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# *WHY LABUAN, MALAYSIA? (NZ perspective from 1 April, 2010)*

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## 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 RULE

## 1. INTRODUCTION

This paper focuses on corporate tax residence and compares the advantages and disadvantages of using a base company in an effective low tax country with an extensive double tax treaty network, such as Malaysia, in relation to investment from New Zealand. This has only really been practical since 1 April, 2010 due to fundamental changes to the New Zealand tax law effected from that date[1].

It should be noted at the outset, that the first step of outbound investment from New Zealand using a base company, will often be achieved through a tax haven, which invariably will not have a treaty with New Zealand. The benefits of treaties is then apparent between the base company country of residence, and the country of the source of the income. The relevant treaty will be likely to be in the form of the OECD Model.

Whilst Malaysia does have a double tax treaty with New Zealand, this paper only discusses briefly how a Malaysian company owned by non-NZ persons can carry out electronic commerce business with NZ without an NZ tax liability. Whilst NZ does not have a policy of requiring a limitation of benefits article in its treaties, "treaty shopping" into NZ is not a

[1] Taxation (International Taxation, Life Insurance, and Remedial Matters) Act 2009, amended the Income Tax Act 2007. The NZ tax year ends 31 March. Prior to 1 April, 2010 passive AND active income of all CFCs other than 8 "grey list" countries, was attributed under the CFC regime. The grey list was Australia, Canada, Germany, Japan, UK, US, Norway & Spain.

focus of this paper. The paper also touches on the use of a Malaysian company carrying out electronic commerce business with the US, even though Malaysia does not have a DTA with the US.

Malaysia has an extensive double tax treaty network with 60 or so countries including China, India, Canada and 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[2], 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[3].

## 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.

[2] Belgium, Luxembourg, Netherlands

[3] usually 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 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.

The Labuan Companies Act, 1990 provides for the incorporation of Labuan Companies ("LC's"), which are required to have a registered office in Labuan, and a resident secretary. Unless exempted, until 11 February, 2010 Labuan companies were only permitted to trade with non-residents of Malaysia or with other Labuan companies, and in a currency other than Malaysian ringgit. From 11 February, 2010, LCs may also transact business with a resident in a currency other than ringgit, provided that the Authority is notified within 10 working days[4].

The Labuan Business Activity Tax Act, 1990 ("LBATA"), taxes "Labuan trading activities" (excluding petroleum activities) carried on by an LC[5] at the rate of 3% on its audited trading profits or, upon election, at a fixed rate of MR20,000 (Approximately US$6,000).

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

The Director General of Inland Revenue may require a person to furnish information for the purposes of LBATA but such information was until 11 February, 2010, regarded as confidential, and not to 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[6]. On 22 February, 2010 the OECD "white listed" Malaysia, as it had entered into or amended 15 of its treaties to adopt the new Art 26(5) of the OECD model on exchange of information not being hindered by bank secrecy[7].

The Income Tax Act, 1967 (Malaysia) provides an election for income derived by an LC to be taxable in Malaysia under either the Income Tax Act, 1967 or LBATA.

Interest, royalties and management fees paid by an LC to a non-resident or another LC are not subject to withholding tax. An LC is not subject to stamp duty under the Stamp Duty Act, 1949. There is no Malaysian tax on dividends paid by an LC in respect of dividends distributed out of income derived from business activities or income exempt from income tax[8].

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

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[4] Many other improvements were effected from 11 February, 2010: The Labuan Companies Act was amended to expressly allow for companies limited by guarantee; the Labuan Trusts Act was amended to abolish the rule against perpetuities, and the Labuan Foundations Act took effect.

[5] or foreign companies registering under the Labuan Companies Act 1990

[6] The Labuan Financial Services and Securities Act 2009, from 11 February, 2010, re-enacted most elements of the Offshore Banking Act 1990, but without s22 which dealt with bank secrecy. See Peter Searle, "OECD white lists Malaysia after Labuan laws are amended", Offshore Investment, Issue 206 (May 2010).

[7] However, Malaysian Government policy has always been to ensure information sharing powers were not used for fishing expeditions, and that there was a *prima facie* case made out by the Government making the request. It is unlikely that the Malaysian authorities will permit automatic information sharing. See Peter Searle, Offshore Investment, *op cit*.

[8] Income Tax (Exemption)(No 22) Order 2007

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money movements can be securely arranged in cooperation with the client's preferred international financial institutions.

## 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.

The UN model retains more taxing rights to the source country, whereas the US model favors the country of residence. The OECD model is in between.

### 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 US's taxation treaties provide a credit basis for the relief of double taxation to be applied by the US 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 DTA "Tie Breaker"

Many DTAs contain "tie breaker" provisions in Article 4 where a person (including a company) is a dual resident.

#### 3.3.1 Malaysia/UK DTA

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 same provision appears in the Malaysia/Australia DTA. After the appeal decision in ***Revenue and Customs v Smallwood*** [2010] EWCA Civ 778 (8 July 2010), it is still likely that "effective management" will continue to be equated with "central management & control", if there is continuity in the place of management during a tax year .

### 3.3.2 Malaysia/India DTA

The equivalent provision of the Malaysia/India DTA provides:

> "*shall be deemed to be a resident of the State in which its place of effective management is situate. If the State in which its place of effective management is situated cannot be determined, then the competent authorities of the Contacting States shall settle the issue by mutual agreement.*"
> .

