sufficient "holding out" in *Starport Futures Trading Corporation, Re* [2009] QSC 94 at ¶ 11, 12, 19. Whilst sales may take place on an internet site and so the company is not found at the physical address by most purchasers, vendors to the company will seek it out at its registered office.

EC Trust (Labuan) Bhd
License : LT0024
Wisma EC Trust, U0195, Jalan Merdeka,
87007 Federal Territory of Labuan,Malaysia
Tel: +6 087 453 858 / 452 858 / 453618
Fax: +6 087 453 616
http://www.ectrustco.com

(b) at the time the royalties were derived, the entity liable to pay the royalties was not an associate of the company;

(c) either of the following subparagraphs applies:

> (i) the matter or thing in respect of which the royalty is consideration originated with the company;
>
> (ii) the company has substantially developed, altered or improved that matter or thing with the result that its market value was substantially enhanced.

7.2 Capital Gain On Disposal Of Labuan Company

Since 2004 Div 768-G has provided a "participation exemption" from capital gains made on disposal of "non-portfolio" shareholdings that have been held for 12 months or more, in proportion to the percentage of "active assets" held by the company.

7.3 Thin Capitalization

The Australian thin capitalization rules in Div 820 are applicable to investment in a CFC as an "outbound investment". The rough rule of thumb is that an Australian company can only gear a Labuan subsidiary at the greater of 3:1, the amount that an arm's length lender would lend, or at no more that 120% of its group world-wide debt level. However, there is no motivation to use any debt funding in a Labuan subsidiary, as it will only give a deduction in Labuan against a maximum 3% tax rate, but interest paid to the Australian parent will be taxed at 30%. However, it may pay to borrow to subscribe for the share capital needed in the Labuan Company, as long as the interest is deductible[24] in Australia under thin cap[25].

7.4 Transfer Pricing

The Australian transfer pricing rules (Div 13) as they related to trading don't feature largely in the current case, as the Labuan company won't be dealing with customers in Australia, nor with associated parties. This assumes the employment of arm's length personnel to staff the operation outside Australia.

However, if the tax haven company's business is partly effected by Australian resident personnel being employees of the company for the purpose of doing the company's business,

[24] see s25-90.
[25] There is a $250,000 *de minimus* interest expense before the rules apply.

whilst separately being employed by an Australian company that continues to carry on the Australian business, gives rise to some issues.

Clearly Div 13 will require them to be paid a market wage for what they do, which will be taxed to them in Australia[26]. If they are not employed directly, the parent company in Australia will have to make an arm's length charge for the provision of their services.

Clearly any staff so engaged will need to refer any board level issues back to the board, to ensure the central management and control of the company is in Malaysia.

Whilst a Labuan company that has not made the election, does not have the benefit of the DTA with Australia, and so the question of whether the Labuan company has a PE in Australia is not strictly relevant, as it is only Australian source income which is taxable to it in Australia, the Australian resident employees should not transact business for the Labuan company from Australia[27]. On the basis that an Australian company is to do the Australian business, all the Australian source income should all be derived by the Australian company, and none by the Labuan company.

Div 13 has most recently been considered in ***Roche Products Pty Ltd v FC of T*** 2008 ATC ¶10-036. It is also the subject of very detailed rulings by the Commissioner e.g. TR94/14 & TR97/20. Some of the most difficult issues will related to intellectual property[28].

8. DIVIDENDS FROM LABUAN

A dividend paid by a Labuan, Malaysia company to an Australian company (in its own right and not as a trustee of a trust), that holds a "non portfolio" shareholding in the Labuan company (10% or more of the voting shares), will be an exempt dividend under s.23AJ of the

