

CFL1

Administration of Offshore Centres

7 APRIL 2003

1. Time allowed : Three (3) hours
2. Total number of questions : Five (5) questions
3. Number of questions to be answered : All five (5) questions [20 marks each]
4. Begin each answer to a new question on a fresh page.
5. Answer **all** questions in **English**.

ANSWER ALL FIVE (5) QUESTIONS

1. Malaysia has concluded double taxation treaty agreements with over 40 countries. Thus, one of the advantages of incorporating an offshore company in Labuan is the tax benefits from such treaties.

In the above context, answer the following questions:

- (a) Define the term "tax avoidance". [3]
- (b) Define the term "tax evasion". [3]
- (c) What is the purpose of a double taxation treaty? [6]
- (d) Define "transactions not at arm's length" for tax purposes. [8]
(Total:20 marks)
2. (a) Define "know your customer policy" in the context of banks complying with the safeguards against money laundering. [5]
- (b) Define "illicit funds" and provide examples of illicit funds. [5]
- (c) Briefly describe the **three** stages of money laundering. [10]
(Total:20 marks)
3. (a) What are "transferable loan certificates" and how are they evidenced? [6]
- (b) What are the reasons driving standby letters of credit business from Labuan offshore banks? [9]
- (c) List the categories of trust services provided by trust companies in Labuan. [5]
(Total:20 marks)
4. (a) Define "offshore captive insurance" and state its features. [10]
- (b) List a company's criteria in its selection of an offshore financial centre. [10]
(Total:20 marks)
5. (a) List and describe **three** categories of offshore banks in Labuan. [12]
- (b) Briefly explain the activities of these offshore banks. [8]
(Total:20 marks)

- END OF QUESTION PAPER -

OUTLINE ANSWERS

Question 1

Candidates seemed able to grasp the concept of tax avoidance and tax evasion. However, there was poor understanding of the rationale for the double taxation treaty and “transactions not at arm’s length” for tax purposes.

1. (a) An exercise involving the structuring of transactions within the legal framework of the law to minimise present or future tax liabilities. Also known as tax planning.
- (b) An exercise to avoid tax obligations through illegal means and is not acceptable to the Inland Revenue Department.
- (c) The purpose is to avoid the incidence of double payment of tax on international income, such as business profits, dividends, and royalties derived in one country and remitted to another. It removes a tax barrier to international trade and investments.
- (d) These are transactions between persons, one of whom has control over the other, between individuals who are relatives of each other, or between persons both of whom are under some other persons’ control.

Question 2

Candidates performed well in this question on money laundering.

2. (a) This means staff of banks are expected to request for proper identification at the time a relationship is established to prevent the creation of fictitious accounts.
- (b) They are funds derived from illegal activities such as smuggling, drugs trafficking, illegal gambling operations, fraud funds and tax evasion gains.
- (c) They are placement (physical disposal of cash), layering (complex transactions to hide audit trail) and integration (final stage where illegal funds become legitimate).

Question 3

Candidates seemed to have only a vague idea about Transferable Loan Certificates (TLCs) and trust services provided by trust companies in Labuan.

3. (a) TLCs are a funding instrument commonly used in international financing; a form of direct lending in either a revolving credit facility type or term loan. The lender has the right to transfer all or part of its commitment to another bank without the consent of the borrower. It is evidenced by a Facility Agreement and a Transfer Certificate.
- (b) ~The reasons driving the standby letters of credit (SLBCs) from Labuan offshore banks are:
 - The Malaysian borrower may require a sizeable Ringgit loan which may exceed the single customer limit (restricted to 30% of their shareholders’ funds) of domestic banks. As offshore banks are higher in capitalisation, it is more convenient for the single risk to be absorbed by an offshore bank. The offshore bank in turn issues several bank guarantees/SLBCs, allotting the Ringgit funding to several domestic banks, thus ensuring their compliance with the domestic banks’ single customer limit.

