PBL 3003 GENERAL INTRODUCTION TO PRINCIPLES OF TAXATION

The European Law Students' Association
MALTA

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TAX LAW

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The Maltese Tax System

Taxation has garnered heightened attention in recent times, a stark contrast to its relatively obscure status in the past. Nowadays, discussions about tax law, tax evasion, and related matters are pervasive. This shift in focus prompts an exploration into the essence of taxation itself.

Taxation, fundamentally, constitutes a form of expropriation wherein individuals are compelled to contribute a portion of their earnings to the state's revenue. It involves the government seizing a percentage of one's income, essentially constituting a form of confiscation.

Various forms of taxation exist, including **Income Tax** and **Value Added Tax (VAT)**, which exemplify direct and indirect taxation, respectively. Income Tax entails the government extracting a portion of an individual's earnings, while VAT involves imposing a tax on the sale of goods and services, thereby affecting consumer spending. This divergence in approach underscores distinct philosophical orientations: **Income Tax discourages work by taxing earnings**, whereas **VAT discourages consumption by taxing purchases**.

Governments navigate a delicate balance between these two tax strategies, each with its economic implications. A state's decision to increase Income Tax signals a disincentive for labour, as higher earnings translate to higher taxes. Conversely, a heavy reliance on VAT prompts consumers to curtail spending. The interplay between these tax policies underscores the nuanced economic considerations at play.

For instance, the **absence of VAT in Malta for an extended period illustrates how different tax regimes cater to distinct economic ecosystems**. Achieving equilibrium between taxes conducive to one economic system versus another is imperative, underscoring the necessity for a judicious approach to taxation policy.

National Insurance

National Insurance (NI) operates akin to taxation in its **mandatory nature but serves as a pension scheme distinct from traditional taxes**. When individuals to contribute to NI, they do so with the understanding that these payments will be returned in the form of a pension upon reaching retirement age. Unlike taxes, where payment does not entail legal entitlement to benefits, **NI contributions carry an expectation of future return**.

Taxation, in contrast, represents a compulsory contribution to the state's revenue without legal expectations for reciprocation. Payment of taxes does not confer specific rights or entitlements under the law. The legal framework surrounding taxation positions it as a mandatory obligation imposed by governmental authority, with non-compliance potentially leading to penalties, including imprisonment. Thus, paying NI remains **OPTIONAL**.

Legal scholar **Austin** characterised taxation as **a compulsory levy imposed by political superiors upon political inferiors, reflecting its universal imposition on citizens**. Failure to fulfil tax obligations can result in legal consequences, highlighting its mandatory nature.

Taxation serves the public interest by funding essential services such as education and healthcare in democratic societies. However, in some instances, tax revenues may be allocated to less noble purposes, underscoring the nuanced relationship between taxpayers and government expenditure.

While tax evasion is universally condemned, it is important to distinguish it from theft legally. Tax evasion, though wrongful, involves a different legal offence than theft, as it **does not entail the misappropriation of another's property**.

Tax Law

Tax Law falls under the umbrella of **Public Law** due to its central focus on the **relationship between individuals and the State**. However, it also encompasses elements from various other legal domains, such as **Criminal Law** and **Administrative Law**, with an increasing prominence of the former in recent times. Additionally, Tax Law intersects with **International Law**, both **public** and **private**, among others, demonstrating its interdisciplinary nature and its ability to permeate into different legal spheres, including **Family Law**.

For instance, consider the case of drug trafficking. While proving someone's involvement in drug trafficking can be challenging, demonstrating tax evasion is comparatively more straightforward. Authorities can scrutinise an individual's lifestyle and assets, questioning the source of their income. Failure to provide a satisfactory explanation can lead to charges of tax evasion, which are often easier to substantiate. Consequently, prosecutions for tax evasion are not uncommon due to this relative ease of proof.

Moreover, tax considerations frequently arise in matters of Family Law, such as during separation agreements. Understanding the implications of taxation is crucial for lawyers advising clients in such situations. Without a solid grasp of taxation principles, legal advice may be incomplete or inaccurate, underscoring the importance of a foundational understanding of Tax Law for legal practitioners.

Income Tax

Regulated by the Income **Tax Act (Cap. 123)**, this legislation was first introduced in **1948** and has since undergone frequent amendments, typically coinciding with annual Budget revisions. Initially conceived as a tax on income, specifically profit, it targeted not only affluent individuals and business owners but also employees who generated profits. The underlying principle was clear: if you earned no profit, you owed no tax, with the aim of providing social security.

Over the years, the scope of the Income Tax Act has expanded significantly. **In 1993, it was broadened to encompass taxation on capital gains, as stipulated in** Art. 5.

The **2006 Amendments** extended its purview to **include property transfers tax**, delineated in **Art. 5A**. Consequently, the Act now encompasses **three distinct taxes**: **income tax on earning**s, **income tax on specific capital gains**, and **property transfer tax**.

Navigating the complexities of income tax law extends beyond Cap. 123 alone. The administrative framework is outlined in the **Income Tax Management Act (Cap. 372)**, supplemented by various legal notices constituting subsidiary legislation. Additionally, judicial rulings and guidelines elucidate the law, though not all judgments are publicly available due to official secrecy obligations. Thus, the Income Tax Act encompasses a broad and intricate legal landscape, requiring comprehensive understanding and expertise.

Value Added Tax (VAT)

Regulated by the **Value Added Tax Act (Chapter 406)**, this tax legislation was enacted in **1998**. Value Added Tax (VAT) differs from income tax, operating as **a levy on the supply of goods and services rather than on income**. Sellers and service providers act as intermediaries or tax collectors, charging VAT on their supplies and remitting it to the Commissioner for Revenue, with the ultimate burden falling on the final consumer or buyer.

By way of definition, VAT is a **consumption tax** that **applies generally to transactions carried out by taxable persons for the purposes of their economic activities and is intended to tax only the final consumer**. It is also characterised by the **principle of neutrality** which applies to the imposition of the tax and which also entails that there is in principle a right of deduction.

Thus, the **deduction system is meant to relieve the trader entirely of the burden of VAT in respect of all his or her transactions, which themselves give rise to the right to deduct**. Local and EU Courts have frequently pointed out that **the right to deduct (and, therefore, the right to the refund of VAT paid) forms an integral part of the VAT mechanism and in principle CANNOT be limited**. It is also crucial to point out that VAT is the **most non-discriminatory form of tax collection**, because it does not take heed of anyone's income or expenditure, and treats all consumers equally – thus extracting the same portion of money from anyone, regardless of their fiscal status.

The introduction of VAT in 1997 and 1998 sparked considerable debate and even influenced a change in government. As a tax of the European Union, **VAT is harmonised across member states**, applied uniformly to supplies of goods and services. It constitutes a consumption tax, with consumers bearing the ultimate cost. Therefore, VAT is effectively paid by all consumers through purchases, with the revenue collected by the Maltese government.

VAT, initially introduced by a **Nationalist government in 1995**, underwent significant changes in **1997** when the newly elected Labour government under ex-Prime Minister **Alfred Sant** implemented a new taxation system known as **CET**. However, VAT was subsequently reinstated by the Nationalist government upon its re-election in September **1998**.

The VAT Act of Malta aligns with the **EU VAT Directive**, providing member states with certain flexibilities in establishing VAT rates while adhering to overarching harmonisation principles. Consequently, although specific rates may vary, the fundamental structure of VAT remains consistent across EU member states.