### 3.3.3 Malaysia/China DTA

The equivalent provision of the Malaysia/China DTA provides:

> "*shall be deemed to be a resident of the State in which its place of effective management is situate. However, if such a person has place of effective management in a Contacting State and a head office in the other Contacting State, the competent authorities of the Contacting States shall by mutual agreement determine the State of which the person in question is a resident.*"

### 3.3.4 Malaysia/New Zealand DTA

The equivalent provision of the Malaysia/New Zealand DTA provides:

> *"shall…be treated solely as a New Zealand resident if the centre of its administrative or practical management is situate in New Zealand and solely as a Malaysian resident if the centre of its administrative or practical management is situate in Malaysia whether or not any person outside New Zealand or Malaysia, as the case may be, exercises or is capable of exercising any overriding control of it or of its policy or affairs in any way whatsoever."*

## 3.4 Exclusion of LC's taxed under LBATA from Treaty Benefits

Generally Malaysia's double tax treaties do not exclude LCs from status as Malaysian residents for the purposes of those agreements. At present, of 60 or so Malaysian double tax treaties, only ten exclude LC's carrying on trading business subject to LBATA. The ten do not include China, India, Canada or New Zealand.

Accordingly, LCs 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[9].

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

LBATA entities were not generally subject to the Malaysian Income Tax Act 1967 on their "offshore" income until an election was announced in the September 2007 Malaysian Budget.

[9] as is required between EU countries

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This treaty exclusion only generally affected in-bound investment into those source countries, that is, to prevent access by the LBATA entity to the exemption from source country tax on business profits derived without a PE in the source country, and to prevent access to reduced 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. For instance, on 28 July, 2002 Malaysia and Australia signed a Second Protocol to their DTA.

Amongst other things, the 2002 Protocol denies LCs, 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 LC 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.

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 LC 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 applies to dividends paid by the ordinary Malaysian company to its shareholders[10].

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

The September, 2007 Malaysian Budget announced that LBATA entities would be entitled to irrevocably elect to become subject to the Income Tax Act 1967. This has now been legislated for[11], effective from 1 January, 2009. As the treaty exclusions were cast generally to catch entities benefiting from LBATA, the LC'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.

The Malaysia/ New Zealand DTA became effective in 1976. There have since been two protocols. Negotiations on amending the DTA commenced in 2009 but are not finalised. If nothing else, it would be expected that the "exchange of information" article will be brought up to date.

## 4. RESIDENCE

[10] ¶ 28 Sch 6 ITA 1967
[11] s3A LBATA, s3B ITA 1967

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), for example, which was adopted as articles 5(7) of the Malaysia/Australia, Malaysia/China, Malaysia/Canada, and article 5(8) of the Malaysia/India double tax agreements.

The classic general law central management and control test, which until 1988 was the sole test of company residence in the United Kingdom[12], was set out in the speech of Lord

[12] see SP 1/90

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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.

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.

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.

Section YD2(1) provides a company is a New Zealand resident[13] if—

(a) it is incorporated in New Zealand;

(b) its head office is in New Zealand:

(c) its centre of management is in New Zealand:

(d) its directors, in their capacity as directors, exercise control of the company in New Zealand, even if the directors' decision-making also occurs outside New Zealand.

In contrast, the United States simply looks to the place of incorporation. However, as we are focusing on investment from Malaysia to source countries other than the US, it is the residence of the "base" company which is relevant, in this case, Malaysia, and in this regard, the UK law will be highly persuasive.

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[13] Section YD3(2) provides that a company is resident in a particular country outside NZ if it is liable to income tax in the country because any of the following is located in the country—

(a) its domicile:(b) its residence:(c) its place of management:(d) any other criterion of a similar nature.

If it is not a resident of any particular country or of more than one on the basis of those tests, by sYD2(4), its residence is determined using the same tests as to determine NZ residence under YD2(1). If no one country of residence emerges, it is treated as resident in the country in which its centre of management is located.

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 not 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 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[14].

## 5. SOURCE OF INCOME

There is a "source of income" article appearing in most of the Malaysia'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[15]. 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 at 322 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*

[14] This is in contrast to the commentators on the UK position, who now all caution against a UK resident director participating other than physically. Caution should also be exercised in NZ, based on the NZ IRD publication "Guide to tax consequences of trading over the internet", originally issued May 2002 (p22), and revised Dec 2007.

[15] Some discussion of the US source rules for trading, services & royalties are set out below to assist in understanding how a Malaysian company have effect e-commerce business with the US, in the absence of a DTA.

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> *money was lent or the contracts of purchase and sale were effected."* (per Lord Bridge) (underlining added)

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[16], Australia[17], or NZ.

### 3.4 Source of Trading Income

Anglo trading income source rule

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.[18] 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.[19] For example, that part of the trade which is manufacturing is carried on where the manufacturing takes place[20].

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[21];
(b) Representative offices, sales promotion, or after-sale services provided the contracts of sale and other trading activities are make or carried on abroad[22].

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 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

[16] 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.
[17] In Australia, the question of source has been referred to as "a practical, hard matter of fact": *Nathan v FC of T* (1918) 25 CLR 183; *Thorpe Nominees Pty Ltd v FC of T* (1988) 19 ATR 1834. It should be noted that subsequent Hong Kong cases have said they were applying the *Hang Seng* case, but first strayed from the "transactions" test to a broader "operations" test, and by 2007, reverted to back to "transactions": see *ING Baring Securities (Hong Kong) Limited v CIR* (2007) HKRC ¶ 90-195.
[18] *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
[19] *C of T v Meeks* (1915) 19 CLR 568; *C of T v Kirk* [1900] AC 588
[20] *Firestone Tyre and Rubber Co Ltd v Llewellin* (1957) 37 TC 111
[21] *Sulley v A-G* (1860) 2 TC 149
[22] *Greenwood v FL Smidth & Co* (1922) 8 TC 193 HL. However, where the contract is entered into in the UK with UK persons, to perform services outside the UK, the trade will still be carried on in the UK: *Erichsen v Last* [1881] 8 QBD 414 at 418 (concerning contacts to transmit telegraphic messages from the UK, and comparing contracts entered into in the UK to carry persons from a UK port abroad).

