

9 August 2006

Proposed Tax Changes

AvanziaTax
Member firm of Taxand Global Alliance
Taxand

AvanziaTax

Member firm of Taxand Global Alliance

* T a x a n d

www.avanzia.com.mt

www.taxand.com

For further details contact:

walter.cutajar@avanzia.com.mt

michelle.sant@avanzia.com.mt

paul.bugeja@avanzia.com.mt

maryanne.cachia@avanzia.com.mt

ruth.agius@avanzia.com.mt

Introduction

On 5th August 2006, the Government published a Pre-Budget Document to the forthcoming budget for calendar year 2007 entitled 'Securing Our Future'. The document contains an analysis of the Maltese economy and its fiscal and monetary developments, highlights various initiatives to stimulate economic growth with particular reference to industry, tourism, research and innovation and submits a programme of action together with details of the proposed changes to our tax system as agreed with the EU Commission.

The purpose of this alert is to highlight the proposed changes to our tax system as outlined in the supplementary paper to the Pre-Budget Document entitled 'Streamlining Company Taxation' and which are of particular interest to 'international clients'.

Our Tax System

Malta's tax system is a full imputation system which treats residents and non-residents in the same way and is therefore non-discriminatory and does not fall foul of EU law on this count. The only feature in Malta's imputation system which requires amendment to be fully compliant with ECJ decisions on imputation systems is to allow a credit for foreign underlying corporate tax to individuals in addition to companies where such a credit is already available. Such an amendment would strengthen the harmony of our tax system by not discriminating in favour of the corporate form.

EU Agreement

Apart from the minor amendment to the full imputation system other changes are necessary to reflect the agreement which Malta reached with the EU Commission as regards our tax rules as they apply to international trading companies and companies operating the Foreign Income Account. While Malta was not in agreement with the Commission that these elements in our tax system constitute State Aid, in the interests of stability and certainty Malta sought to reach agreement with the Commission on a revised tax system

with appropriate transitional arrangements. The Commission agreed with the Maltese proposal on a revised tax system and in its decision the Commission invites Malta to implement this with effect from 1 January 2007.

In principle, this proposal extends the refundable tax credit system to dividend payments made by all Maltese companies to all their shareholders.

The Proposal in detail

The Government is proposing to retain the present imputation system of taxation whereby the tax paid by companies will essentially remain a tax prepaid on behalf of the shareholders, the shareholder level being the level where tax is finally determined. The Government is proposing to introduce the notion of an economic rent, as well as enhancing the distinction as to how profits are derived, whereby profits from immovable property will be excluded from the tax refund system agreed to with the EU Commission. These profits need to be treated differently since land is not a mobile factor and such profits do not only arise as a result of the inputs of capital and labour, but because land has an inherent value relative to its location. For this purpose such profits will, for tax purposes, be allocated to an immovable property account and shall be treated in the same manner as they have been treated to date.

As is also currently the case, company profits will be allocated to tax accounts in order to determine the tax treatment of such profits upon distribution to shareholders as dividends. Within the above economic conceptual framework company profits will be divided between profits on which tax will not be available for refund since they are deemed to be the company's contribution towards the country's provision of public goods, and profits which will be allocated to the Maltese Taxed Account and the Foreign Income Account on which a tax refund is available. Upon the payment of a dividend from such profits, shareholders, whether they are resident or non-resident, may claim a refund of part or the whole of the tax paid on the distributed profits. The refund will

generally be equal to 6/7 of the Malta tax paid on the distributed profits from such accounts.

When the distributing company claims double taxation relief, the current provisions remain unchanged and a tax refund of 2/3 of the Malta tax paid on the distributed profits may be claimed. These changes will not affect local residents.

Participating Holding

The tax refund however is increased to 100% when the profits distributed were derived by the distributing company from a participating holding. The definition of a participating holding will essentially remain as it is today. However as the case in other EU members states certain anti-abuse provisions will be introduced aimed at distributions received from companies having mainly passive income where such income has not been taxed at more than 5%. Currently a shareholding in a non-resident company will qualify as a participating holding of a Maltese company if:

- (a) the Malta company holds equity shares in a non-resident company and it:
 - (i) has at least 10% of the equity shares in the non-resident company; or
 - (ii) is an equity shareholder in the non-resident company and is entitled to purchase the balance of the equity shares of the non-resident company, or it has the right of first refusal to purchase such shares; or
 - (iii) is an equity shareholder in the non-resident company and is entitled to either sit on the Board or appoint a person on the Board of that subsidiary as a director; or
 - (iv) is an equity shareholder which invests a minimum in the non-resident company of Lm500,000 (or the equivalent in a foreign currency); or
 - (v) holds the shares in the non-resident company for the furtherance of its own business.

- (b) the holding is not held as trading stock for the purpose of a trade.

It should be noted that the rules in (a) will remain applicable for participating holdings existing at 31 December 2006 until the end of 2010.

With regards to acquisitions of participating holdings made on or after 1 January 2007, where the non resident company, having mainly passive income, is not resident or incorporated in a tax treaty, EU or EEA jurisdiction or a country which levies a tax on corporate profits at a rate which is at least 50% of the Maltese corporate income tax rate, the following additional conditions must be satisfied:

- (a) the shares in the non-resident company must not be held as a portfolio investment. In any event a participation of at least 25% in the capital of a non-resident company 90% of the assets of which consist of portfolio investments and non-trading financial assets shall be deemed to be a portfolio investment; and
- (b) the non-resident company or its passive income must have been subject to tax at a rate which is not less than 5%.

Participation Exemption

As from 1 January 2007 Malta will also introduce a participation exemption which will exempt from tax dividends and capital gains derived from participating holdings.

Effective Date

Under the agreement with the EU, the proposals will take effect from 1 January, 2007, and the existing tax refunds will be retained up to 2010 for beneficiaries existing as at 31 December, 2006. The tax refunds under the extended system will not be materially different from those currently applicable.

Conclusion

This is an important agreement for Malta and helps ensure its future ability to continue to be an attractive and competitive environment for international business and investment.