Duty on Documents & Transfers

This tax is commonly referred to as **'stamp duty'**, and it operates as a **transactional levy**. When engaging in certain transactions, such as purchasing immovable property or shares, individuals are required to pay **duty on the associated documents and transfers**.

Traditionally, stamp duty involved the **affixing of a physical stamp to documents**. **Notaries** historically managed this process, with old contracts often bearing stamped markings denoting the payment of tax. Initially, this involved purchasing stamps through the postal services, which were government-operated at the time. Over time, the procedures for paying stamp duty evolved, moving towards physical document stamping at designated departments.

In the context of property transactions, **notaries have the responsibility, alongside collecting income tax, to collect duty on documents and transfers**. Typically, this tax burden falls on the buyer, as it is considered an expense associated with the contract. Buyers are generally responsible for covering all expenses related to the contract. Thus, it could be asserted that **a notary is a tax collector**.

The Income Tax Act

The Maltese Income Tax Law is distinct and operates within a broader constitutional and administrative framework. Breaches of the Maltese tax system are treated as acts of **fraud** and **evasion**, with numerous provisions carrying penal consequences. These provisions must be interpreted and enforced in accordance with the safeguards of due process, akin to principles applied in criminal law contexts.

Additionally, the Maltese tax system incorporates **general principles of law**, including **customary principles of international tax law**. These principles serve as integral components of the system, influencing its interpretation and application. Thus, the Maltese Income Tax Law operates within a comprehensive legal framework that encompasses constitutional, administrative, and international legal norms.

Sources of Income Tax Law

The primary legislative sources governing taxation in Malta are the **Income Tax Act (Cap. 123)** and the **Income Tax Management Act (Cap. 372)**. Both acts grant **authority to the Minister of Finance to establish subsidiary regulations** complementing the provisions outlined within.

The Income Tax Act (ITA) outlines **substantive rules governing various aspects of taxation**, including **taxable profits**, **jurisdiction to tax**, **deductions**, **exemptions**, **tax rates**, **taxable receipts**, and **taxable persons**.

Conversely, the Income Tax Management Act (ITMA) serves as the **administrative arm of the legal framework**, delineating rules pertaining to **judicial review** and **fundamental tax compliance obligations**.

In practice, the Income Tax Act encompasses **3 distinct taxes**:

1. **Tax on Income** (**Art. 4**), which has been in force since **1948** and serves as the cornerstone of the tax system.
2. **Tax on Capital Gains** (**Art. 5**), supplemented by subsidiary legislation such as the Capital Gains Rules.
3. **Property Transfers Tax**, introduced in **2006** through **Art. 5A**.

Thus, within the Income Tax Act, one encounters three separate tax regimes, each governed by its specific provisions: Article 4 for Income tax, Article 5 for Certain Capital Gains tax, and Article 5A for Property Transfers tax.

The Taxation on Income

Art. 4 of the Income Tax Act (ITA) outlines the various sources that constitute income for taxation purposes:

- **Profits derived from a trade**, **business**, **profession**, or **vocation**;
- **Earnings from employment** or **holding an office**;
- **Dividends**, **premiums**, **interest**, or **discounts**;
- **Pensions**, **charges**, **annuities**, or **annual payments**;
- **Rental income**, **royalties**, **premiums**, and **any profits generated from property ownership**;
- **Any other gains not explicitly mentioned above**, covered under a **catch-all clause**.

Art. 4 presents a **non-exhaustive definition of income**, offering a descriptive overview of taxable sources. Furthermore, **Art. 4 (1) (g)** serves as a **blanket provision**, encompassing "***any other income***" not specifically enumerated in the preceding sections. As such, income, regardless of its nature or classification, falls within the purview of taxation due to the inclusive provisions outlined in the law.

Taxation on Certain Capital Gains

Art. 5 of the Income Tax Act (ITA) is pivotal in **regulating capital gains**, outlining the tax treatment of such gains, including the **identification of chargeable assets, allowable deductions and exemptions**, and **various computational rules**.

While all income is subject to taxation, **only capital gains arising from the disposal of taxable assets trigger taxable capital gains**. Therefore, it is essential to distinguish between Art. 4 and Art. 5 of the ITA.

Art. 5 specifies that **capital gains tax is applicable when there is a transfer or assignment of rights over certain capital assets**. The law provides an **exclusive list** of chargeable assets, including **immovable property**, **securities**, **goodwill**, **trademarks**, **tradenames**, **beneficial interests in a trust**, as well as **instances involving value shifting and de-grouping**.

Unlike income, **NOT all capital gains are taxable**, but **only those falling within the specified list of chargeable assets outlined in Art. 5**.

For example, if someone inherits immovable property and subsequently sells it, resulting in a capital gain, they are liable to pay capital gains tax. However, if they also inherit a collection of valuable watches and sell them for a profit exceeding the value of the property, the sale of the watches would not incur a taxable capital gain. This is because watches are not included in the list of chargeable assets specified in Art. 5.

Therefore, the individual would only be taxed on the property sale, assuming it qualifies as a capital asset rather than income.

Property Tax Transfers

__Art. 5A of the Income Tax Act (ITA)__ pertains to **Property Transfers Tax (PTT)**, which concerns the **transfer of immovable property located in Malta**, including any associated rights over such property.

Unlike capital gains tax, **Property Transfers Tax operates as a turnover tax rather than a tax on profit**. It is specifically applicable to transactions involving the transfer of immovable property within Malta. Importantly, Property Transfers Tax and Capital Gains Tax are mutually exclusive, meaning they cannot both be applied to the same transaction.

By default, Property Transfers Tax is applicable, but there are circumstances established by law where individuals have the option to **opt ou**t of PTT and instead be subject to the capital gains tax rules for the transfer. This provides flexibility in taxation for certain property transactions, allowing individuals to choose the most advantageous tax treatment based on their specific circumstances.

The opt-out system may apply to **transfers occurring within 7 years of acquiring immovable property**, provided the transferor explicitly declares the exclusion of property transfer tax in the deed of transfer. Secondly, it encompasses **transfers within special designated areas if the transferor was the property owner at the area's initial designation**, with a declaration excluding property transfer tax. Thirdly, it extends to **transfers between co-owners for the purpose of establishing their sole ordinary residence**, contingent upon a declaration excluding property transfer tax.

Additionally, it includes **property expropriated by the Government of Malta and certain business property transfers**. Specifically, the latter involves the replacement of business property within one year with new property solely for business use, with a declaration excluding property transfer tax, subject to specific conditions such as the continuous business use of the replacement property for at least 2 years.

The law provides for **automatic opt-out of property** transfer tax in 2 specific scenarios: **during a transfer of immovable property through judicial sale by auction** or in the course of a **winding up by the Court**. Additionally, there are two other situations where opting out of property transfer tax is not solely dependent on the choice of the transferor, but rather relies heavily on specific conditions:

1. If the **transfer of property is executed by a non-resident** individual in Malta who is a tax resident in another country, the **opt-out is triggered when the transferor submits a statement signed by the tax authorities of their country of residence**. This statement confirms both the individual's residency status and their obligation to pay tax on gains or profits derived from the transfer of immovable property in Malta.