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*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[23] – 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.

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. Also see OECD discussion draft, "Are the current treaty rules for taxing business profits appropriate for e-commerce?" (26 Nov 2003), which concluded that unless evidence emerged that the existing rules weren't working, they should be left alone. 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.

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. This particular provision of the Electronic Transactions Act follows the UNCITRAL Model Law on Electronic Commerce 1996 Art 14(5), which has been adopted in many countries, including China, Malaysia[24], New Zealand[25], and many US States and Canadian Provinces.

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)).

In New Zealand sYD4(2) provides that income derived from a business has a source in New Zealand if—

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[23] This rule was applied in relation to e-mails recently in *Thomas & Anor v BPE Solicitors (A Firm)* [2010] EWHC 306 (Ch) (19 February 2010). This rule is also referred to in "Guide to tax consequences of trading over the internet" *op cit* p12.

[24] s23 Electronic Commerce Act 2006

[25] s9 Electronic Transactions Act 2002, is to the same effect, as it specifies that the rules in ss10-13 shall apply unless the parties otherwise agree.

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(a) the business is wholly carried on in NZ:

(b) the business is partly carried on in NZ, to the extent to which the income is apportioned to a NZ source under sYD5

Further, sYD4(3) specifies that income derived by a person from a contract has a source in NZ if the contract is—

(a) made in NZ, except to the extent to which the person wholly or partly performs the contract outside NZ, and the income is apportioned to a source outside NZ under sYD5:

(b) made outside NZ but the person wholly or partly performs the contract here, to the extent to which the income is apportioned to a NZ source under sYD5.

Section YD5(3) specifies:

> The result of the apportionment… must be that the person's net income or net loss, in relation to the business or contract, is the same as a separate and independent person would have if they were carrying out only the person's activities in NZ and dealing at arm's length.

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".

US trading income source rule

In relation to inventory, the source rule depends on whether the inventory is purchased or manufactured.

The source of income from the sale of purchased inventory is where the sale takes place, which for US purposes, is where the title passes[26], not where the contract is entered into. So a purchase outside the US and its sale within the US is US source gross income[27], and a purchase within the US and its sale outside the US is foreign source gross income[28].

The source of income from the sale of manufactured inventory is allocated between the place of manufacture and the place of sale[29]. By regulation, the gross income is apportioned 50/50 between production activities and sales activities[30]. Where the production activities are entirely within the US or entirely outside the US, the source of the production activities is the

[26] Reg 1.861-7(c)
[27] s861(a)(6)
[28] s862(a)(6)
[29] s863(b)
[30] Unless an election is made to use the Independent Factory Price (IFP) method, based on sales to wholly independent distributors

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location of the production assets[31]. The source of the sales activity is as for purchased inventory[32].

Accordingly, a foreign company selling goods into the US without an agent in the US, nor office or other fixed place of business in the US, should not have US source income from the sale of goods provided title passes outside the US. If title must pass in the US, the use of a foreign website to effect sale of the goods to US parties should assist avoiding the income being effectively connected with a US trade or business[33].

## 3.5 Source of services income

### Anglo service income source rule

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

1. where the work is performed[34];
2. where the contract to perform the work is negotiated and executed; and
3. where payment is made[35].

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[36], 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.

### US service income source rule

The Code expressly refers to "personal services" and specifies that services performed in the US have a US source, but with a $3,000 *de minimus* exemption for certain non-resident alien individuals[37]. Apportionment is required where the services are performed partly within and partly without the US[38]. Reg 1.861-4(b)(1) makes it clear that where a company provides the services of its employee, it is where the employees perform the services that is relevant[39], and that the payroll of the relevant employees performing services in particular countries

[31] Reg 1.863-3(c)(1)
[32] Reg 1.863-3(c)(2)
[33] Polito, Anthony P., "Trade or Business Within the United States as an Interpretive Problem Under the Internal Revenue Code: Five Propositions". Hastings Business Law Journal, Vol. 4, Spring 2008; Suffolk University Law School Research Paper No. 08-08. Available at SSRN: http://ssrn.com/abstract=1092155

[34] *IRC v Brackett* [1986] STC 521 at 540, [1986] 60 TC 124 at 149; *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
[35] *Evans v FC of T* 81 ATC 4512. In NZ, sYD4(4) specifies employment income "earned" in NZ is sourced in NZ even if the employer is not resident, but there is nothing specific about contractors.
[36] *FC of T v Mitchum* (1965) 113 CLR 401; (1965) 9 AITR 559
[37] The threshold hasn't changed since 1954, and so is now almost meaningless. The individual must be present in the US for less than 90 days during a taxable year, and the payor is not entitled to a US tax deduction: s861(a)(3)
[38] s863(b)(1)
[39] Also see *Bank of America v United States* 680 F.2d 142 (Ct Cl. 1982) re "negotiation commissions"; *Commissioner v Hawaiian Philippine Co* 100 F. 2d 988 (9th Cir. 1939)

compared to the total payroll, may provide a basis for apportionment. Where services are provided without any attendance in the US, it appears that none of the income would have a US source[40]. Where the contract is negotiated and executed, or where payment is made, are not relevant[41].

