



Exemption from Labuan Tax: Enhancing Islamic Financial Services Sector

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Introduction

Labuan is renowned for its tax friendly regime. The standard income tax rate for Labuan entities is competitively set at 3% of audited net profits, provided they meet the economic substance requirements. This makes Labuan an attractive destination for businesses seeking a tax-efficient environment. Labuan entities which are eligible for the 3% tax rate must be engaged in Labuan trading business activities which include banking, insurance, international trading, fund management, leasing, shipping operations, and provision of legal, accounting, payroll, backroom processing services, etc.

Recently, the Labuan tax regime introduced a tax exemption for financial services sector adhering to Syariah principles for the years of assessment 2024 to 2028, pursuant to the newly gazetted Labuan Business Activity Tax (Exemption) Order 2024 (“2024 Exemption”) issued on 10 May 2024. Eligible companies have to meet the substance requirements below.

Substance Requirements

Labuan implemented substance requirements to ensure that Labuan entities operating within the jurisdiction have a meaningful presence and conduct genuine business activities. These requirements align with international standards and address concerns related to Base Erosion and Profit Shifting (BEPS).

Effective from Year of Assessment (YA) 2019, a Labuan entity must ensure it qualifies as a Labuan entity under Section 2B of the Labuan Business Activity Tax Act 1990 (LBATA) to benefit from the 3% tax rate on chargeable audited net profits. To qualify, the entity must:

- Employ an adequate number of full-time employees in Labuan.
- Incur an adequate amount of annual operating expenditure in Labuan,

The minimum number of employees and annual operating expenditure shall be those as prescribed by the Minister under Section 21 of LBATA.

Substance Requirements (cont.)

As a result, the Labuan Business Activity Tax (Requirements for Labuan Business Activity) Regulations 2021 (“Substance Regulations 2021”) were gazetted on 19 November 2021 and came into operation on 1 January 2019. These regulations specify the minimum number of employees and the minimum annual operating expenditure for 20 types of trading activities and 2 types of non-trading activities, as detailed in Schedules 1 and 2 of the Substance Regulations 2021. Labuan entities must maintain proper documentation and records, including meeting minutes, financial records, and other relevant documents, to support their compliance with substance requirements.

Entities that fail to meet the substance requirements may risk losing the benefits of Labuan's preferential tax regime and subject to corporate tax rate at 24%. Hence, it is crucial for businesses operating in Labuan to fulfill the substance requirements to ensure regulatory compliance.

Current tax position for Islamic and non-Islamic financial services-related sector

Under the existing requirements, the financial services-related sector operating in Labuan is subject to the following substance requirements to qualify for the 3% tax rate:

No	Labuan Entity	Minimum number of full time employees in Labuan	Minimum amount of annual operating expenditure in Labuan (RM)
1	Labuan bank, Labuan investment bank, Labuan Islamic bank or Labuan Islamic investment bank	3	200,000
2	Labuan credit token company or Labuan Islamic credit token company	2	100,000
3	Labuan fund manager	2	100,000
4	Labuan International Financial Exchange	2	120,000

Tax Exemption for Islamic financial services-related sector during YA2024 to YA2028

For a period of 5 years from YA2024 to YA2028, Labuan entities undertaking financial services-related activities adhering to Syariah principles will be granted tax exemptions. The exemption seeks to promote the Islamic financial services-related sector that adheres to Syariah principles.

The list of Labuan entities and the prescribed qualifying activities stated in the 2024 Exemption are summarised below:

No	Labuan Entity	Qualifying Activity
1	Labuan bank, Labuan investment bank, Labuan Islamic bank or Labuan Islamic investment bank	Islamic banking business that leverages digital solutions and adheres to Syariah principles for: <ul style="list-style-type: none"> (a) raising funds; (b) managing risks including credit, currency and interest risks; (c) taking hedging positions; (d) providing financing or other financial services to customers; (e) managing regulatory capital; (f) preparing regulatory reports and returns; (g) deposit taking for Labuan Islamic bank and Labuan bank approved to carry on Labuan Islamic banking; (h) providing consultancy and advisory services relating to investment matters including dealing in securities or making and managing Islamic investment
2	Labuan credit token company or Labuan Islamic credit token company	Islamic Digital Token Issuer which: <ul style="list-style-type: none"> (a) issues Islamic credit token or Islamic securities token via built-in technology or outsourced technology; (b) provides in-house wallet (hot and cold wallet) for storing of Islamic digital token and approved as a payment system operator
3	Labuan fund manager	Providing fund management services based on Syariah principles and utilisation of digital solutions in respect of Islamic securities including Islamic securities tokens for: <ul style="list-style-type: none"> (a) management services; (b) investment advice; (c) administrative services; (d) dealing in securities
4	Labuan International Financial Exchange	Undertaking the business of Islamic Exchange which is: <ul style="list-style-type: none"> (a) based on Syariah principles and utilisation of digital solutions in— <ul style="list-style-type: none"> (i) listing; (ii) licensing; or (iii) trading; or (b) based on the rules and by-laws of the Exchange, other matters related to the securities market and financial instruments

Tax Filing Requirements

Despite the tax exemption, Labuan entities must continue to file annual tax returns. The exemption does not absolve them from complying with any requirements to submit returns, statements of bank accounts, or other information under LBATA. If the Labuan entity has income other than the exempted income, each activity or business must be treated as a separate source, with separate accounts maintained for each, to ensure compliance during tax audits.

How Crowe can help

Tax optimization leveraging the Labuan tax regime requires close coordination between auditors and tax consultants, both during the setup stage and the annual review of the Labuan entities' operations to meet the substance requirements. Our team of assurance and tax professionals can support your Labuan entities in complying with the audit and tax statutory requirements in Labuan, including

- Audit services.
- Tax compliance and advisory services: Preparation of tax computations, tax filing and tax review of Labuan structure.
- Other services: Internal audit, IT audit, cyber-security and corporate recovery services.



Conclusion

Labuan is an appealing destination for businesses and investors due to its low tax regime. The full tax exemption for Islamic financial services from YA2024 to 2028 aims to promote Labuan as an Islamic financial hub. The absence of tax, combined with a streamlined regulatory environment, enhances Labuan as an attractive destination to operate Syariah compliant financial services related services. However, it is essential to stay updated with the latest tax regulations, as they are subject to change from time to time. Businesses should monitor official government sources and seek professional advice to ensure compliance with current policies. Labuan's journey in fostering a favorable tax regime highlights the importance of adaptability and proactiveness in navigating the evolving landscape of international taxation.

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