2. In cases where the **transfer of property occurs after November 1st, 2005**, pursuant to a **lease agreement entered into before that date**, and the **agreement includes an option to purchase the property at a pre-agreed price**, the opt-out from property transfer tax is applicable.

Taxable Receipts

Chargeable Income

Taxable persons are liable to pay tax on their **chargeable income**, as defined in **Art. 2 of the Income Tax Act (ITA)** as "***the total income of any person for one year***." In essence, chargeable income encompasses all income and certain capital gains, after accounting for specific exemptions and deductions as outlined in the provisions of the ITA. Consequently, the ITA imposes taxes on all income, certain capital gains, and transfers of immovable property situated in Malta.

Although both types of receipts are reported in the same tax return, it is crucial to distinguish between the processes involved in determining taxable income and taxable capital gains for various reasons:

a. **Determining Tax Liability**: While all gains of an income nature are generally taxable, only capital gains resulting from specific transfers listed in Article 5(1)(a) of the ITA are subject to taxation.

b. **Computational Purposes**: The methodologies used to determine taxable income for income tax purposes differ from those used for assessing taxable capital gains.

c. **Exemptions & Deductions**: Certain exemptions and deductions are applicable exclusively to capital gains.

d. **Treatment of Losses**: The tax treatment of revenue losses differs from that of capital losses.

e. **Jurisdictional Rules**: Distinctions are made between gains of a capital nature and those of an income nature, particularly concerning the taxability of income arising abroad to individuals domiciled but not ordinarily resident in Malta.

Therefore, distinguishing between income and capital gains is crucial due to variations in taxability and computation methods. While all income is generally taxable, only specific capital gains are subject to taxation, with different rules governing exemptions, deductions, treatment of losses, and jurisdictional considerations for each category.

Capital, Income, and Capital Gains

In Malta, where capital itself remains untaxed and income is the focus of taxation, IT IS essential to differentiate between receipts of a capital nature and those of an income nature.

The defining characteristic of capital is its permanence; it remains **static**. Conversely, **income is characterised by its recurring and circulating nature**. When capital is put to use, it has the potential to generate income. **Silke's** perspective, often cited by our courts, elucidates that **revenue or profit derived from a property or asset without changing ownership is typically considered income rather than capital**.

For instance, proceeds from the disposal of a revenue-generating asset constitute a capital gain, while payments generated from utilising capital represent income. Our courts frequently refer to British case law, particularly the doctrine of badges of trade, which establishes presumptions regarding the presence or absence of trade. If a trade exists, the returns from such activities are considered income rather than capital gains. However, this determination must be made on a case-by-case basis.

To distinguish between income and capital gains, consider the analogy of fruit and tree: income is akin to the fruit, recurring and derived from capital, while capital gain represents the tree itself, static and subject to occasional transfer. The application of badges of trade, originating from English law, aids in this distinction, offering a framework for analysis.

CASE LAW: ***BSC 23/02***
The BSC rendered a significant decision regarding **badges of trade** here, which is considered one of its notable rulings. In this case, the Board employed various badges of trade to determine that the company's activities involving immovable property constituted ventures resembling trade, thereby **categorising the income derived from these activities as of an income nature**. Several badges of trade were considered by the Board, including the interval of time between purchase and resale, additional work carried out on the properties, and the organizational structure of the business. Additionally, the Board placed significance on how the asset was recorded in the company's accounting records. Notably, the classification of an asset as trading stock indicates that profits arising from its sale are of a trading nature. **This decision underscores the importance of analysing various factors, or badges of trade, to discern whether transactions constitute trading activities or not, thereby influencing the tax treatment of income derived from such transactions**.

CASE LAW: ***Rutledge v. CIR***
Commonly referred to as the **Great Toilet Paper case** due to its involvement with the purchase and sale of toilet paper. In this case, Rutledge, an international entrepreneur, seized an opportunity to acquire stocks of toilet paper from a company on the brink of bankruptcy, purchasing them at significantly reduced prices. He then resold these stocks in bulk, generating substantial profits. However, Rutledge did not declare this profit in his tax return, claiming it to be a capital gain. The Inland Revenue disagreed, asserting that the **profit constituted trading income**. To resolve this dispute, the Court introduced the concept of badges of trade, which serve to differentiate between income and capital gains. The key question was whether the profit derived from the sale of toilet paper constituted a capital gain or trading income, and whether identifiable badges of trade were present in the transaction. The Court concluded that the **toilet paper stocks were trading stock rather than capital assets**. One crucial badge of trade evident in this case was the nature of the goods involved – toilet paper. Rutledge did not purchase the toilet paper for personal use; it was acquired solely for resale. The nature of the goods, coupled with the large quantity involved, indicated a trading activity rather than a capital investment. These badges of trade act as **symptoms**, aiding in the identification of trading activities.

Badges of Trade

1. Supplementary Work

CASE LAW: ***Martin v. Loriee***
In this British case, which serves as another example of badges of trade in action, a British individual purchased a **military vessel and transformed it into a fishing trawler before selling it for a profit**. By undertaking supplementary work to convert the asset, he **changed its nature**, a significant badge of trade.

Similarly, in Malta, **this badge of trade is frequently applied in property cases**. For instance, consider a case where a husband convicted of murdering his wife, while in prison, married a prison warden he met, intending to establish a new home with her elsewhere. Unsure what to do with his property in Marsaskala, he eventually decided to convert the villa into units and sell them individually. When reporting this transaction, he declared the profit as a capital gain, but the Inland Revenue disputed this, arguing it was income.

The determining factor in such cases is whether there was a profit-seeking motive. In this instance, the original intention was not to trade but to reside in the property. Despite the presence of the important badge of trade indicating supplementary work, the Tribunal ruled that the absence of other badges of trade, coupled with the unique circumstances of the case, led to the conclusion that no trade had occurred.

It is noteworthy that the Revenue did not appeal the decision in ***Martin v. Loriee***, indicating that the specific circumstances influenced the outcome.

Moreover, **badges of trade are NOT cumulative**; they are merely **indicators**, and each case is subject to its own judgment. Despite the presence of a significant badge of trade, the Tribunal concluded that a trade had not taken place in this particular case.

Let us consider an example: Suppose I am a lawyer, and I have owned a collectable car for 20 years. When I eventually sell it, I make a profit. Is this profit classified as income or a capital gain? Since the car was purchased for personal use and was owned for many years, the profit from its sale is not subject to tax.

Now, let us imagine a car dealer purchases the same car, sells it, and makes a profit. Would the car dealer be subject to tax? In this scenario, the profit would indeed be taxable income. Several badges of trade are evident here, including the organisation of the business and a profit-seeking motive. Additionally, a crucial factor is the interval of time between purchase and resale: if the car dealer sells the vehicle immediately after purchase, as is often the case, this short interval indicates a trading activity. Therefore, the profit generated by the car dealer from the sale of the car would be taxable income.

2. Incidence of Transactions

The frequency of transactions is another significant badge of trade. While the lawyer bought and sold the car as a one-off occurrence over 20 years, the car dealer engages in buying and selling cars on a daily basis. Therefore, the dealer's numerous transactions indicate a pattern of regular trading activity.

In summary, the frequency of transactions can serve as a decisive factor in determining whether an individual or entity is engaged in trading activities.