### 3.6 Source of royalties

#### Anglo royalties source rule

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.

In New Zealand, sYD4(9) specifies that a royalty has a source in NZ if it is—

- (a) paid by a NZ resident and not made in connection with a business they carry on outside NZ through a fixed establishment outside NZ:
- (b) paid by a non-resident, and for which the non-resident is allowed a deduction.

#### US royalties source rule

Royalties have a US source if use of the property in the US[42]. Whilst this could create a "cascading royalty" problem where IP is licensed and sub-licensed, the Court in ***SDI Netherlands NV v Commissioner*** 107 T.C. 161 (US Tax Ct.1996) found that the royalties paid by a Netherlands sub-licensor of IP from a Bermudan licensor related to royalties received by the Netherlands company from the US, was not US source income.

If property is created for a customer, in which a copyright subsists, then the consideration for the work and the vesting of the copyright, will be for services[43]. If ownership of the property in which copyright subsists remains with the creator, but a party is licensed to make copies and distribution them to the public, the consideration would be a royalty[44]. However, where an article such as a music CD is for the use only of the purchaser, the consideration is for

[40] *Cook v United States* 599 F. 2d 400 (Ct. Cl. 1979), which dealt with the source issue, but also confirmed that the delivery of the non-resident artist's work into the US was regarded as "earned income" for the purposes of s911, rather than the sale of goods

[41] As to the sometimes difficult difference between services and royalties, see *Karrer v United States* 152 F. Supp. 66 (Ct. Cl. 1957); *Boulez v Commissioner* 83 T.C. 584 (US Tax Ct. 1984)

[42] s861(a)(4). *CIR v Wodehouse* 337 US 369 (1949), confirmed that an agreement for use inside and outside the US that does not specify the fee split will not be capable of apportionment

[43] This is consistent with *Robinson v Graves* [1935] 1 KB 579 at 587, where a contract to paint portrait was held not to be a contract for the sale of goods, but a contract to provide services with ancillary materials

[44] Reg 1.861-18(c)(2). NZ IRD Tax Information Bulletin Vol 15 No 11 (Nov 2003) says the NZ position is consistent with the US Reg.

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"goods"[45]. The same result as for the sale of a music CD should follow for own use copyrighted material downloaded from the internet.

## 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. 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[46]. 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.

The OECD model definition of PE is similar to the US model, and also the Malaysian model[47]. However, as the format of the "permanent establishment" article of taxation treaties is subject to significant variations, at least with developing countries, where the UN model is influential[48], it is necessary to examine each particular taxation treaty carefully in this regard.

The "permanent establishment" article in Malaysian model 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).

[45] See Reg 1.861(1)(c)(ii) dealing with "shrink-wrap" computer software. The same result should follow re music CDs. In Australia, this is the case: see TR93/12 ¶ 32-34.
[46] also see TR2001/11
[47] On the OECD definition, see generally, "Is there a permanent establishment?", IFA Cahiers Vol 94a (2009)
[48] The UN model, in addition to the familiar provisions from the OECD and US models, extends the concept of PE to services provided by personnel of an enterprise of the other contacting state where they are present for more than 6 months within any 12 month period, and has more elaborate agency principles.

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The concept of "office" is always important. The office need not be exclusively for the use of the taxpayer, but must be available for its occupation[49], for example, a party regularly being found at a market[50], even if the stall that is occupied is not the same stall on each market day. If the taxpayer does not lease its own office in the country of incorporation, 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 the country of incorporation. It is also where the company can be found in its country of incorporation by virtue of its "holding out" on stationary, advertising, and signage at that office[51].

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: ***Taisei Fire & Marine Ins Co Ltd v CIR*** 104 T.C. 535 (1995).

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[49] 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.

[50] 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. However, the OECD commentary on Art 5 at ¶ 42.6 inserted in 2003 clarifies that human activity is unimportant if it is not actually necessary for the business, perhaps following the landmark German pipeline decision (BFH, 20 Oct 1996, II R 12/92, BStBl II 1997). Also see 26.1 re pipelines & cables, and ¶ 10.9 re vending & gaming machines operated by the owner in the other country .

[51] *Unisys Corporation v FC of T* [2002] NSWSC 1115 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 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 customers, suppliers to the company will seek it out at its registered office.

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Importantly, the OECD model commentary at ¶ 42.10 says a foreign resident enterprise will not have a PE in the customer's country solely by virtue of making sales of trading stock through a website hosted by a customer country resident internet service provider[52]. 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.

The US also occasionally adopts a provision of the UN model in agreements with developing countries, being a "service PE", which includes where an individual is present in the other state for 183 days or more during a 12 month period and during the time present more than 50 % of the gross active business revenues of the enterprise consists of income derived from the services performed by the individual. That provision is also contained in the 5th protocol to US/Canada treaty signed in 2007 (and also in the Australia/New Zealand agreement signed in 2009).

## 6.1 Trading with the U.S.

As previously mentioned, Malaysia does not have a DTA with the US. However, as the US is such an important destination for trade, something should be said about it.