- Domestic banks are not prepared to take the project risk or borrower's corporate risk directly. By sourcing Bank Guarantees/SLBCs offshore in Labuan, credit risk is shifted to an international financial institution risk. Thus, the funding bank benefits in terms of a lower measurement as the offshore banks' risk is only computed at 20% risk weight, the offshore banks being mainly from OECD countries.
 - Overall aggregate funding cost – domestic banks' pricing of Ringgit loans are expected to be lower against bank risks compared with a direct credit risk which is likely to be priced higher. The offshore bank, on the other hand, may price its commission charges at very competitive rates, reflecting the intense competition of international financing.
- (c) Fund/investment management, custody services, advisory and administrative services, portfolio management, and trust services.

Question 4

Candidates were able to get good marks from listing a company's criteria in selecting an offshore financial centre, but were unable to answer well on the concept of "offshore captive insurance".

4. (a) An offshore captive insurance is a genuine insurance or reinsurance company, owned either by a non-insurance company, a group of insured or others, wishing to primarily insure or reinsure the risks of the owners or their affiliates.

The features of offshore captive insurance are as follows:

- It is not domestic insurance
- The subject matter of the contract is other than:
 - property which at the time of making of the contract is situated in Malaysia or is in transit to or from Malaysia,
 - a ship or an aircraft registered in Malaysia and all liabilities arising from the operation of such ship or aircraft,
 - the life or any contingency-related to any person who, at the time of making the contract, is a resident, or
 - a risk of any nature in respect of any person who, at the time of making the contract, is a resident
- It is transacted in foreign currencies, and includes offshore captive insurance business
- There is strict secrecy and confidentiality in relation of the disclosure of the affairs of policy holders
- The insured is either:
 - a related company of the offshore insurer; or
 - associate corporation of the offshore insurer; or
 - any other person in respect of whom the offshore insurer is authorised by LOFSA to provide insurance or reinsurance

- (b) Criteria in selection of an offshore financial centre:

- Tax reduction benefit
- Privacy and confidentiality of business transactions
- Lower cost of living abroad and doing business
- Avoidance of currency restrictions
- Import freedom for personal effects
- Minimum government controls
- Capital availability

Question 5

A candidate misunderstood part (a), which asked for the categories of offshore banks in Labuan and gave the wrong answers.

Candidates were able to describe the activities of offshore banks.

5. (a) Offshore banking business in Labuan may be categorised into 3 groups. The first group comprises the subsidiaries of Malaysian banks in Labuan. They primarily undertake 'out-out' business to tap the regional market in terms of the lending business. Dealers in Labuan carry out foreign currency operations, which cater also to the domestic requirement of their parent bank. Examples are Maybank, Public Bank and AmBank.

The second category comprises branches or subsidiaries of foreign banks, which have a domestic banking license. These banks utilise Labuan to market their foreign currency products to Malaysian companies as well as overseas subsidiaries of Malaysian corporates. Occasionally their regional assets may be booked out of Labuan if there are tax benefits. Examples in this group are Citibank, Chase Bank and Bank of America.

In the third category, we have branches/subsidiaries of foreign banks without a presence in Malaysia. The majority of banks in this category utilise their Labuan operations to tap the Malaysian market for credit business, both direct and indirect. Direct credit business would be providing foreign currency loans, mostly in US Dollars. Indirect credits would be the provision of Ringgit denominated bank guarantees or standby letters of credit [SBLCs]. This category of banks also follows the Malaysian corporates in their 'reverse investments' ventures by funding their overseas investments in foreign currencies. Examples of banks in this category are DBS Bank, Dresdner Bank, CSFB, BNP Paribas and the Japanese banks.

- (b) The activities include foreign currency loans, issuance of Standby Letter of Credits and Bank Guarantees, money market transactions, foreign currency deposits, bonds underwriting, private banking activities and insurance business.