

WHY LABUAN, MALAYSIA? (from a UK perspective)

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2. 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:

- (a) investment into the UK;
- (b) investment from the UK.

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 -

- (1) 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.
- (2) Provided the non-resident does not have a "permanent establishment" in the other Contracting State:

- (a) “business profits” sourced in the other Contracting State are protected from source country tax;
 - (b) Interest, dividends and royalties are subject to a reduced rate of withholding tax.
- (3) 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 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.

INVESTMENT INTO THE U.K.

Non-resident companies for UK purposes, are those that are not incorporated in the UK, and have their “central management and control” outside the UK.

The UK has separate regimes for corporations tax¹, income tax², and capital gains tax³. However, capital gains made by a company are treated as ordinary income, although indexation is available.

For the corporations tax year commencing 1 April, 2008, the full rate of corporations tax is 28%. The small company tax rate of 21% is only available to a non-resident trading company which is a resident of a country which has a double tax treaty with the UK, which contains a non-discrimination article⁴.

Under the domestic law, a non-resident company will only have a liability to UK corporations tax if it carries on a trade in the UK through a permanent establishment (PE) in the UK. Only its trading and property income attributable to the PE, and only gains on assets situated in the UK used for the purposes of the PE, are subject to the corporations tax.

¹ mainly found in the Income and Corporations Taxes Act 1988

² mainly now found in the Income Tax (Earnings and Pensions) Act 2003; the Income Tax (Trading and Other Income) Act 2005, and the Income Tax Act 2007

³ mainly found in the Taxation of Chargeable Gains Act 1992

⁴ which the Malaysia / UK treaty does, assuming the treaty applies in the situation under consideration; the small companies rate applies to UK profits of up to £300,000, and shades out on UK profits up to £1.5M, but takes into account profits of the world-wide group

For trading income, as the UK only taxes non-resident companies on trading income attributable to a UK PE, and as the domestic definition of PE is now closely based on OECD model treaty definition, whether the non-resident company is a resident of a country with a treaty with the UK is not very important. However, for non-resident non-corporate taxpayers, the test is whether a trade is carried on wholly or partly in the UK, which is potentially far wider than having a PE (which requires a fixed place of business in the UK or a dependent agent there habitually acting⁵ on the non-resident's behalf), and so treaty protection is valuable.

However, where the non-resident company is to derive investment income associated with the UK, the existence of a treaty is important, especially in relation to interest and royalties.

Under the domestic law, income not attributable to a non-resident company's PE may still be subject to withholding tax under the income tax regime, but is reduced by the UK / Malaysia treaty (where it applies) as follows:

	Domestic rate ⁶	Treaty rate
Interest	20%	10%
Rents	20%	unaffected by treaty
Royalties ⁷	20%	8%
Dividends	0%	unaffected by treaty
Capital gains ⁸	0%	unaffected by treaty

Rental income of a non-resident is subject to income tax, in relation to land in the UK.

Savings and investment income, including interest, of a non-resident is subject to income tax if sourced in the UK, as is royalty income. However, to the extent that the payer is a UK resident company, and withholding is required, if the source is determined not to be the UK, a refund would then need to be sought by the non-resident payee.

⁵ This is a point of difference to the OECD model, which requires the dependent agent to be habitually entering into contracts in the name of the non-resident: for comment on this and other differences, and the UK approach to attribution of profit to the PE: see Andrew Senior, UK Branch Reporter, "The attribution of profits to permanent establishments", IFA Cahiers Vol 91b (2006)

⁶ Where the payer of interest or royalties is a company, and the recipient is an associated company in another EU country, if the payment is the subject of Directive 2003/49/EC (the Interest and Royalty Directive), no withholding tax is due. As there is no domestic dividend withholding tax, the equivalent EU Parent-Subsidiary Directive (90/435/EEC) only has limited relevance in the UK in relation to inbound investment

⁷ only in relation to patent and copyright royalties (excluding film)

⁸ although gains by companies on the disposal of land where the sole or main object was realising a gain by disposal, or developing and disposing, are treated as income

Dividend income of a non-resident is subject to income tax if paid by a UK resident company.

3. Taxation and regulation of Labuan incorporated and resident companies

The Offshore Financial Centre 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 was established as an International Offshore Financial Centre (IOFC) and Freeport by six Acts passed by the Malaysian Parliament in 1990 and as such, offers unparalleled advantages as an investment, asset protection and/or e-commerce centre.