Under the US domestic law, a non-resident trading company will only have a liability to US income tax on its trading if it carries on a "trade or business" which is "effectively connected" with the US. The selling of goods into the US on a "considerable, continuous and regular" basis[53] would certainly be a "trade or business" but the question is whether the level of activity in the US makes it a US trade or business[54] (***Handfield v Commissioner*** 23 T.C. 633 (Tax Ct. 1955). The solicitation of orders, the inspection of merchandise, and the purchase and sale of merchandise in the US by Argentine resident individuals, was enough for the "trade or business" to be "effectively connected" with the US in ***US v Balanovski*** 236 F.2d 298 (2d Cir. 1956). If the "trade or business" is effected even through an independent agent in the US, this may still be "effectively connected" with the US: ***Lewenhaupt v Commissioner*** 20 T.C. 151 (Tax Ct. 1953). This is a lower threshold than a treaty "permanent establishment" (PE) in the US, where a dependent agent still has to have and exercise an authority to contract on a habitual basis to constitute a treaty PE[55].

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[52] The ATO accepts this position in TD2005/2. It is worth considering all the OECD commentary on electronic commerce in 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 US Technical Explanation on the 2006 US model article on PE doesn't say anything about the issue. It is worth noting that in the Australian case of *Gebo Investments (Labuan) Ltd v Signatory Investments Pty Ltd* [2005] NSWSC 544, the issue arose whether the use of a Malaysian server could allow a Labuan company to be regarded as "carrying on business in Australia" for the purpose of the Corporations Law. Interesting at ¶ 34, whether material was uploaded to the website from Australia, or queries to the website were dealt with from Australia were specified as questions on which there was no evidence, but which may have been relevant. In the context of the PE article of a treaty, as the OECD model commentary doesn't mention those issues, they should not be relevant to the question under the PE article of a treaty.

[53] *Lewellyn v Pittsburgh, B&L.E.R. Co* 222 F. 177, 185-6 (3rd Cir. 1915)

[54] Also see Rev. Rul. 73-158, 1973-1 Cum. Bull 337

[55] However, trading in securities or commodities for the foreign taxpayer's own account even though a dependent agent and even if the taxpayer has an office in the US is excluded from being a US trade or business, as long as the taxpayer is not a "dealer". Even a "dealer" will not have a trade of business in the US as long as the taxpayer trades through an independent agent, as long as the taxpayer does not have an office in the US: s865(b)(2)(A)(i) &(ii), & 864(b)(2)(C).

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Whereas the application of a treaty is very valuable for a non-resident investor into the US, due to the universal use of Limitation of Benefits Articles in US treaties, a treaty will not usually be available by "treaty shopping" to an ultimate owner in a country that does not have a treaty with the US e.g. Malaysia. For taxpayers from such countries, knowledge of the US domestic rules may still allow for business with the US without a US tax liability, especially via electronic commerce[56]. Whilst there is no case on e-commerce, the case of the Mexican broadcaster into the US is a close parallel: ***Commissioner v Piedras Negras Broadcasting Co*** 127 F. 2nd 260 (5th Cir. 1942).

## 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[57].

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 controlled foreign corporation (CFC) and their related foreign investment fund[58] and transferor[59] 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.

Concerned at existing US holding companies "inverting" their group into a group with a foreign holding company, in 2003 the US introduced provisions which go as far as deeming such foreign holding companies to be domestic companies[60].

### 7.1 Investment from New Zealand

The CFC provisions of the NZ tax law from 1 April, 2010 are designed to deal with unacceptable deferral of NZ tax by NZ companies forming controlled "base" companies outside NZ (except in most cases, Australia).

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[56] For a full analysis of the topic generally, see Polito *op cit.*

[57] Singapore taxes Singapore companies on foreign source income remitted into Singapore, which has borne less than 15% foreign tax.

[58] FIFs in Australia (Part XI) & NZ (sEX28 ff); in the UK, the Overseas Funds regime in s756A ff ICTA 1988, in those countries being where the fund is not controlled, *contra* a CFC, but may or may not be trading. In the US the equivalent is a Passive Foreign Investment Corporation (PFIC –s1297) which may or may not be controlled, but only covers funds with predominately passive income. [note business trusts are treated as companies in the US: *Morrissey* case 296 US 344 (1935); *Hynes v Commissioner* 74 TC 1266 (1980)]

[59] In the US, like provisions are called the "Grantor Trust" rules: s679. In the UK, the "settlor interested trusts" regime in s619 ff ITTOIA 2005, and the "transfer of assets abroad" provisions in ss714-751 ITA 2007

[60] If 80% or more of stock of foreign holding company is owned by same persons who owned stock in US holding company: s7874

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Control

Whether the NZ CFC regime applies to attribute income to a NZ resident or not depends on whether a NZ resident directly or indirectly controls a 40% or more interest in the company, unless a non resident actually has control; or 5 or fewer NZ residents directly or indirectly control more than 50% in the company, or a NZ resident has actual control, by whatever means, (in which case the company is a "CFC")(sEX1).

CFC Attribution

Attribution from a CFC (sCQ2) then depends on:

(1) the type of income derived by the CFC;

(2) whether the CFC is a resident of Australia (other than in relation to exempt foreign branch profits or OBU profits); and

(3) whether the CFC passes the "active income test".

Only NZ residents with an "attribution interest" of 10% or more may have income of the CFC attributed to them (sEX14).

Active Income Test

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

Passive and Tainted Income

Section EX20B only applies to passive income and tainted income, which is attributable back to the NZ controlling shareholders in the Labuan company. Passive income includes such things as interest. Income from the provision of "personal services" is not passive income, but may be "tainted" (sEX20B(9)).

Such "personal services" income will be "tainted" if:

(a) they are not essential support for a product supplied by the CFC;

(b) 80% or more of the CFCs income is provided by NZ resident owners; or

(c) the CFCs business structure requires depreciable property, unless it cost more than the greater of, $75,000, and 25% of the CFCs total income for the relevant period.