The other strains of badges of trade are the following:

3. **Nature/subject matter of Goods**
4. **Organisation of the business**
5. **Profit Seeking Motive**
6. **Quantity of Goods**
7. **Interval of Time between Purchase and re-Sale**

Classification of Income

Once it is established that a taxable receipt, whether a gain or profit, falls under the classification of income, it must then be further categorised according to the **six categories** outlined in Art. 4 of the Income Tax Act (ITA). This classification is crucial not only for reporting purposes but also because it determines the specific deductions and computational rules applicable to each category.

For instance, certain deductions are only permitted in specific circumstances. Bad debts, for example, can be claimed as deductions only in the context of a trade venture. Similarly, maintenance allowances are eligible for deduction only against rental income.

By sub-classifying taxable receipts according to the categories defined in Art. 4, taxpayers ensure accurate reporting and compliance with the relevant deduction and computational rules applicable to each category of income.

> (1) Subject to the provisions of this Act, Income Tax shall be payable at the rate or rates specified hereafter for the year of assessment commencing on 1st January, 1993 but only with respect to any capital gains made on or after the 25th November, 1992 and for each subsequent year of assessment upon the capital gains as defined in article 5 accruing or derived from Malta or elsewhere, and whether received in Malta or not, and for the year of assessment commencing on 1st January, 1949 and for each subsequent year of assessment upon the income of any person accruing in or derived from Malta or elsewhere, and whether received in Malta or not in respect of […]
>
> **Art. 4**, *ITA*

Trading Income – Art. 4 (1) (a)

Under this article, a **gain is subject to taxation if it arises from an activity of an independent nature, typically indicative of trade**. The determination of whether such activity constitutes a trade is established through the application of badges of trade, which help identify trading activities. It is important to note that trade losses are incurred within the scope of trade ventures.

Furthermore, **gains of a trading nature are subject to specific computational rules outlined in the tax legislation**. Even illegal trades are generally taxable under this article, highlighting the broad scope of taxable activities covered by the law.

CASE LAW: ***Case 34, 1956***
This case ascertained that gains by a gambler are NOT taxable.

CASE LAW: ***Melita Insurance Brokers Ltd. v. Joseph u Margaret Fenech***
"Naturalment, dan ma jfissirx li l-konvenuti ghandhom, minhbba f'ghemil illecitu li kellhom sehem fih huma wkoll, jag]mlu qligh gratis, ghax fuq id-dhul ghandhom ihallsu t-taxxa.

Employment Income – Art. 4 (1) (b)

This concept implies the existence of an **employer-employee relationship**, where the employee relies on the employer for their income.

Dividends, Premiums, Interest or Discounts – Art. 4 (1) (c)

Dividends signify a portion of a company's earnings distributed proportionally among its shareholders, typically representing a return on their investment in shares. According to **Art. 2 of the Income Tax Act (ITA)**, the **exhaustive definition** of '*dividend*' encompasses various forms of **distributions**, including bonus shares, distributions made by companies or partnerships, and distributions from cooperative societies to their members.

Garner defines this as "**a portion of a company's earnings**".

This definition is **broad and extends beyond cash distributions**, covering distributions made by partnerships *en commandite*, which have both general and limited partners, and even bonus shares. Additionally, distributions made by liquidators during the winding up of a company, to the extent that they represent company or partnership income, are deemed as dividends for income tax purposes, as outlined in **Art. 47 of the ITA**.

Taxation of dividends essentially taxes profits that have already been taxed at the corporate level, potentially resulting in economic double taxation. However, Malta's full **imputation system** aims to **eliminate double taxation** by allowing for tax credits when profits are distributed from the foreign income account to the Malta taxed account. This system may even entitle individuals to a tax refund on the tax paid by the company.

Premiums are additional sums of money beyond regular payments, akin to bonuses. However, only premiums of a revenue nature are subject to taxation under Article 4 of the tax laws, while those derived from immovable property are exempt.

Discounts, on the other hand, are gains provided to financial institutions upon the maturity of bills of exchange. This represents the discrepancy between the acquisition cost of the bill and the actual amount received upon maturity. Taxation is levied based on the amount stated in the bill of exchange, not the discounted amount at maturity. The tax is applied to the full amount.

Interest pertains to a fee paid by a borrower to the lender for using their assets. The Japanese Bond case clarified that interest income should be taxed only upon receipt. Additionally, interest received from sources outside Malta is taxable in Malta and does not qualify for exemption related to income from participating holdings.

Pension, Charges, Annuities or Annual Payments – Art. 4 (1) (d)

These payments occur on a regular basis.

Pensions, generally, are subject to taxation. They encompass various state pensions such as those for invalidity, disability, injury, unemployment benefits, widowhood, retirement, age, and caregiving, among others. However, Art. 12 (1) (g) and (h) of the Income Tax Act **exempt from income tax certain disability pensions arising from war-related causes and pensions granted to dependent relatives of Commonwealth armed forces members killed on war service**. Additionally, exempt from taxes are state pensions like social assistance, age pensions, marriage grants, children's allowance, and foster care allowance.

Regarding annuities and annual payments, these denote income-based annuities, not those related to capital.

CASE LAW: *Case 17, 1950*
Here, it was affirmed that **an annual payment mandated on a legatee as a condition for inheriting the family business constituted an income-based annuity and thus, taxable**.

Annuities are typically taxable, except when they are for a fixed period or comprise instalment payments of a predetermined capital sum. For instance, when an individual purchases an annuity ensuring a specified income until death, it is considered a straightforward sale by instalments.

Alimony payments are sums provided to a separated spouse by the husband as stipulated in separation agreements.

CASE LAW: *Case 55, 1964*
Here, the **Courts affirmed that alimony payments made by a husband to his estranged wife were considered income and subject to taxation akin to an annuity**. These payments are taxable for the recipient. However, a challenge arises from the lack of a defined term within the Income Tax Act (ITA), as the Civil Code employs the term "**maintenance**." Thus, a crucial question emerges: ***should these terms be interpreted as interchangeable***?

Rents, Royalties, Premiums and any other Profits arising from Property – Art. 4 (1) (e)

Rents encompass both lease and emphyteusis agreements. Rental income falls under this provision and is taxable, provided it is not of a trading nature. For instance, an individual renting out a holiday flat must declare their rental income in their tax return. **However, those engaged in property leasing as a business must report rents received as trading income under Art. 4 (1) (a) of the Income Tax Act (ITA), NOT Art. 4 (1) (e)**. This distinction is crucial for **computational purposes**.

Royalties can be classified into **2 categories**: **recurring royalties**, such as those paid for the use of a trademark or patent, and **royalties paid upon the outright transfer of an intellectual property right**.

Recurring royalties are taxable under Article 4 (1) (e) as they constitute income. Conversely, royalties derived from the transfer of intellectual property rights represent capital gains and are taxable under Art. 5. In essence, royalties denote payments made to an author or inventor for each copy of a work sold under a copyright or patent.

Gains or Profits NOT Falling Under any of the Foregoing Paragraphs – Art. 4 (1) (g)

This provision encompasses **all income from property which is of a revenue nature**.

Jurisdiction to Income Tax

This is akin to **Art. 5 of the Criminal Code** in a tax context. Unlike other laws, the Income Tax Act categorises individuals as either **100% Maltese** or **50% Maltese**. Consequently, **some individuals are taxable on their global income**, while others are not.