The Offshore Companies Act, 1990 provides for the incorporation of offshore companies, which are required to have a registered office in Labuan, at least one director and a resident secretary. Unless exempted, Labuan offshore companies must 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 company⁹ at the rate of 3% on its audited offshore trading profits or, upon election, at a fixed rate of MR20,000. (The MR is fixed at the rate of 3.8 to the US\$).

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

The Director General of Inland Revenue may require a person to furnish information for the purposes of LOBATA but such information shall be regarded as confidential and shall not be communicated or disclosed to any person except for the purpose of the Act only. For further information concerning Labuan’s stringent confidentiality regime, see <http://www.ectrust.com.my/documents/Confidentiality.html>

The Income Tax (Amendment) Act, 1990 (Malaysia) provides that income derived by an offshore company from its offshore business activity will not be taxable in Malaysia under the Income Tax Act, 1967.

⁹ or foreign companies registering under the Labuan Offshore Companies Act 1990

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.

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.

4. Framework of International Taxation

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.

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.

Malaysia/UK DTA

The Malaysia/ UK 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(3) provides that the person –

”shall be deemed to be a resident of the Contracting State in which its place of effective management is situated”.

Exclusion of Labuan

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 eight exclude Labuan companies carrying on offshore trading business subject to LOBATA.

Accordingly, Labuan companies are extremely useful for doing treaty protected business with about 50 countries. It should also be noted that Malaysia’s treaties do not contain “mutual assistance” provisions requiring Malaysia to enforce tax judgments obtained in treaty countries¹⁰.

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 subject to the Malaysian Income Tax Act 1967 on their “offshore” income.

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.

Diplomatic notes exchanged under the 1997 UK Treaty deny Labuan offshore companies, [with effect from 1 January, 1999], the benefit of protection from UK tax on income sourced in the UK. The denial of protection by the double tax treaty means the Labuan company would be denied of the lower rates of withholding tax on UK interest and royalties provided by the treaty. UK source trading income is unaffected, as the UK only taxes such income in the hands of a non-resident company which has a PE in the UK, and the definition of PE is on OECD model treaty lines. UK dividends are unaffected as the UK does not levy withholding tax on them.

¹⁰ as is required between EU countries

A response by clients affected by such exclusions, was for the LOBATA entity to form an ordinary Malaysian subsidiary, through 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 Labuan entities who 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.

If a Labuan company makes the election and seeks treaty benefits in the UK, as the UK requires notification of reliance on treaty benefits before either approving payment out of the UK at (lower) treaty rate, or a request for a refund if tax has already been withheld at (higher) non-treaty rates, HMRC will have to accept the argument that a Labuan company that makes the election is entitled to treaty benefits.

Due to the specific anti-avoidance provisions discussed below, it is unlikely ordinarily UK resident individuals¹¹ would be able to use a Labuan company to invest back into the UK.

5. Residence of Companies

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.

¹¹ see IR20 which equates “ordinarily UK resident” with habitual residence

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 jure 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/UK 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 Kingdom¹², was set out in the speech of Lord

¹² see SP 1/90

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.

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.

Most recently, 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 relevant principles to be gleaned from the relevant authorities are:-

- (1) Effective Management should be where the board of directors regularly meets to conduct and manage the business including ratifying any decisions made by others and
- (2) A majority of the board should be residents of the jurisdiction the company is or purports to be resident of.

6. 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 UK¹³.

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.¹⁴ 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

¹³ 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

¹⁴ *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

activities are carried out.¹⁵ For example, that part of the trade which is manufacturing, is carried on where the manufacturing takes place¹⁶.

A service trade is carried on where the services are performed¹⁷.

For UK purposes, two forms of activity do not amount to trading in the UK:

- i. Purchasing goods or services in the UK for use in the business abroad¹⁸;
- ii. Representative offices, sales promotion, or after-sale services provided the contracts of sale and other trading activities are made or carried on abroad¹⁹.

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 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 East Corporation was applied by the New South Wales Supreme Court in Mendelson-Zeller Co Inc v T & C Provedores 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

¹⁵ *C of T v Meeks* (1915) 19 CLR 568; *C of T v Kirk* [1900] AC 588

¹⁶ *Firestone Tyre and Rubber Co Ltd v Llewellyn* (1957) 37 TC 111

¹⁷ *IRC v Brackett* [1986] STC 521

¹⁸ *Sulley v A-G* (1860) 2 TC 149

¹⁹ *Greenwood v FL Smidh & Co* (1922) 8 TC 193 HL

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 (s14(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". There are only 10 of Malaysia's 60 treaties that have any qualification on the application of the treaty to a Labuan company (viz. United Kingdom The Netherlands, Japan, Australia, Indonesia, South Korea, Norway, Sweden, Finland and Luxembourg).