[26] The 2009 Budget announcement that s23AG is to be effectively repealed which would only have been relevant in the current circumstances if the Australian resident employees of the tax haven company were going to have spend 90 days periods outside Australian on their foreign employment.
[27] In any event, there is authority that the mere presence of employees in Australia should not mean that the company is trading in Australia, if sales contracts are not entered into in Australia: see *Greenwood v F L Smidth & Co* (1922) 8 TC 193 HL. If only purchases are contracted for in Australia, there is authority that the company should not be trading in Australia: see *Sulley v A-G* (1860) 2 TC 149;
[28] Refer IFA Cahiers "Transfer pricing and intangibles" Vol 92a (2007). The Commissioner's assertion that Art 9 "Associated Enterprises" article of the OECD model DTA empowers the Commissioner to use "profit split" methodologies, when they are not part of Div 13, was not necessary to consider in *Roche Products* as the Commissioner there did not press the issue, but Downes J expressed the view, *obiter*, that the DTAs did not provide a taxing power (see ¶ 190-191), which observation is consistent with orthodox theory. Also see TR2001/13 at ¶33._

ITAA 1936. This result is unaffected by the 2002 Protocol to the Australia/Malaysia double tax treaty.

If the Australian holding company distributes dividends to its shareholders, those dividends will be assessable to the shareholders. As no Australian tax was paid on the dividend received from Labuan, no franking credits will be available in relation to the Labuan dividends. That is, the use of a Labuan subsidiary in those circumstances, would only achieve tax deferral for as long as dividends are not paid by the Australian holding company to its shareholders.

9. USE OF LABUAN COMPANIES

From the analysis above, it will become apparent that for Australian owned Labuan companies, to avoid attribution under the Australian CFC the income should not be passive income, tainted sales, tainted services, or tainted royalty income.

To illustrate the diversity of uses of Labuan companies, we set out some examples, in each referring to the Australian client as "Austco" and its offshore subsidiary company as "Offshoreco". In each case, Austco:

- wants to do the offshore business in the same time zone; keep the cost of doing offshore business down; preferably in English; in a country with a recognisable legal system; that is reasonably politically stable
- realises that a website will allow clients to find it, rather than the other way around
- wants to choose an international base that will allow it maximum flexibility for potential customers in many jurisdictions

9.1 Trading in Goods

- Austco is in the business of buying goods in or outside Australia, and selling them in and outside Australia
- Austco is looking for more vendors and purchasers
- Austco accepts that sales in Australia are probably best effected through Austco, but wants to make sales outside Australia though Offshoreco, to enhance its international credentials
- If Offshoreco is formed under the Labuan regime, if the source of its income will be from Offshoreco purchasing goods either in or outside Australia from unrelated suppliers, and selling the goods to unrelated customers outside Australia, none of that income will be attributed back to Austco as the holding company under the CFC regime i.e. the income will not be "tainted sales income"

9.2 Manufacturer "Offshoring"

- Austco is in the business of manufacturing goods in Australia with raw material sourced in or outside Australia, and selling the finished product in or outside Australia
- Austco is looking for more purchasers
- Austco wants to commence manufacturing in China, due to its significantly lower costs
- Austco accepts that sales in Australia are probably best effected through Austco, but wants to make sales outside Australia though Offshoreco, to enhance its international credentials
- If a subsidiary of Offshoreco can be formed in China (Chinaco), that will manufacture the goods to Offshoreco's specifications, using raw materials purchased either in or outside Australia from unrelated suppliers, and selling the finished product to Offshoreco on a cost plus basis, none of Chinaco's income will be attributed back to Austco as the holding company under the CFC regime i.e. the income will not be "tainted sales income"
- If Offshoreco is formed under the Labuan regime, then as the source of its income will be from Offshoreco buying finished product from Chinaco, and selling the goods to unrelated customers outside Australia, none of that income will be attributed back to Austco as the holding company under the CFC regime i.e. the income will not be "tainted sales income"

9.3 Provider of Services

9.3.1 Computer Services

- Austco is in the computer services business
- So far, it has only done work for Australian resident clients
- Austco is looking to do work for clients overseas
- If Offshoreco is formed under the Labuan regime, then as the source of its income will be from providing services to clients outside Australia (including related parties after 1 July, 2004), none of that income will be attributed back to Austco as the holding company under the CFC regime i.e. the income will not be "tainted services income"