The regulations governing the jurisdiction of the Income Tax are outlined in **Art. 4 (1) (g) of the Income Tax Act**.

Malta asserts its jurisdiction to tax based on **territoriality**, **ordinary residence**, **domicile**, and **remittance**. Essentially, Malta has the authority to tax:

- Income and taxable capital gains **arising within Malta**.
- Income and taxable capital gains **arising abroad for individuals who are ordinarily resident and domiciled in Malta**.
- **Foreign source income received in Malta by individuals who are ordinarily resident but NOT domiciled in Malta**.
- **Foreign source income received in Malta by individuals who are NOT ordinarily resident but are domiciled in Malta**.

Individuals who are **both ordinarily resident** and **domiciled** in Malta are subject to **unlimited or full liability for taxation**. Conversely, individuals who are **either NOT ordinarily resident** or **NOT domiciled in Malta** are subject to **limited liability**.

Hence, it is crucial to understand the basic rules outlined in Art. 4. **Income and chargeable gains originating in Malta are always subject to taxation in Malta, regardless of the individual receiving such income**. However, for **foreign source income and capital gains**, **the tax liability depends on the individual's level of connection to Malta**. Individuals who are both ordinarily resident and domiciled in Malta are taxed on their worldwide income. But individuals who are either not ordinarily resident or not domiciled in Malta are not taxed on worldwide income. **Instead, they are subject to tax on a remittance basis**.

For foreign source income, individuals who are **either NOT ordinarily resident** or **NOT domiciled in Malta** are **taxed in Malta only if they physically receive their foreign source income in Malta. If the income is received outside Malta, it is NOT subject to tax in Malta**. Additionally, these individuals are not subject to tax on their foreign source capital gains.

In sum therefore, the tenet of **Fiscal Jurisdiction** connotes that the point of departure is that income and chargeable gains arising in Malta are always taxable in Malta.

Temporary Residents

Art. 13 of the Income Tax Act outlines a special regime for individuals termed as temporary residents. These individuals are **neither ordinarily resident nor domiciled in Malta but spend a short period in the country**.

To qualify as temporary residents, individuals must meet all three criteria:

1. They are **physically present** in Malta for **less than 183 days**.
2. Their presence in Malta is for a **temporary purpose only**.
3. They **do not establish a permanent residence or home in Malta**.

Temporary residents are only taxed on income generated within Malta. They are not taxed on foreign source income, even if received in Malta, and are exempt from tax on their foreign source capital gains.

Agricultural, Manufacturing and other Productive Undertakings

Art. 4 (3) of the Income Tax Act outlines special jurisdictional rules concerning the income of certain undertakings. According to the general rule, **income earned by these undertakings from selling products grown or produced in Malta in a wholesale market is taxable in Malta**. This applies even if the wholesale market is located outside Malta or if the sales contract is executed abroad.

However, there is an **exception** to this rule stated in the proviso to the article. This **exception applies when the Commissioner determines that profits have been increased due to treatment of the product outside Malta, excluding handling, grading, blending, sorting, packaging, or disposal**. In such cases, the **increase in profits attributable to the foreign activity is NOT subject to Maltese tax**. Therefore, if treatment abroad significantly enhances the marketability of products grown or produced in Malta, income derived from the profit related to the foreign activity is exempt from Maltese tax liability.

Shipping & Air Transport

Art. 28 of the Income Tax Act includes specific provisions concerning profits generated from transporting passengers, mails, livestock, or goods by non-resident shipowners. According to these rules, **profits earned by non-resident ship owners from such activities are subject to taxation in Malta when Malta serves as a port of call**.

Additionally, **Act I of 2010** introduced **Art. 29 (2) to the Income Tax Act**. This article stipulates that **income earned by an owner, lessor, or operator of one or more aircraft or aircraft engines, engaged in international passenger or goods transportation, is considered to arise outside of Malta**. This is the case regardless of whether the aircraft has made calls at or operated from any airport in Malta.

Income Arising in Malta

Income and capital gains originating in Malta are subject to taxation in Malta regardless of the status of the recipient, whether they are a non-resident, non-domiciliary, or temporary resident.

In determining the source country of income, Malta tends to adhere to the **British doctrine** of "***trading in***" versus "***trading with***." This doctrine asserts that **income with a substantial link to a jurisdiction is considered "trade in" income and is taxable in that jurisdiction**, while **income with a weak connection is categorised as "trade with" and is not taxed in that jurisdiction**.

For international transactions, the Commission of Inland Revenue follows specific guidelines to ascertain whether income is deemed to arise in Malta:

- **Income from immovable property** in a particular state is considered to **arise in that state**.
- **Income from services performed physically** within a state is deemed to **arise in that state**.
- **Passive income such as dividends**, **royalties**, and **interests** is considered to arise in the country **where the payer resides**.
- Income from **intangible property rights** is deemed to arise in the **country where those rights are exploited**.
- **Revenue from the sale of tangible property** is considered to arise **where the asset is situated and where the sale legally takes place**.
- **Employment income of sportsmen** and **artists** is deemed to **arise in the location where their work is performed**.

The **activities test** is also significant, stipulating that **earned income arises in the country where the activities generating the income are physically conducted**. This principle ensures that income is taxable in the country where it is generated.

Ultimately, income is deemed to arise in Malta when the activities generating the income are carried out within Malta. Additionally, **income from a contract is subject to taxation in Malta if the contract is executed within Maltese territory**.

The Income Tax Act defines "**Malta**" as encompassing the **Island of Malta**, the **Island of Gozo**, and **other islands within the Maltese Archipelago**, including their **territorial waters and the continental shelf**. This definition clarifies the geographic scope within which income is subject to Maltese taxation.

Ordinary Residence

The concept of ordinary residence in Maltese tax law has been influenced by **British legal decisions** rather than being solely derived from Civil Law principles. While the Income Tax Act (ITA) **does NOT explicitly define** "**ordinary residence**," it does define "**resident**," with the understanding that **being a resident does NOT necessarily equate to being ordinarily resident**.

Ordinary residence entails more than mere physical presence; it implies a **continuous presence in a place that forms part of an individual's everyday life**. This distinction is determined through legalistic considerations of facts and circumstances.

Two tests are commonly used to establish ordinary residence:

A **physical presence test,** which considers the **duration**, **regularity**, and **frequency** of an individual's stays in a country.

AND

A **facts and circumstances test**, which evaluates **family** and **business ties**, the **nature of visits to a country**, and other relevant factors.

To be considered ordinarily resident in Malta, an individual must ***either***:

- **Spend more than 183 days** in Malta in a calendar year, or
- **Average more than 90 days** per calendar year in Malta **over a 3-year period**.

Moreover, individuals with a fixed and regular presence in Malta, visiting regularly year after year, may also be deemed ordinarily resident in Malta.

Domicile

Domicile is a legal concept deeply rooted in **Common Law**, governing personal matters such as inheritance and marriage. It serves as a "guardian angel" of sorts, **following individuals wherever they go and dictating the legal framework that applies to them in various personal affairs**.

Unlike residence, which can change frequently based on physical presence, **domicile is more enduring and permanent**, **reflecting a person's long-term connection to a particular legal jurisdiction**. This concept of domicile plays a crucial role in determining an individual's tax liability, particularly in cases where the person may be subject to taxation in multiple jurisdictions due to their global financial interests or frequent international travel.