Source Of Interest

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

conclude that four factors must all be considered²⁰ to decide the source of interest income, none of which alone will be decisive:

1. The residence of the debtor;
2. the source from which the interest is paid;
3. where the interest is paid; and
4. the nature and location of any security.

However, they then say “interest paid by a UK resident should generally be paid under deduction of tax”, except where:

1. The interest is paid by a foreign branch of a UK company is regarded as having a foreign source if the loan was raised for the purposes of the foreign branch’s business; and conversely
2. Interest paid by the UK branch of a foreign company is regarded as having a UK source if the loan was raised for the purpose of the UK branch’s business.

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 UK where 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.

7. 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).

²⁰ Tax Bulletin 9 (1993); In Australia, the place where the loan contract was entered into, and the place where the funds were advanced were considered important in concluding that the source 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)

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 Income Tax Assessment 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. Most recently, the concept was considered in Australia in *Unysis Ltd v FC of T* (2002) 51 ATR 386, under the US/Australia treaty²¹. Very 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 UK'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 the UK'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.

Sometimes the provisions of the "permanent establishment" article are applied for the purposes of determining the existence of a permanent establishment outside both

²¹ also see TR2001/11

countries, and whether an enterprise, not being an enterprise of one of the countries, has a permanent establishment in the other country.

8. High tax countries' use of "controlled foreign corporation" anti-avoidance 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. A good example in the Asia Pacific region is 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)²² and transferor trust rules²³, 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 Trends", General Report – 2001 IFA Cahiers, vol.B, pp 21-89.

INVESTMENT FROM THE U.K.

UK COMPANIES INVESTING ABROAD

The CFC provisions of the UK tax law are designed to deal with unacceptable deferral of UK tax by UK resident companies forming controlled companies in "low tax" countries, and not declaring dividends back to the UK.

"Low tax" is defined as 75% of the UK company tax rate.

²² In the UK, the Overseas Funds regime in s756A ff ICTA 1988

²³ 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

However, even if the foreign company is a CFC, there are four main exceptions²⁴ to the “apportionment” of the profits of the CFC back to the UK companies who own at least 25% of the interests in the CFC:

1. the CFC has an acceptable distribution policy (at least 90% of the CFC’s profits²⁵);
2. the CFC is engaged in “exempt” activities;
3. the CFC is resident in countries excluded by regulations;
4. the purpose of the transactions giving rise to the CFC’s profit, or the purpose for the CFC’s existence, is not a reduction of UK tax²⁶.

Control

A company is controlled by persons resident in the UK if they have the power to secure that the affairs of a company are conducted in accordance with their wishes. This may be through shares or powers in the company’s articles. In addition, where there are two persons who taken together control the company, and one is resident in the UK with at least 40%, and the other is not resident with at least 40% but less than 55%, the resident will be taken to control the company for CFC purposes.

Excluded Countries

Controlled Foreign Companies (Excluded Countries) Regulations 1988 (SI 1998/3081) specify some countries where if the CFC is resident, are excluded from the CFC provisions outright e.g. Australia. It specifies others which are to be excluded subject to further considerations e.g. Malaysia.

In the case of Malaysia, all but four types of Malaysian resident company are excluded from the CFC provisions. One of those is “companies obtaining a tax benefit under the Offshore Companies Act (Island of Labuan) 1990.

If a Labuan company is controlled by UK companies, and makes the election to become subject to the Income Tax Act 1967, then they won’t be “obtaining a tax benefit under the Offshore Companies Act (Island of Labuan) 1990” (although as seen above, this is a somewhat incorrect cross-reference to the Offshore Companies Act rather than to LOBATA), but there is a further requirement for exclusion. That is, that the “non-local source income” of the Malaysian company be less than 10% of the “commercially qualified income”. This condition necessarily, will not be met in the contemplated circumstances.

Exempt Activities

²⁴ there is also a *de minimus* exemption where the CFC has not more than £50,000 profit in the accounting period. The “public quotation” exemption was repealed from 6 December, 2006

²⁵ to be paid within 18 months of end of accounting period

²⁶ which is not easy to prove if the profits arise from transactions with British residents: see *Association of British Travel Agents Ltd v IRC* [2003] STC (SCD) 194

It is still possible to be exempt from the CFC provisions if the CFC is engaged in “exempt” activities, which give rise to profits which represent 50% or more of the CFC’s total profit. If the test is failed, all of the CFC’s profits are apportioned, not just those from non-exempt activities. That is, the UK CFC “apportions” on a whole of entity basis, whereas for instance, the Australian CFC “attributes” on an item of income basis. Foreign tax paid is correspondingly apportioned, so as to be available as a credit against the UK tax liability on the apportioned profits.