9.3.2 Architectural Drafting

- Austco is in the architectural drafting profession
- So far, it has only done work for Australian resident clients
- Austco is looking to do work from clients overseas
- If Offshoreco is formed under the Labuan regime, then as the source of its income will be from providing services to clients outside Australia (including related parties after 1 July, 2004), none of that income will be attributed back to Austco as the holding company under the CFC regime i.e. the income will not be "tainted services income"

9.4 Royalties

9.4.1 Software Licensing

- Austco is in the computer software writing business
- Austco is looking to license clients overseas
- Austco wants to license its programs to overseas clients though an offshore company (Offshoreco), to enhance its international credentials
- If Offshoreco is formed under the Labuan regime, and writes new programs from there, then as the source of its income will be royalties from unrelated clients outside Australia, none of that income will be attributed back to Austco as the holding company under the CFC regime i.e. the income will not be "tainted royalty income"

9.4.2 Book Author

- An Australian resident individual (Aussie) is a writer
- So far, she has only "sold" the rights to her copyright to Australian based publishers
- She has received advice that as she has reached a relatively successful stage, that she should form an Australian company (Austco) she would control, for whom she would write books, and vest the copyright in the books immediately in Austco in return for a salary, so that all "super profit" would accrue to Austco
- Austco is set up for Australian business
- Aussie (and Austco) also look to become established internationally
- Aussie realises that the advice she has received about using Austco in Australia, may translate for offshore deals though an offshore company (Offshoreco), from which she could draw a salary, it turn enhancing her international credentials
- Aussie wants to choose an international basis that will allow it maximum flexibility for potential publishers in many jurisdictions
- If Offshoreco is formed under the Labuan regime, and Aussie writes her books for Offshoreco for a salary, and Offshore does not "sell" the copyright, but licenses it, then as the source of Offshoreco's income will be royalties from unrelated publishers outside Australia, none of that income will be attributed back to Austco as the holding company under the CFC regime i.e. the income will not be "tainted royalty income"

9.4.3 Rock Band

- Australian resident individuals are a Rock & Roll band (OzRock)
- So far, OzRock has only "sold" the rights to its copyright in its sound recordings to Australian based publishers
- OzRock members have received advice that as they had reached a relatively successful stage, that they should form an Australian company (Austco) they would control, for whom they would record soundtracks, and vest the copy right in the soundtracks

immediately in Austco in return for a salary, so that all "super profit" would accrue to Austco

- Austco is set up for Australian business
- OzRock (and Austco) also looking to become established internationally
- OzRock members realise that the advice they has received about using Austco in Australia, may translate for offshore deals though an offshore company (Offshoreco), from which they could draw a salary, it turn enhancing their international credentials
- OzRock want to choose an international base that will allow them maximum flexibility for potential record companies in many jurisdictions
- If Offshoreco is formed under the Labuan regime, and OzRock perform their music for Offshoreco for a salary, and Offshore does not "sell" the copyright in the sound recordings, but licenses them, then as the source of Offshoreco's income will be royalties from unrelated record companies outside Australia, none of that income will be attributed back to Austco as the holding company under the CFC regime i.e the income will not be "tainted royalty income"

9.4.4 Music Composer

- An Australian resident individual (Ozzie) is a music compose (e.g. Rock & Roll)
- So far, he has only "sold" the rights to his copyright to Australian based publishers
- He has received advice that as he has reached a relatively successful stage, that he should form an Australian company (Austco) he would control, for whom he would write music, and vest the copy right in the music immediately in Austco in return for a salary, so that all "super profit" would accrue to Austco
- Austco is set up for Australian business
- Ozzie (and Austco) also looking to become established internationally
- Ozzie realises that the advice he has received about using Austco in Australia, may translate for offshore deals though an offshore company (Offshoreco), from which he could draw a salary, it turn enhancing his international credentials
- Ozzie wants to choose an international basis that will allow it maximum flexibility for potential publishers in many jurisdictions
- If Offshoreco is formed under the Labuan regime, and Ozzie writes his music for Offshoreco for a salary, and Offshore does not "sell" the copyright, but licenses it, then as the source of Offshoreco's income will be royalties from unrelated publishers and performers outside Australia, none of that income will be attributed back to Austco as the holding company under the CFC regime i.e the income will not be "tainted royalty income"