Royalties will not be "attributable royalties" (sEX20B(5)) where all of the following conditions are satisfied:

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

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

(d) the property is not "linked with NZ" (sEX20B(14)), i.e:

- (i) was owned by a NZ resident;
- (ii) owned by a non-resident and used in a NZ PE;
- (iii) created or developed in NZ;
- (iv) had substantial value added in NZ;
- (v) had a deduction claimed in respect of it in NZ.

## 7.2 Capital Gain On Disposal Of Labuan Company

As NZ does not have a general capital gains tax, a capital gain on the disposal of shares in the CFC is not subject to NZ tax. Note however, that NZ taxes speculative profits as ordinary income.

## 7.3 Thin Capitalization

The NZ thin capitalization rules in Subpart FE are applicable to investment in a CFC as an "outbound investment". The rough rule of thumb is that a NZ 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 110% of its group world-wide debt level (sEX20D(2)). 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 NZ 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[61] in NZ under thin cap[62].

## 7.4 Transfer Pricing

The NZ transfer pricing rules (sGC13) as they related to trading don't feature largely in the current case, as the Labuan company won't be dealing with customers in NZ, nor with associated parties (sYB2). This assumes the employment of arm's length personnel to staff the operation outside NZ.

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

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[61] see sDB55.

[62] There is a $250,000 general *de minimus* interest expense before the rules apply, and this *de minimus* is effective raised to $1M in the case of most CFCs.

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separately being employed by a NZ company that continues to carry on the NZ business, that gives rise to some issues.

Clearly sGC13 will require them to be paid a market wage for what they do, which will be taxed to them in NZ. If they are not employed directly, the parent company in NZ 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 LC currently has the benefit of the DTA with NZ, if the LC does not have a PE in NZ, the LC should not be directly subject to NZ on it trading profits. If an LC was to be excluded from the benefit of the NZ DTA in the future, as it is only NZ source income which is taxable to it in NZ, the NZ resident employees should not transact business for the LC from NZ[63]. On the basis that a NZ company is to do the NZ business, all the NZ source income should all be derived by the NZ company, and none by the LC.

Some of the most difficult issues will related to intellectual property[64].

## 8. DIVIDENDS FROM LABUAN

From 1 April, 2010, a dividend paid by a Labuan, Malaysia company to a NZ company (in its own right and not as a trustee of a trust), that holds a "non portfolio" shareholding in the LC (10% or more of the voting shares), will be an exempt dividend under s CW9.

If the NZ holding company distributes dividends to its shareholders, those dividends will be assessable to the shareholders. As no NZ 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 NZ holding company to its shareholders.

Unlike several EU countries[65]; Australia, and now NZ[66], the US subjects to tax, all dividend from foreign companies, with a credit[67] for foreign withholding tax only, in the case of

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[63] In any event, there is UK authority, which if applied, to the effect that the mere presence of employees in NZ should not mean that the company is trading in NZ, if sales contracts are not entered into in NZ: see *Greenwood v F L Smidth & Co* (1922) 8 TC NZ: see *Sulley v A-G* (1860) 2 TC 149;

[64] Refer IFA Cahiers "Transfer pricing and intangibles" Vol 92a (2007). The Australian Div 13 has most recently been considered in *SNF (Australia) Pty Ltd v FC of T* [2010] FCA 635 (25 June 2010), and in *Roche Products Pty Ltd v FC of T* 2008 ATC ¶10-036. It is also the subject of very detailed rulings by the Australian Commissioner e.g. TR94/14 & TR97/20. The Australian 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. *In SNF (Australia)* the Commissioner did again not press the issue, but Middleton J had an each way bet by observing some merit in the Commissioner's argument as the statutory provisions allowing amendment of assessment displayed an intention that the DTAs might provide such a power, at ¶ 23, but at ¶ 131 quotes from *Roche Products* as to the inconsistency between profit based methodologies, and the arm's length principle, concluding that the Australian losses were not the result of transfer pricing, but management problems. (Also see TR2001/13 at ¶33. In NZ, the Act specifically provides for the use of "profit split" methodologies.

individuals and trusts. US companies owning a non-portfolio interest (10%) in foreign companies are also entitled to a proportionate credit for underlying foreign tax (the so-called "indirect tax credit"[68]).

## 9. USE OF LABUAN COMPANIES

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

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

- 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

- NZco is in the business of buying goods in or outside NZ, and selling them in and outside NZ
- NZco is looking for more vendors and purchasers
- NZco accepts that sales in NZ are probably best effected through NZco, but wants to make sales outside NZ 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 NZ from unrelated suppliers, and selling the goods to unrelated customers outside NZ, none of that income will be attributed back to NZco as the holding company under the CFC regime i.e. the income will not be "attributable income"

### 9.2 Manufacturer "Offshoring"

- NZco is in the business of manufacturing goods in NZ with raw material sourced in or outside NZ, and selling the finished product in or outside NZ
- NZco is looking for more customers
- NZco wants to engage an unrelated contract manufacturer in China, due to its significantly lower costs
- NZco accepts that sales in NZ are probably best effected through NZco, but wants to make sales outside NZ though Offshoreco, to enhance its international reputation
- If Offshoreco is formed under the Labuan regime, then as the source of its income will be from Offshoreco buying raw materials from unrelated suppliers and selling the goods to unrelated customers outside NZ, none of that income will be attributed back to NZco as

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[65] The Netherlands, Denmark, Belgium, Germany, Italy, Switzerland, Sweden. The UK is also moving to introduce a participation privilege, at least for large business

[66] Such dividends were only previously exempt if coming from "grey list" countries.