Part II of Sch 25 ICTA 1988 specifies those activities which are exempt. In the simple case of one Labuan subsidiary with no sub-subsidiaries, its activities will be exempt if²⁷:

- (b) there is a business establishment²⁸ of the Labuan company in Malaysia;
- (c) whose business is effectively managed²⁹ there; and
- (d) which does not have as its main business,
 - (i) an investment business³⁰; or
 - (ii) dealing in goods for delivery to or from the UK, or to or from associated persons;
 - (iii) in the case of a company mainly engaged in wholesale, distributive [financial or service] business, less than 50% of its gross trading receipts fall within (ii).

Treasury Consent

The acquisition of shares or debentures in a non-resident company to be controlled by a UK resident company, is subject to Treasury consent³¹. Broadly, if the acquisition is of non-redeemable shares, and is for full value, specific consent³² is not required due to the publication of “Treasury General Consents 1988”.

UK INDIVIDUALS INVESTING FROM THE UK

The CFC provisions do not apply to UK resident individuals³³. However, ordinarily UK resident individuals wishing to obtain tax deferral from a foreign trading business, may find it easier to form a UK resident company, which has a CFC. The reason is that the anti-avoidance provisions applicable to individuals do not contain an “exempt” activities test

²⁷ para 6(1) Sch 25, although as a result of the ECJ decision in *Cadbury Schweppes plc v IRC* (12 Dec 2006), s751A ICTA 1988 now limits apportionment from business establishments in EEA Territories

²⁸ para 7 Sch 25 requires the company to occupy and use with a reasonable degree of permanence

²⁹ para 8 Sch 25 requires the number of employees to be adequate to deal with the volume of the company’s business, and services performed by the company are not performed in the UK

³⁰ para 9 Sch 25 includes holding intellectual property as “investment business”

³¹ s765 ICTA 1988, and s766 provides for penalties including imprisonment

³² If the acquisition is within the EU but otherwise would have required specific consent, s765A ITCA 1988 specifies only information is required after the fact of acquisition

³³ nor is Treasury Consent required

which can be self-assessed, but require disclosure of the circumstances of the “transfer of assets abroad” to met the “purpose” test, to avoid “apportionment”.

Having said that, the fact that the trading business is to be conducted from a Labuan does not itself preclude satisfaction of the “purpose” test. In *Carvill v IRC* [2002] STC 1167 the taxpayer met the “purpose” test even though using a Bermudian holding company³⁴. It should be noted that the UK does not have a general anti-avoidance rule (GAAR).

It should be noted that just as capital gains of a CFC may be excluded from “chargeable profits” of the CFC due to the “exempt activities” exclusion, gains made by a foreign (close) company in which UK residents individuals are “participators”, on the disposal of assets used for the purposes of a trade carried on by the foreign company, are not apportioned back to them³⁵.

Capital Gain On Disposal Of Labuan Company

In 2002, a substantial shareholder exemption from taxation of capital gains by companies, was introduced (Sch 7AC TCGA 1992), which also applies to shareholdings in foreign companies. It applies only to companies, where both the “investing company” and “company invested in” (at least 10% owned) are trading companies both before and after the disposal. The requirement that the investing company be trading may disentitle relief in many holding company cases where there is only one trading subsidiary. The shareholding must be held for a continuous period of at least 12 months during the period before disposal. A trading company is one which does not include substantial extent non-trading activities (interpreted by HMRC as not more than 20% based on earnings and assets).

Thin Capitalization

The UK thin capitalization rules are applicable to investment in a CFC. Those rules are a part of the anti-transfer pricing regime³⁶. The rough rule of thumb is that a UK company can only gear a Labuan subsidiary 1:1. However, there is no motivation to use any debt funding of Labuan subsidiary, as it will only give a deduction in Labuan against a maximum 3% tax rate, but interest paid to the UK parent will be taxed at 28%. However, it may pay to borrow to subscribe for the share capital needed in the Labuan company, as long as the interest is deductible in the UK.

Transfer Pricing

The UK transfer pricing rules as they related to trading, don’t feature largely in the current case, as the Labuan company won’t be dealing with customers in the UK, nor with associated parties, in order to only engage in “exempt activities” under the CFC provisions.