EC Trust (Labuan) Bhd
License : LT0024
Wisma EC Trust, U0195, Jalan Merdeka,
87007 Federal Territory of Labuan,Malaysia
Tel: +6 087 453 858 / 452 858 / 453618
Fax: +6 087 453 616
http://www.ectrustco.com

Each of the examples may involve transfer pricing issues which will need to be carefully considered[29]. Perhaps the most important thing to note, is that the OECD Transfer Pricing Guidelines specify that the arrangement must be arm's length when it is entered into, "without using hindsight"[30].

10. COMPARISON WITH HONG KONG AND SINGAPORE

Hong Kong IRD Practice Note (reviewed 15 May, 2002) concerning the "Territorial Source Principle of Taxation" interprets "Hong Kong sourced profits" very broadly, so Hong Kong tax rates of currently 17.5% are increasing likely to apply. In order to prove that the profits from trading in goods bought and sold outside Hong Kong does ***not*** have a source in Hong Kong, the Hong Kong company must prove that substantial activity of the company was effected outside Hong Kong, thereby putting the Hong Kong company at greater risk of being taxable on its profits in the high tax jurisdictions in which it makes sales: see ***CIR v Euro Tech Far East Ltd*** (1995) 1 HKRC para 90-076 and Board of Review cases ***D28/86 and D47/93 (Case D24)*** (1994) 1 HKRC para 80-274); and compare ***CIR v Magna Industrial Co Ltd*** [1996] HKCA 542.

Singapore's ordinary company tax rate is currently 18%, and the ability to get a special 10% tax rate requires Ministerial approval, which usually requires an expensive office set up with employment of high wage staff. As Singapore companies are taxable on income accruing in or derived from Singapore (and foreign source income remitted into Singapore), the difficulties described above for companies trading in goods through Hong Kong, also arise in Singapore. In any event, profits can generally only be paid out of Singapore companies as a dividend, if Singapore company tax is paid on those profits.

---

[29] It is assumed that where individuals are concerned, that their decision to incorporate is itself not a Part IVA issue. This will largely depend on whether in the industry concerned, incorporation is usually undertaken to avoid personal liability, and that otherwise the PSI provisions do not apply. In relation to transfer pricing, as the Labuan company is not entitled to be benefit of the Australia / Malaysia DTA, Art 9 "Associated Enterprises" is probably irrelevant, and so a transfer pricing adjustment if any, must be valid under Div 13, which is restricted to arm's length pricing methods, and does not authorised the use of "profit split" methods, with which Art 9 is associated. It is noted that Div 13 was introduced in 1982, and unlike Sch 28AA in the UK, has not been cross referenced to the OECD Transfer Pricing Guidelines (which discuss "profit split" methods), first issued in 1995. The clearest statement of the Commissioner's position appears to be a paper entitled, "Transfer pricing and business restructuring", by Jim Killaly, TIA Vic State Convention 2008. However, the Commissioner may now be re-thinking his line, as per his speech, "In the best interests of Australia" (15 June 2009).

[30] ¶ 6.32, although the ability to re-negotiate may be part of the arm's length bargain, see ¶ 6.34. The US "super royalty" regime (Reg 1.482.4(f)(2)(i)) is clearly out of step with the OECD, of which it is a member.

The Hong Kong tax problems which arose in cases such as *Euro Tech* and D28/86 and D47/93 do not arise in Labuan, where the 3% tax rate (or flat tax of RM20,000 (US$5,250)) encourages Labuan offshore companies to be taxable on their trading activities "carried on in or from Labuan … with non-residents". Thus, there is greater flexibility in relation to trading in goods, thereby reducing the risk of assessment to Offshoreco in the high tax jurisdictions with which Offshoreco trades.