<u>CASE LAW</u>: ***Commissioner for Inland Revenue v. Duchess of Portland***
In this case, 'domicile' was described as "**a physical presence in a country as an inhabitant of it**."

Domicile is a singular and foundational concept in legal terms, distinct from mere residence. At birth, an individual acquires their **domicile of origin**, typically from their **father**, and if that is not ascertainable, **from their mother or the place where they are found**. This **domicile of origin persists throughout life** unless supplanted by a **domicile of choice**.

Changing one's domicile involves both **physical presence** and a **clear intention** to permanently reside in a new jurisdiction, known as ***animus manendi et non rediendi***. Essentially, if you leave your domicile of origin with no intention of returning, and establish yourself in a new place with the intent to make it your permanent home, your domicile changes. It is not merely about physical presence but also about the state of mind regarding where one intends to live permanently.

<u>Dicey</u> and **<u>Morris</u>** offer succinct principles on residence and domicile:

- **Residence** entails more than mere physical presence; it **involves being an inhabitant of a country rather than a mere visitor**.
- An **individual can acquire a domicile of choice by both residing in a country** AND **having the intention** of permanent or indefinite residence there.

Moreover, various circumstances indicating residence or the intention to reside permanently should be considered when determining if an individual has acquired a domicile of choice in a particular country.

Gaines-Cooper v. R & C Commrs, 2006

This landmark judgement, whilst piecing out how to award a justiciable verdict, established various definitions pertinent to this topic of jurisdiction.

1. **Domicile**

In determining domicile, the court considered the totality of evidence, including events postulated after the purported acquisition of domicile. **Residence**, in this context, referred to **physical presence as an inhabitant**.

In cases **where an individual resided in two countries**, all facts were scrutinised, with **emphasis placed on the principle that one could only acquire a domicile of choice in a new country if it was their primary residence**. This required both **physical presence** AND the **intention of permanent and indefinite residence** — a commitment to make the new country their home, establish themselves and their family there, and spend their remaining days in that location.

In the case at hand, the **evidence did not support the conclusion that the Seychelles was the taxpayer's primary residence**. England remained the focal point of his life and interests, indicating that his chief residence was there. Furthermore, **there was no evidence of an intention for permanent and indefinite residence in the Seychelles**, nor any determination to establish himself and his family there permanently.

The Court also shed emphasis on the **persistent nature of domicile of origin**, noting its strong adherence to an individual. Despite the fact that Cooper had leased out his residence in the UK at one point, the Court concluded that **his primary residence still remained in England**. His **enduring ties to England made it clear that he had not acquired a domicile of choice in the Seychelles**. Consequently, the taxpayer failed to prove that he abandoned his domicile of origin in England.

2. **Residence**

The pertinent legislation did not provide a specific definition of "residence," thus requiring the term to be interpreted according to its natural and ordinary meaning. "***Residence***" and "***to reside***" were understood **as dwelling permanently or for a significant period**, having **one's settled or usual abode**, or **living in a particular place**. Determining whether an individual was resident in the UK was a factual matter for the special commissioners to decide. No statutory duration was prescribed, necessitating consideration of all relevant facts, including the duration of the individual's presence in the UK, the regularity and frequency of visits, as well as birth, family, and business ties.

The availability of living accommodation in the UK was a relevant factor, although subject to certain provisions. The presence of a home elsewhere held no significance; an individual could reside in two places, but if one of those places was the UK, they were liable to tax there.

Despite the taxpayer's belief that he was resident in the Seychelles, the **circumstances indicated that he resided in both the UK and the Seychelles**. Therefore, under general principles, he was **deemed resident in the UK**.

3. **<u>Temporary Purpose</u>**

The phrase "temporary purpose" was interpreted according to its natural meaning, signifying a **casual purpose distinct from habitual activities**. In the case at hand, the **taxpayer's visits to the UK did NOT serve a limited duration**; they were part of his permanent lifestyle rather than transient or occasional. **His presence in the UK was not prompted by passing needs but aligned with his regular habits**, indicating a permanent purpose rather than a temporary one. The mere brevity of the visits did not automatically classify them as temporary.

The second requirement was the **absence of an intention to establish residence in the UK**. Evidence showed that **the taxpayer lacked a subjective intention to establish UK residence for tax purposes and took measures to avoid meeting residency criteria**. However, this subjective lack of intention **did not negate the objective fact of residence**. As both requirements — temporary purpose and absence of intention to establish residence — were considered **cumulative**, and the taxpayer was found not to be in the UK for a temporary purpose, the **exemption in the law did NOT apply**.

4. **<u>Ordinary Residence</u>**

The notion of "ordinary residence" implies a **habitual presence in a location**, forming part of **one's regular life**. In the scenario at hand, the **taxpayer's residency in the UK during the assessment years was ongoing, extending from year to year**. This residency was considered **ordinary**, even though the taxpayer's lifestyle might be considered extraordinary by some standards. Additionally, even if there were isolated years when the taxpayer was not physically present in the UK, he would still be deemed ordinarily resident there due to the continuous nature of his residency.

Ordinary Residence & Domicile of a Body of Persons

In the realm of legal entities, such as companies, the distinction between residence and ordinary residence becomes less clear-cut. Unlike individuals, **companies lack personal ties, families, or habitual living arrangements**. Therefore, the definition of residence provided in <u>Art. 2 of the Income Tax Act (ITA)</u> is essentially **understood to represent the concept of ordinary residence for companies under <u>Art. 4 of the ITA</u>**.

When applying the concept of ordinary residence to a company, it draws from Common Law principles, as established in landmark cases like the ***Egyptian DELTA*** case and the ***Cesena Sulphur*** case. These cases elucidated that **the residence of a company is determined by where its board of directors convenes and conducts its managerial and decision-making activities**.

Art. 2, ITA

Art. 2 of the Income Tax Act (ITA) encompasses both the **Incorporation Test** and the **Management and Control Test**.

According to the **Incorporation Test**, **any company established under Maltese law is automatically regarded as a resident of Malta for tax purposes**.

For companies incorporated **outside of Malta**, the law employs the **Management and Control Test**. This test stipulates that **a company incorporated abroad is deemed a resident of Malta if its management and control operations are carried out within Malta**. In other words, if the key decision-making processes and strategic management of the company occur within Malta, it is considered a resident company for tax purposes.

Management & Control

The concept of management and control originated outside the scope of taxation in the **UK**. It emerged primarily within the legal domain to determine the jurisdiction of British courts over foreign companies. By establishing where a company's management and control are located, courts could ascertain whether the company fell under their jurisdiction for legal matters. This concept later found application in taxation to determine the tax residency status of companies.

CASE LAW: ***Calcutta Jure Mills Co Ltd v. Nicholson***
This decision forms the **basis of the common law notion of management and control**. The **Court held that a company is resident where the company's real business is carried out, where the company's central management and control is found**. "The use of the word 'residence' is founded upon the habits of a natural man and is therefore inapplicable to the artificial and legal person whom we call a corporation. But for the purpose of giving effect to the words of the legislature an artificial residence must be assigned to this artificial person, and one formed on the analogy of natural persons. There is not much difficulty in defining the residence of an individual; it is where he sleeps and lives... when you deal with a trading corporation it means the place not where the form or shadow of business, but where the real trade and business is carried on... There is a German expression applicable to it which is well known to foreign jurists – der Mittelpunkt der Geschafte; and the French term is *le centre de l-enterprise'*, the central point of the business."