[67] s901

[68] s902

the NZ holding company under the CFC regime i.e. the income will not be "attributable income".

9.3 Provider of Services

*9.3.1 Computer Services*

- NZco is in the computer services business
- So far, it has only done work for NZ resident clients
- NZco 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 NZ, provided that less than 80% of the fees are derived via NZ resident owners, none of that income will be attributed back to NZco as the holding company under the CFC regime i.e. the income will not be "attributable income"

*9.3.2 Architectural Drafting*

- NZco is in the architectural drafting profession
- So far, it has only done work for NZ resident clients
- NZco 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 NZ, provided that less than 80% of the fees are derived via NZ resident owners, none of that income will be attributed back to NZco as the holding company under the CFC regime i.e. the income will not be "attributable income"

9.4 Royalties

*9.4.1 Software Licensing*

- NZco is in the computer software writing business
- NZco is looking to license clients overseas
- NZco 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 (and not in NZ), then as the source of its income will be royalties from unrelated clients outside NZ, none of that income will be attributed back to NZco as the holding company under the CFC regime i.e. the income will not be "attributable royalties"

*9.4.2 Book Author*

- A NZ resident individual (Kiwi) is a writer
- So far, she has only "sold" the rights to her copyright to NZ based publishers
- She has received advice that as she has reached a relatively successful stage, that she should form a NZ company (NZco) she would control, for whom she would write books, and vest the copyright in the books immediately in NZco in return for a salary, so that all "super profit" would accrue to NZco
- NZco is set up for NZ business
- Kiwi (and NZco) also look to become established internationally

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- Kiwi realises that the advice she has received about using NZco in NZ, may translate for offshore deals though an offshore company (Offshoreco), from which she could draw a salary, it turn enhancing her international credentials
- Kiwi wants to choose an international basis that will allow her maximum flexibility for potential publishers in many jurisdictions
- If Offshoreco is formed under the Labuan regime, and Kiwi writes her books for Offshoreco for a salary, outside NZ, 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 NZ, none of that income will be attributed back to NZco as the holding company under the CFC regime i.e. the income will not be "attributable royalties"

*9.4.3 Rock Band*

- NZ resident individuals are a Rock & Roll band (NzRock)
- So far, NzRock has only "sold" the rights to its copyright in its sound recordings to NZ based publishers
- NzRock members have received advice that as they had reached a relatively successful stage, that they should form a NZ company (NZco) they would control, for whom they would record soundtracks, and vest the copy right in the soundtracks immediately in NZco in return for a salary, so that all "super profit" would accrue to NZco
- NZco is set up for NZ business
- NzRock (and NZco) also looking to become established internationally
- NzRock members realise that the advice they has received about using NZco in NZ, may translate for offshore deals though an offshore company (Offshoreco), from which they could draw a salary, it turn enhancing their international credentials
- NzRock 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 NzRock perform their music for Offshoreco for a salary, outside NZ, 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 NZ, none of that income will be attributed back to NZco as the holding company under the CFC regime i.e the income will not be "attributable royalties"

*9.4.4 Music Composer*

- A NZ resident individual (Nozzie) is a music composer (e.g. Rock & Roll)
- So far, he has only "sold" the rights to his copyright to NZ based publishers
- He has received advice that as he has reached a relatively successful stage, that he should form a NZ company (NZco) he would control, for whom he would write music, and vest the copyright in the music immediately in NZco in return for a salary, so that all "super profit" would accrue to NZco
- NZco is set up for NZ business
- Nozzie (and NZco) also looking to become established internationally
- Nozie realises that the advice he has received about using NZco in NZa, may translate for offshore deals though an offshore company (Offshoreco), from which he could draw a salary, it turn enhancing his international credentials
- Nozzie 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 Nozzie writes his music for Offshoreco for a salary while outside NZ, 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 NZ, none of that income will be attributed back to NZco as the holding company under the CFC regime i.e the income will not be "attributable royalties"

Each of the examples may involve transfer pricing issues which will need to be carefully considered[69]. 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"[70].

## 10. COMPARISON WITH HONG KONG AND SINGAPORE

Hong Kong IRD Practice Note 21 (reviewed March, 1998) concerning the "Territorial Source Principle of Taxation" interprets "Hong Kong sourced profits" very broadly, so Hong Kong tax rates of currently 16.5% are increasing likely to apply. IRD Practice Note 21 at ¶ 29 says it will "'only be in rare cases that a taxpayer with a principal place of business in Hong Kong can earn profits which are not chargeable to profits tax under s14' (TVBI)". 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 HK-TVB International Limited*** (1992) 1 HKRC ¶ 90-064, ***CIR v Euro Tech Far East Ltd*** (1995) 1 HKRC ¶ 90-076 and Board of Review cases ***D28/86 and D47/93 (Case D24)*** (1994) 1 HKRC ¶ 80-274); but compare ***CIR v Magna Industrial Co Ltd*** [1996] HKCA 542 and ***ING Baring Securities (Hong Kong) Limited v CIR*** (2007) HKRC ¶ 90-195.

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Singapore's 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. As Singapore companies are taxable on income accruing in or derived from Singapore (and foreign source income remitted into Singapore, which has not borne at least 15% foreign tax), the difficulties described above for companies trading in goods through Hong Kong, also arise in Singapore[71].