11. GENERAL ANTI-AVOIDANCE PROVISION

In order to examine the question of the potential application of the Australian general anti-avoidance provision (Part IVA) it is necessary to have some factual background. Assume the following:

- Austco prefers to set up the offshore company in a time zone that has a "window' with the Australian business day. Accordingly, the area under consideration spans, China, South Korea, Japan, Hong Kong, Thailand, Vietnam, Malaysia, The Phillipines, Singapore, & Indonesia
- Austco wants to keep the costs of its offshore company down
- Austco prefers to set up in a country with a British Common Law background as this is the legal system it understands
- Austco prefers to deal with staff and customers, to the extent possible, in English
- Austco prefers as stable as possible political climate
- Austco wishes to incur the least possible overseas taxes on its world-wide income. This requires as low a possible offshore tax rate and an extensive network of double tax agreements to minimise source country tax

Discussion

- Based on these considerations, it narrows its choice down to three jurisdictions, Hong Kong, Singapore & Malaysia
- The cost of doing business in Hong Kong is high
- Whilst Hong Kong has no tax on foreign source income, as its only has a few double tax treaties, most third country source income tax may be payable in those countries for sales made by Offshoreco if it was resident in Hong Kong.
- The cost of doing business in Singapore is nearly as high as Hong Kong, but Singapore has an extensive list of double tax treaties. However, its ordinary company tax rate is currently 17%, and the ability to get a special 10% tax rate requires Ministerial approval, which usually requires an expensive office set up with employment of high wage staff.

- Labuan, Malaysia has excellent telecommunications including Broadband internet, a modern airport serviced by several 737 jet flights per day, extensive port facilities, and cheap but reliable mail and courier services.

These facts provide both the subjective and objective purpose of the choice to use a Labuan company to transact the overseas business. However, the objective purpose will only be relevant if there is a "tax benefit" of the "scheme" as defined.

Part IVA was considered most relevantly, in ***Consolidated Press Holdings Pty Ltd v FC of T*** (2001) 47 ATR 229. At ¶ 97, the Part IVA scheme was the interposition of a resident company (MLG) between the Australian borrower company (CPH), and the UK incorporated companies (apparently then tax residents of Hong Kong), that were to make the takeover bid for BAT Industries plc. The "tax benefit" was the unimpeded deduction for interest that would otherwise have been quarantined by s79D. The dominant purpose of the scheme was to obtain the unimpeded interest deduction. The reasonable hypothesis was that MLG would not have been interposed if the scheme had not been implemented: ¶ 87. Also see Full Federal Court 42 ATR 575 at ¶ 87 & 88.

The question in the current case is whether the interposition of a tax haven company between an Australian company and the foreign activity, raises a Part IVA issue. It will not, unless there is a "tax benefit" as defined.

The use of a tax haven company rather than an resident company to conduct an offshore business doesn't create an Australian "tax benefit" subject to Part IVA, as since 1 July 2004, the trading business in any country through a PE will be non-assessable non-exempt ("NANE") income, via s23AH for a resident company, and if via a tax haven company owed by a resident company, will not be attributed under the CFC regime, due to the active income exemption under Part X, and dividends to the resident company from the tax haven resident company will be NANE income, via s23AJ. The reasonable hypothesis is that if a non-resident company had not conducted the foreign business, it would have been conducted by a resident company with a PE in the place where the foreign business was set up.

Since the introduction of Div 768-G on 1 April, 2004, a capital gain on the disposal of the active business by the resident company will be NANE income under s23AH, and alternatively, a sale of the shares by the resident company, in a tax haven subsidiary carrying on the same business, would also be NANE income[31].

[31] It should be noted that the sale of the active business by a CFC was never attributable, as s446(1)(k) only included in the "passive income" of a CFC, a net gain from the disposal of "tainted assets". The sale of shares by a CFC in a subsidiary CFC with an active business, is also not attributable even though shares are "tainted

DISCLAIMER

This paper does not constitute advice. It should not be relied on as such. Persons wishing to explore these opportunities further should seek professional advice.

