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The much awaited amendments to the Income Tax Act and the Income Management Act have now been enacted through Act II of 2007. These changes address the harmful tax measures identified by the Code of Conduct and bring into effect those changes agreed upon with the European Commission.

The changes are retrospective from 1 January 2007, and include various transitional provisions for existing companies and shareholders benefiting from the previous tax refund system. In most cases, the changes will not have a material effect on companies operating outside Malta or having foreign source income and on non-resident shareholders.

The Maltese tax system will continue to be based on the full imputation system of taxation and both resident and non-resident shareholders are entitled to a full credit of the income tax paid by the company. Any excess credit is refunded in full to the shareholder. Moreover the tax refunds on distributions from the foreign income account have now been extended to distributions from the Maltese taxed account and may be claimed by all shareholders.

## Salient changes

As highlighted above the tax refunds are now available on distributions from the foreign income account (FIA) and the Maltese taxed account (MTA) and all shareholders are entitled to claim these tax refunds.

It is no longer possible to register companies with the status of an international trading company, but all existing companies registered up to 31 December 2006 may continue to benefit from the previous system until 31 December 2010. Existing International Trading Companies and companies operating the foreign income account may at any time opt to the new tax system before such date.

Two new tax accounts were introduced, namely the Final Tax Account (FTA), the Immovable Property Account (IPA). Profits from immovable property situated in Malta and certain local investment income are allocated to these tax accounts and distributions from these tax accounts do not give rise to any tax refunds.

The concept of 'economic rent' is being introduced but detailed rules on how it is calculated and rules regarding the allocation of profits related to immovable property in Malta and certain other local activities have not yet been published.

The tax refunds applicable to shareholders upon distribution of profits out of the FIA and MTA vary as follows:

- 6/7ths of the company tax in respect of trading activities,
- 5/7ths of the company tax in respect of passive interest and royalties as defined in the Act,
- 2/3rds or even full tax refund in respect of income on which the Malta company is entitled to claim double taxation relief.

A company deriving foreign source income is also entitled to claim the Flat Rate Foreign Tax Credit (FRFTC) even if no foreign tax has been suffered. Upon a distribution of such foreign source income the shareholder may claim a 2/3rds tax refund so that the effective tax rate achieved would be 6.25%. Companies wishing to apply the FRFTC on profits allocated to the FIA will need to be empowered through a specific clause in their Memorandum of Association.

Holding companies that derive dividend income or capital gains from a 'participating holding' may now apply for a participation exemption. Alternatively, the Maltese holding company may elect to be subject and pay income tax and upon a distribution of profits the shareholder is entitled to claim a full refund of the company income tax.

The definition of a 'participation holding' has been amended. A Maltese company is considered to have a participating holding if it holds equity shares in a non-resident company or a qualifying body of persons and it:

- has at least 10% of the equity shares in the non-resident company; or
- 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
- 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
- is an equity shareholder which invests a minimum in the non-resident company of Lm500,000 (or equivalent in a foreign currency) and such investment is held for a at least a period of 183 days; or
- holds the shares in the non-resident company for the furtherance of its own business and the holding is not held as trading stock for the purpose of a trade;

Furthermore the non-resident company in question must satisfy any one of the following three conditions:

- it is resident or incorporated in the EU,
- it is subject to foreign tax of a minimum of 15%,
- it does not derive more than 50% of its income from passive interest and royalties.

or alternatively must satisfy both of the following conditions:

- (a) the shares in the non-resident company must not be held as a portfolio investment; and
- (b) the non-resident company or its passive interest or royalties have been subject to tax at a rate which is not less than 5%.

A 'portfolio investment' is an investment in securities held as part of a portfolio of similar investments for the purpose of risk spreading and where such an investment is not a strategic investment and is done with no intention of influencing the management of the underlying company. Furthermore, it is important to note that the holding of shares by a Maltese company in a foreign body of persons which derives more than 50% of its income from portfolio investments is deemed a portfolio investment.

The above definition applies to participation holdings acquired on or after 1 January 2007. As from 1 January 2011 the new definition of participation holding will also apply to participation holdings acquired on or before 31 December 2006. Existing holding companies should therefore review the investments and see what action needs to be taken, if any, before 1 January 2011 to ensure that the investment continues to qualify as a participating holding.

It is interesting to note that under the new tax system, branches of overseas companies are treated like any other company registered in Malta, and the tax accounting system and tax refund system may also apply.

### Implications for companies with non-resident shareholders under the new system

The effective tax rate for trading companies increases from 4.17% to 5%.

The definition for 'participation holding' now contains certain anti-abuse provisions and thus the applicable tax refunds may change from a full refund to 2/3rds or 5/7ths should the investment no longer qualify as a participating

holding.

Companies deriving income from a participation holding may now opt for the participation exemption on dividend income and capital gains. Such companies will not pay any income tax in Malta. The need of a 'dividend feeder company' may also be eliminated. On the other hand, the use of multiple layers of Maltese companies in a structure will no longer preclude the right to claim the tax refund.

The new definition and rules relating to passive interest or royalty income and the empowerment clause referred to above gives rise to more tax planning opportunities using Maltese companies.

The new tax system allows companies to have a mixture of both trading income as well as passive income without any implications on the refund entitlements to shareholders.

There is no need for companies to trade exclusively outside Malta and with non-resident for its shareholders to be entitled to the tax refund. The new system is more flexible provided the tax accounting and allocation rules are adhered to.

### Other information

- Malta will continue not to levy any withholding tax;
- Malta has no thin capitalisation rules or debt-to-equity ratios;
- Malta has no capital duty and wealth taxes;
- No stamp duties on share transfers in companies owned by non-residents;
- Non-residents are exempt from any capital gains on certain share transfers;
- Maltese companies may benefit from the EU Parent-Subsidiary Directive and the Interest and Royalties Directive apart from a wide tax treaty network;
- Under the re-domiciliation provisions it is possible to migrate companies into and out of Malta without the need of winding up or liquidation costs;
- No exchange control regulations and business may be conducted freely in any currency.

Following the agreement with the EU, Malta has now positioned itself as a truly financial centre of repute and these tax changes to our tax legislation will continue to enhance Malta's position as an efficient and effective jurisdiction for international business activities.