In this case, the **Court rejected the Incorporation Test**, saying that **it was merely a factor to be taken into account**, and therefore, not a determining factor:

“Registration, like the birth of an individual, is a fact which must be taken into consideration in determining the question of residence. It may be a strong circumstance, but it is only a circumstance. It would be idle to say that in the case of an individual the birth was conclusive of the residence. So, drawing an analogy between a natural and an artificial person, you may say that in the case of a corporation the place of its registration is the place of its birth, and is a fact to be considered with all the others. If you find that a company which is registered in a particular country, acts in that country, has its office and receives its dividends in that country, you may say that those facts, coupled with the registration, lead you to the conclusion that its residence is in that country.”

The court's ruling underscores the significance of where the real and substantial business activities of a company are conducted. Here, the **court emphasised that the location where the directors make critical decisions and hold meetings is crucial in determining the company's centre point**. Despite manufacturing operations occurring in Italy, the **administrative part of the business conducted by the directors in London was deemed as the main place of business**. This highlights the importance of the administrative hub in establishing the company's canter of operations.

<u>CASE LAW</u>: ***Swedish Central Railway Company v. Thompson***

This case highlighted the principle that **the determination of a company's residence for tax purposes hinges on substance rather than form**. Even if a company's board of directors holds meetings in different locations, including abroad, factors such as the location of the company's seal, bank account, transfer books, and administrative functions can be pivotal in determining its residence. Moreover, the case law clarifies that a company can have more than one residence for tax purposes.

In situations where decision-making authority is vested in a body other than the board of directors, such as the shareholders, **the location where this decision-making body convenes becomes paramount**.

<u>CASE LAW</u>: The ***Bullock*** Case

This principle was also underscored here, where the **courts emphasised that the essence of management and control lies in where the actual decisions are made, irrespective of the formal designation of the decision-making body**. Therefore, if shareholders, rather than directors, are the ones making decisions, the company's management and control are deemed to reside where the shareholders convene, regardless of the nomenclature used for the decision-making body.

CASE LAW: ***Regina v. Dimsey***
This case illustrated the principle of **substance over form** in tax residency determination and highlights the consequences of attempting to evade taxes through profit shifting. Despite the formalities indicating that the revenue-generating asset was owned by a company incorporated in a tax haven with non-UK directors and operations, the crucial factor was the actual control and decision-making process, which was traced back to the UK resident entrepreneur. The discovery of faxes from the UK resident giving instructions to the directors in the tax haven exposed the true nature of the arrangement. Despite efforts to conceal the control and management of the company, the courts ruled that the substance of the situation prevailed over the formalities. Since the decision-making and control were effectively exercised from the UK, the company was deemed to be resident in the UK for tax purposes. This case underscores the **importance of transparency** and **honesty** in tax planning and the consequences of attempting to evade taxes through deceptive practices. Tax authorities are vigilant in detecting such schemes and have the authority to investigate and take action against those involved in tax evasion.

Larta BV holds that it **is not an issue to have a nominated Board of directors**, so long as the **decision are *de facto* taken by themselves**, and not by someone else.

Domicile of a Body of Persons

The concept of domicile for bodies of persons differs from that of individuals. **For companies, domicile is primarily determined by the place of incorporation**. A company is considered domiciled where it is **incorporated**, irrespective of where its operations or management take place.

However, **Maltese law introduces exceptions to the general common law rule regarding the domicile of companies**. Companies established in Malta have the option to relocate their base to another jurisdiction, a process known as **re-domiciliation**. Similarly, foreign companies can also be re-domiciled to Malta under certain conditions outlined in legislation such as the **Companies Act**.

This means that **companies in Malta can change their domicile by ceasing to be registered under a foreign jurisdiction and being continued under the Laws of Malta**, and vice versa. These regulations provide flexibility for companies to adjust their domicile based on their operational and strategic needs.

In summary, while the place of incorporation determines a company's domicile, Maltese law offers provisions for companies to change their domicile through re-domiciliation procedures. Additionally, a company's ordinary residence can also be determined by where it is managed and controlled.

Tax Returns

Taxpayers are required to complete a form, with distinct versions for individuals and companies. The individual form, due by **June 30th** for most, is typically simpler.

Positioned in the top **left corner** is the **logo of the Commissioner for Revenue**, the governing body overseeing tax affairs. In the centre, the form is labelled as an **'income tax return'**, while the **right-hand side** prompts individuals to furnish their **contact information** and **ID details**, pre-filled by the Department for accuracy. This section is to be completed only if the provided information is outdated or incorrect. Taxpayers are reminded of their responsibility to update the Department regarding changes in residency to avoid communication issues.

A separate section addresses **marital status**, acknowledging its impact on taxation, historically with biases against women, though recent changes afford them certain rights in filing separately. Options include indicating single, married, in a civil union, or cohabiting (treated akin to married couples for tax purposes), as well as separated, divorced, widowed, or single parent status.

The following section pertains to **residence** and **domicile**, requiring indication of whether one is subject to worldwide taxation or not.

Taxpayers are **legally obligated to sign their return**, and failure to accurately complete it constitutes an offence. **Spouses share joint and several liability** in this regard. Furthermore, if decisions affecting the return are made based on professional advice, such advice must be included with the income tax submission. Moreover, it is vital to remind that only **specific capital gains**, outlined in Art. 5, incur taxation.

The tax return mirrors Art. 4 by requiring **reporting of employment income**, including the disclosure of private employer numbers and gross emoluments. Additionally, income from trade, business, profession, or self-employment must be **declared**, with reference to associated VAT numbers for self-employed individuals.

Within the relevant section, **pensions** are declared, challenging the **misconception of their non-taxable status**. However, pensioners often benefit from specific reliefs and tax concessions, resulting in no tax liability on their state pension. Pre-printed reference numbers streamline the process for pension declarations, aligning with their specific governance.

Expenses are deductible for tax purposes only if they are incurred in a context directly related to revenue generation, establishing a clear cause-and-effect relationship. Examples outlined in the law itself include **salaries**, **wages**, **interest on capital loans**, and **commercial rent**.

Tax Deductions

Within the income tax return, **Art. 14 of the Income Tax Act (ITA)** serves as a guide, providing **examples of deductible expenses**. The return itself mirrors this legal framework, reflecting the stipulations outlined in Art. 14. It is important to acknowledge that the **return also references additional allowable deductions beyond those specified in Art. 14**. The law further delineates these other allowable deductions, presenting a comprehensive list of qualifying expenses for tax deduction purposes.

Pre-trading expenses are also a relevant topic to this particular notion. Pre-trading expenses are those which are incurred **not less than 18 months** before the production of income is being accrued. They are normally **NOT deductible**, unless they pertain to the **cost of advertising**, **salaries and wages of employees**, and **staff training**.

Rules on Deductions

The primary regulations governing **allowable tax deductions for income tax purposes** are outlined in **Art. 14-14H** ITA, as well as **Art. 26 ITA**. Additionally, supplementary legislation provides further guidelines on tax deductions, including:

- The **Deduction for Wear and Tear of Plant and Machinery Rules**
- The Deduction (**school fees**) Regulations
- The **Pre-trading Expenditure Regulations**
- The Donations (**National Heritage**) Rules
- Donations (**Sports and Culture**) Rules
- The Deduction of Expenses in respect of **Immovable Property**

Crucial regulations regarding tax deductions can be found in the Income Tax Deductions Rules **SL 123.07**, which encompasses rules concerning tax deductions for vehicles and emolument deductions.