PETER K. SEARLE
ROBERT GORDON
www.ectrustco.com

29 September, 2009

Peter Searle BA, LLB (Hons), LLM is a Trust Officer and Barrister who has been a tax and trust law specialist for over 30 years. He commenced his tax career in 1977 in the Compliance and Appeals Division of the Australian Taxation Office in Canberra.

He completed an Honours degree in Law, including International Law, at the Australian National University in 1979 and was admitted as a Solicitor and Barrister in the Supreme Court of Victoria in 1982. From 1982 until 1985 he worked as a Senior Taxation Manager at Coopers and Lybrand where his clients included large multinational corporate groups. He completed a Masters of Law in Taxation at Monash University in 1985. In 1986 Peter was called to the Victorian Bar and for the next sixteen years was an Australian barrister appearing in taxation, commercial, equity, bankruptcy, insurance and criminal law cases in the High Court of Australia, the Federal Court of Australia and the State Supreme Courts.

Peter moved to the Federal Territory of Labuan, Malaysia in 2001/ 2002, where he is a Director and Trust Officer of EC Trust (Labuan) Bhd (www.ectrustco.com). Peter is a prolific writer and speaker at numerous international conferences including the International Bar Association, the Australian Taxation Institute and the Asia Pacific Bar Association and has been Assistant Editor of the "Australian Tax Review", President of the Victorian Society for Computers and the Law and Vice President of the International Commission of Jurists (Victorian Division).

---

assets" under s317, because s389 allows Div 768-G to have operation in relation to a CFC through the "residency assumption" (s383) in calculating the attributable income of a CFC. The same logic allows a CFC to receive dividends (defined as passive income) to avoid attribution on the dividends as s389 does not exclude s23AJ. Prior to 1 July, 2004, that result was achieved by s402(2), as it then read.

A number of his articles concerning international taxation, company and trust law may be viewed online at http://www.ectrustco.com/documents/whitepapers.asp.

Robert Gordon BA LLB LLM FCPA commenced his tax career in 1979 with Greenwood Challoner & Co., Chartered Accountants, in Sydney and worked with Ernst & Whinney (Sydney), Coopers and Lybrand (Melbourne) and Minter Ellison (Melbourne) before becoming a tax partner at Corrs Chambers Westgarth, Solicitors, in Sydney. He is admitted to practice in England and Wales as well as in four Australian States. Since 1992 he has been a member of the New South Wales Bar specializing in international tax and other revenue law. In 2006 he had a one year sabbatical in London where he studied international tax. He now has chambers in Melbourne.

EC Trust (Labuan) Bhd
License : LT0024
Wisma EC Trust, U0195, Jalan Merdeka,
87007 Federal Territory of Labuan,Malaysia
Tel: +6 087 453 858 / 452 858 / 453618
Fax: +6 087 453 616
http://www.ectrustco.com

Appendix A - Treaties have also been initialled with Brunei, Oman, Qatar, and Yemen. *Shipping & Air profits only tax treaty. +excludes Labuan Offshore companies taxed under LOBATA. # net yet effective

MALAYSIAN DOUBLE TAX AGREEMENTS

Albania	Indonesia+	Romania
Argentina*	Ireland	Russia
Australia+	Italy	Saudi Arabia Seychelles
Austria Bahrain	Japan+	Singapore South Africa South Korea+ Spain
Bangladesh	Jordan Kazakhstan#	Sri Lanka Sudan
Belgium Bosnia& Herzegovina#	Kyrgyztan Kuwait Lebanon Luxembourg+	Sweden+
Canada Chile #	Malta	Switzerland Syria
China Croatia	Mauritius	Thailand
Czech Republic	Mongolia Morocco	Turkey
Denmark	Myanmar #	United Arab Emirates
Egypt	Namibia	United Kingdom+
Fiji	Netherlands+	United States of America*
Finland+	New Zealand	Uzbekistan Venezuela #

France
Germany
Hungary
India
Iran #
Norway+
Pakistan
PapuaNew Guinea
Philippines
Poland
Vietnam
Zimbabwe #