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Update note - Revised Guidelines on the Establishment and Operations of Labuan Leasing Business – Impact on Aviation

The Labuan Financial Services Authority (“Labuan FSA”) has, at the end of December 2017, released revised Guidelines on the Establishment and Operations of Labuan Leasing Business (“Revised Guidelines”), in place of the 2013 guidelines.

The Revised Guidelines have introduced a number of new requirements for Labuan leasing companies. In particular, the changes to the *Operational Requirements* in the Revised Guidelines would appear to be more restrictive for Labuan leasing companies, as Labuan leasing companies will have to comply with new requirements.

These new requirements include the following: (i) having sufficient capital commensurate with the business of the company; (ii) establishing adequate internal policies and controls; and (iii) maintaining adequate and proper records and books of accounts in Labuan. There are also requirements to obtain Labuan FSA’s approval for certain changes related to the lessee / leased asset / shareholders / appointment of Directors. These latter requirements could even be read as imposing an undue fetter on the business of the Labuan company.

In addition, the Labuan company has to have substantial activities and is to perform strategic functions in Labuan. Substance is further defined as including physical presence, key leasing activities, employment (relevant to leasing), as well as annual business spending. At first glance, it appears that the substance and strategy requirements would result in increasing complexity and costs around leasing activities in Labuan. Added to that is the fact that the annual licence fee of RM60,000 and the per-transaction fee of RM20,000 now applies to all leasing transactions, which fee previously applied only to transactions involving resident Malaysian lessees.

Although the Revised Guidelines took effect on 1st January 2018, both existing and new Labuan leasing companies should take note that the substance requirements will only take effect on 1st January 2019, and hence there is a transition period in order to comply with these new requirements.

Some lessors, particularly lessors in the aviation leasing industry, are concerned about the Revised Guidelines, and have sought further clarity. As the relevant regulator, Labuan FSA has indicated that they are open to engagement with leasing parties, to try and address any concerns or issues that may arise. In addition, there is a conference which is scheduled to be held in the third week of March 2018, during which the leasing industry may expect the Regulator to share insights into the Revised Guidelines and their development.

Asset leasing is an important area of business for the Labuan International Business and Financial Centre ("Labuan IBFC"). As of December 2016, there were 376 leasing companies in Labuan, with aviation assets making up approximately USD16,000mil out of the total USD50,000mil assets leased by those leasing companies. The large majority of these aviation leasing companies were set up by the various aviation operators in Malaysia, and/or by the lessors that lease aircraft to Malaysian carriers. Looking at recent developments in the aviation leasing market, there is also focus on making Labuan IBFC an aviation leasing centre, especially for the Asian markets.

In fact, Labuan leasing companies have already featured strongly in the structures of various operating and finance leases for aviation assets in Malaysia. Establishing a Labuan leasing company allows the ultimate lessee, usually a Malaysian carrier, to be able to benefit from Malaysia's extensive tax treaty network, as well as from the favourable corporate tax rates that apply to Labuan IBFC. The question being asked now is whether the Revised Guidelines will result in a major change in the business of aviation leasing in Malaysia.

It is important to note that the introduction of the Revised Guidelines was not an arbitrary nor sudden act by Labuan FSA. At the end of 2015, the OECD's final recommendations on the Base Erosion and Profit Shifting ("BEPS") Project, were adopted by the G20 Finance Ministers. These recommendations were designed to prevent tax planning strategies that shift profits to jurisdictions where there are lower tax rates. With this as a background, we understand that Labuan FSA's issuance of the Revised Guidelines is setting the framework for Labuan leasing companies to be able to meet Malaysia's commitment to the OECD's BEPS initiatives moving forward.

Lessors and lessees alike may want to note that Malaysia has previously been whitelisted by the OECD. In addition, the long aviation history in Labuan IBFC and in Malaysia generally, means that there is now a large aviation-related talent pool available in-country, built up over the years and over the different air operators.

From the perspective of having an ecosystem in place for aviation leasing transactions, Malaysia is able to offer the relevant expertise as well as other positive factors – a common law legal system that is familiar to most lessors, a stable economy and country, a relatively lower cost of doing business (compared to most other aviation hubs in Asia), the availability of sufficient capital (via domestic and international financial institutions) and geographical proximity to the fast-growing Asia Pacific area.

We also understand that to date, most other similar jurisdictions (eg. The Cayman Islands, the British Virgin Islands, Bermuda, the Maldives, etc) have yet to make changes to their laws, to put the OECD BEPS requirements into effect, and would in time follow suit with their own guidance towards ensuring that their commitment to the OECD is intact.

As a first mover in the area of BEPS compliance, we believe that the Revised Guidelines present an opportunity to the aviation leasing industry in Malaysia, to make the changes necessary to be able to demonstrate sufficient substance in this jurisdiction. In addition, with the relatively low cost structure of Labuan and Malaysia overlaid onto the new operational requirements, we believe that compliance with the Revised Guidelines, and indirectly with the OECD BEPS requirements, will eventually have a minimal impact on the efficacy of the existing structures – and that Labuan IBFC, will remain as a favourable destination for aviation leasing moving forward.

Lessors may even find that, with Malaysia's extensive tax treaty network, lessors will be able to administer transactions in other markets from their Labuan offices, too.

As such, we would encourage lessors and lessees to view the Revised Guidelines as an opportunity to make positive changes to their aviation leasing businesses, and as an opportunity to consider the expansion of their leasing businesses from Malaysia into other markets as well.

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Datin Shelina Razaly Wahid began her legal career as a litigation lawyer for 3 years before moving in-house as corporate counsel with one of the largest downstream multinational petroleum companies in Malaysia.

Over the course of 6 years as in-house counsel for Shell Malaysia, Shelina served various roles – including being the Company focal point for all HR-related legal matters; responsible for setting up the in-house Litigation Management Program; and had direct responsibility for managing all major litigation matters.

In 2007 Shelina was a pioneer member of the senior management team at AirAsia X Berhad. As Legal Director, Shelina worked across all spheres of aviation, including HR matters, operations and engineering – with particular focus in Aircraft Leasing and Financing, Engines and Avionics as well as Aviation / Aerospace regulatory matters. While in AirAsia X, she saw through the successful AirAsia X Berhad Initial Public Offering (July 2013).

Returning to legal practice in 2014, Shelina currently leads the Aviation and Aerospace practice group at Abdullah Chan & Co; working with both lessors / financiers and operators alike; and with various service providers in the MRO, engineering and other support services and aerospace training areas as well.

A graduate from the University of Bristol, Shelina completed her Bar Vocational course in London in 1996 and was called to the Malaysian Bar in 1998.

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