³⁴ See more particularly at [2000] STC (SCD) 143 para 92

³⁵ s13(5) TCGA 1992

³⁶ Sch 28 AA para 1A

9. Dividends from Labuan

Unlike several EU countries³⁷, and even Australia, the UK subjects to tax, all dividend from foreign companies, with a credit for foreign withholding tax only, in the case of individuals and trusts. UK resident companies owning a non-portfolio interest (10%) in foreign companies, are also entitled to a proportionate credit for underlying foreign tax.

UK Treasury have a consultation paper³⁸ published seeking to explore the introduction of a “participation exemption” regime in the UK in relation to non-portfolio shareholding, but as yet there has been no announcement of its adoption. The paper recognizes the potential incompatibility of the UK approach on portfolio dividends, with a recent decision of the ECJ.

In recent days, there have been a number of London Stock Exchange listed companies announce that they are moving their domicile to Ireland³⁹ due to the UK tax situation on foreign source income, which will no doubt force the issue politically. Whilst the potential adoption of a “participation exemption” regime is welcomed, the consultation paper proposes a revision of the CFC regime to an item of income basis which will apportion significant passive income which is currently sheltered as long as it is not the main business of the foreign company⁴⁰. It should be noted that those trading profits currently sheltered by the “exempt activities” test are proposed to continue to be sheltered under a revised regime.

10. 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 UK client as “UKco” and its offshore subsidiary company as “Offshoreco”. In each case, UKco:

- wants to 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

³⁷ The Netherlands, Denmark, Belgium, Germany, Italy, Switzerland, Sweden

³⁸ “Taxation of the foreign profits of companies: a discussion document”, HM Treasury/HM Revenue & Customs, June, 2007

³⁹ Shire Pharmaceuticals plc; United Business Media plc

⁴⁰ In order to reduce the risk of further attack in the ECJ, the new measures termed “controlled company” (CC) regime, would apply to both domestic and foreign controlled companies. The proposed “participation exemption” would not apply to “small” companies as defined by EU Directive (less than 50 employees, and assets and turnover less than €50M).

- wants to choose an international base that will allow it maximum flexibility for potential customers in many jurisdictions

10.1 Trading in Goods

- UKco is in the business of buying goods in or outside the UK, and selling them in and outside the UK
- UKco is looking for more vendors and purchasers
- UKco accepts that sales in the UK are probably best effected through UKco, but wants to make sales outside the UK through Offshoreco, to enhance its international credentials
- If Offshoreco is formed under the Labuan regime, with effective management in Malaysia, and sufficient employees in Malaysia (or at least outside the UK) to service the business, if the source of its income will be from Offshoreco purchasing goods outside the UK from unrelated suppliers, and selling the goods to unrelated customers outside the UK, none of that income will be apportioned back to UKco as the holding company under the CFC regime.

10.2 Provider of Services

10.2.1 Computer Services

- UKco is in the computer services business
- So far, it has only done work for UK resident clients
- UKco is looking to do work for clients overseas
- If Offshoreco is formed under the Labuan regime, with effective management in Malaysia, and sufficient employees in Malaysia (or at least outside the UK) to service the business, then as the source of its income will be from providing services to clients outside the UK, none of that income will be apportioned back to UKco as the holding company under the CFC regime.

10.2.2 Architectural Drafting

- UKco is in the architectural drafting profession
- So far, it has only done work for UK resident clients
- UKco is looking to do work from clients overseas
- If Offshoreco is formed under the Labuan regime, with effective management in Malaysia, and sufficient employees in Malaysia (or at least outside the UK) to service the business, then as the source of its income will be from providing services to clients outside the UK, none of that income will be apportioned back to UKco as the holding company under the CFC regime.

11. 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 16% 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.

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\$5,260)) 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.

Ironically, if the Labuan company elects to become chargeable under the Malaysian Income Tax Act 1967, in order to access the previously denied 10 treaties, these cases from Hong Kong and Singapore will be equally applicable to the Labuan company so electing. This may lead to two subsidiaries incorporated in Labuan, one electing, for business with previously excluded treaty countries, and the second Labuan company not electing, for all other treaty countries (and perhaps non-treaty countries).

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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Appendix A

MALAYSIAN DOUBLE TAX AGREEMENTS

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

Hungary

PapuaNew
Guinea

India

Philippines

Iran #

Poland

Treaties have also been initialled with Brunei, Oman, Qatar, and Yemen. *Restricted double tax treaty.
+excludes Labuan Offshore companies. # net yet effective

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