The Hong Kong tax problems which arose in cases such as *HK-TVB*, *Euro Tech* and D28/86 and D47/93 do not arise in Labuan, where the 3% tax rate (or flat tax of RM20,000

[69] It is assumed that where individuals are concerned, that their decision to incorporate is itself not a GAAR 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 the most recent NZ GAAR case, *CIR v Penny and Hooper* [2010] NZCA 231 (4 June 2010), the Court of Appeal found the GAAR applied to medical incorporations, where the company paid the doctor less than an arm's length salary. The PSI provisions were not in dispute (ssGB27-GB29), nor was the fact of incorporation. The GAAR applied due to the low salaries being motivated by the differential between the personal and corporate rates of tax.

[70] ¶ 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, and controversially requires periodic adjustment of royalties to reflect profitability from use of the IP.

[71] *TTT Pte Ltd v Comptroller of Income Tax* [1995] 2 MSTC 5189

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(US$6,000)) 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 RULE

In order to examine the question of the potential application of the NZ general anti-avoidance rule (GAAR) it is necessary to have some factual background. Assume the following:

- NZco prefers to set up the offshore company in the south-east Asian region. Accordingly, the area under consideration spans, China, South Korea, Japan, Hong Kong, Thailand, Vietnam, Malaysia, The Phillipines, Singapore, India & Indonesia. Vanuatu might also be considered
- NZco wants to keep the costs of its offshore company down
- NZco prefers to set up in a country with a British Common Law background as this is the legal system it understands
- NZco prefers to deal with staff and customers, to the extent possible, in English
- NZco prefers as stable as possible political climate
- NZco 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[72]
- The cost of doing business in Hong Kong is high
- Whilst Hong Kong has no tax on foreign source income, it only has a few double tax treaties[73]. Therefore there is more risk of paying source country source income, or if that is to be avoided, more risk of having Hong Kong source income subject to tax at 17.5%.
- 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[74].
- Labuan, Malaysia has excellent telecommunications including Broadband internet, a modern airport serviced by several 737 and Airbus 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.

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[72] Traditionally, investment into India has often been structured using the India / Mauritius DTA, but there is now significant political pressure to change that DTA, especially since the recent protocol to the India / Singapore DTA. Mauritius sitting out in the Indian Ocean, is not as convenient an all purpose base company location compared to the three jurisdictions chosen, for the reasons identified.

[73] It has a DTA with China, but using a Hong Kong company to do business in China without a PE is invariably going to make the Hong Kong company subject to Profits Tax in HK on the Chinese profits.

[74] The cost of renting an apartment or office in Singapore or Hong Kong is approximately eight to ten times the cost in Malaysia. A Labuan company can buy an apartment or office for approximately the same cost of renting a similar sized apartment or office for one year in Singapore of Hong Kong.

The NZ GAAR has most recently been considered by the Supreme Court of New Zealand (since 2003 the ultimate court of appeal) in *Ben Nevis Forestry Ventures Ltd & Ors v CIR* [2008] NZSC 115. That case concerned the deductibility of certain artificially deferred expenditure on an agricultural scheme.

The decision in *Ben Nevis* was applied most recently in *CIR v Penny and Hooper* (*op cit*)*, and before that in Westpac Banking Corporation v CIR* [2009] NZHC 1388. The Westpac case concerned a "repo" scheme whereby the bank derived exempt income on foreign shares in special purpose companies it had set up in US and UK, but claimed a deduction for the cost of the acquisition of the shares.

The function of the GAAR was described in *Ben Nevis*[75]: "…to prevent use of the specific provisions which fall outside their intended scope in the overall scheme of the Act."

"A classic indicator of a use that is outside Parliamentary contemplation is the structuring of an arrangement so that the taxpayer gains the benefit of a specific provision in an artificial or contrived way."[76]

However, the Court pointed out[77]: "On the approach we have set out, taxpayers have the freedom to structure transaction to their best tax advantage. They may utilize available tax incentives in whatever way the applicable legislative text, read in the light of its context and purpose, permits."

Provided the reasons for the use of the Labuan company are substantiated, and sufficient substance is present in its operations, the GAAR should not be relevant[78].

## 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.

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[75] at para 106
[76] at para 108
[77] at para 111; referred to as one of the notable aspects of *Ben Nevis* in *Westpac* at para 197.
[78] The result might be different if NZ residents formed LCs to derive income from NZ sources protected by the Malaysia / NZ DTA.

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Peter moved to the Federal Territory of Labuan, Malaysia in 2001/ 2002, where he is Managing 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).

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

## *MALAYSIAN DOUBLE TAX AGREEMENTS*

| | | |
|---|---|---|
| Albania | Indonesia+ | Romania |
| Argentina* | Ireland | Russia |
| Australia+ | Italy | Saudi Arabia<br>Seychelles |
| Austria<br>Bahrain | Japan+ | Singapore<br>South Africa<br>South Korea+<br>Spain |
| Bangladesh | Jordan<br>Kazakhstan# | Sri Lanka<br>Sudan |
| Belgium<br>Bosnia&<br>Herzegovina# | Kyrgyztan<br>Kuwait<br>Lebanon<br>Luxembourg+ | Sweden+ |
| Canada<br>Chile # | Malta | Switzerland<br>Syria |
| China<br>Croatia | Mauritius | Thailand |
| Czech Republic | Mongolia<br>Morocco | Turkey |
| Denmark | Myanmar # | United Arab Emirates |
| Egypt | Namibia | United Kingdom+ |
| Fiji | Netherlands+ | United States of America* |
| Finland+ | New Zealand | Uzbekistan<br>Venezuela # |
| France | Norway+ | Vietnam |
| Germany | Pakistan | Zimbabwe # |
| Hungary | PapuaNew<br>Guinea | |
| India | Philippines | |
| Iran # | Poland | |

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