Tax deductions can be categorised as follows:

- **Expenses incurred in the production of income as per Art. 4 (1) (a) ITA**.
- **Expenses incurred in the production of ANY income**.
- **Traditional Capital Allowances**.
- **Expenses Incurred by Employers**.
- **Expenses in respect of Immovable Property**.
- **Expenses of a Private Nature expressly deductible**.
- **Other Deductions**.

Art. 14 is referred to as the **positive test** because it describes what is allowably deductible, whereas **Art. 26** is dubbed as the **negative test** because it lists what CANNOT be deductible.

Tax Profit & Accounting Profit

Taxable profit differs from accounting profit, necessitating adjustments for certain expenses deducted in accounting but not permitted for tax purposes. While expenses are generally allowable for tax purposes if they are wholly and exclusively incurred in income production, accounting standards do not always require such stringent criteria for expense recognition.

Similarly, while depreciation in accounting aligns with wear and tear allowance in taxation, their calculation methodologies differ. Depreciation follows accounting standards, whereas capital allowances adhere to specific tax regulations.

Provisions, though accounted for in financial statements, are typically added back for tax purposes. Likewise, **unrealised losses deducted in accounting are often reversed for tax computation**. Conversely, certain items recognised as profits in accounting may be excluded from tax assessment. For instance, **unrealised gains deducted in accounting are typically added back for taxation purposes**.

Furthermore, the tax treatment of bad debts differs from accounting practices. Additionally, while donations are accounted for in accordance with accounting standards, they are generally not tax deductible, with few exceptions.

Art. 14, ITA

(1) For the purpose of ascertaining the total income of any person there shall be deducted all outgoings and expenses incurred by such person during the year preceding the year of assessment to the extent to which such outgoings and expenses were wholly and exclusively incurred in the production of the income, including –
Art. 14, *ITA*

"…outgoings and expenses incurred…"

CASE LAW: The ***James Flood Pry. Ltd*** Case
This was a seminal case for interpreting the abovementioned term, wherein British Courts discussed that while the term "*outgoing or expense*" might imply an actual disbursement, **strictly adhering to such interpretation could lead to peculiar and inconsistent outcomes**.

CASE LAW: ***The Elder Smith & Co Ltd Case***
Here, the term "**incurred**" was defined as the **act of "contracting of a debt"**.

"...wholly and exclusively incurred..."

Simply put, the phrase "*wholly and exclusively incurred in the production of the income*" indicates that **an expense is permissible if it is spent for the sole purpose of generating income**. There needs to be a **clear *nexus* between the expense and the actual process of earning income.**

In the case of employment income, **only expenses that are wholly**, **exclusively**, and **necessarily incurred in generating that income are deductible**. This means that for employment income, there is an additional criterion: **the expense must be essential for generating the income to be considered deductible**.

"...the extent to which such outgoings and expenses..."

Generally, expenses with a **dual nature**, serving both income production and non-income production purposes, are **NOT deductible**. The case of ***Mallalieu v. Drummond*** illustrates this principle, where a barrister's claim for expenses on **black attire**, used both for personal and court purposes, was denied.

However, **if it is possible to apportion the expenditure between business and personal use, and if such apportionment aligns with the intent of the law, it may be allowed**. For instance, if an expense serves both business and personal purposes, only the portion directly related to the business can be deducted.

CASE LAW: ***BSC 16/1971***
Here, it was clarified that while the "*wholly and exclusively*" rule **typically does not allow for apportionment**. However, **certain types of expenses *can* be apportioned if it is demonstrated that the portion claimed for deduction was solely and exclusively incurred for business purpose**s. The ruling emphasised that apportionment cannot be justified merely because an expense was partially incurred for business purposes; it must be wholly for business reasons to be eligible for deduction.

"...in the production of income..."

An **expense qualifies for deduction if it is incurred in the process of generating income**. Jurisprudence emanating from the Court of Appeal has highlighted the **necessity of a distinct and direct link between the expense and the actual income earned**, stating that expenditure must be for the purpose of earning profit.

While an expense does not need to be directly attributable to income-generating activities, there must be a **clear cause-and-effect relationship between the expenditure and income production**. For instance, a medical expense was disallowed as it lacked this direct link to income production.

CASE LAW: *Case 154, 1987*
Here, the Court of Appeal allowed the deduction of damages paid by a tax consultant to a client due to an error in managing the client's affairs, indicating a **broad interpretation of deductible expenses related to income generation**.

Fines stemming from income production activities are typically not deductible, as they serve a deterrent purpose rather than facilitating income generation. Even if an act resulting in a fine also generates income, the fine itself is not considered an allowable deduction.

The Court of Appeal has persistently stressed the **importance of strict interpretation of the articles governing deductions**, emphasising that the intention expressed by the words of the enactments is paramount. Consequently, **an expense is deductible only if it directly contributes to income generation**.

Proportionality

An expense is deemed allowable if it is considered "**reasonable to allow" by the Board**, which typically accepts expenditures that are deemed reasonable and proportionate. For instance, in one case, a sales commission paid by a trader to his son was disallowed as it was deemed excessive and unreasonable. To be deductible, such a salary must be commensurate with the services rendered.

The Board occasionally permits the **deduction of reasonable traveling expenses** necessary for promotional activities and fostering commercial relationships, acknowledging the essential nature of such expenditures for business development.

However, the Board differentiates between **allowable** and **non-allowable traveling expenses**. While expenses incurred in commuting from home to work were deemed non-deductible, expenses related to travel between patients were considered allowable. Thus, it is construed that **traveling from one's residence to the workplace is a personal choice and not a duty-related performance**.

Insurance premiums are deductible if they are incurred for insuring assets utilised in the trade. Premiums paid for policies covering fixed assets, stock in trade, plant and machinery, and capital employed in income production have been recognised as allowable deductions.

Expenses Incurred in the Production of Income as per Art. 4 (1) (a), ITA

Certain expenditures are allowable against income derived from activities outlined in Art. 4 (1) (a) of the ITA, commonly known as **trading income**. One such deduction is for **bad debts** (Art. 14 (1) (d) of the ITA).

The Commissioner holds discretion in determining what qualifies as a bad debt for tax purposes. Generally, a debt is considered bad if:

- The **debtor has passed away without assets** (for individuals) or has been **liquidated** (for companies).
- The debtor has become **insolvent**.
- The debt is time-barred (***preskritta***).
- The **creditor has taken all necessary steps to secure the debt** (e.g., issued legal notices, warrants, etc.).

If a debt previously written off as bad is later recovered, it must be reported as income in a subsequent tax return under Art. 4 (1) (a) of the ITA.

Bad debts and losses are both tax-deductible under Art. 14 (1) (d) and Art. 14 (1) (g) of the ITA, respectively.

Bad Debts:

Bad debts, as defined by revenue guidelines, encompass debts that are time-barred or owed by a debtor who has declared bankruptcy. Additionally, contributions made by employers to pensions, including their portion of social security payments, are deductible for tax purposes.

Losses:

Losses incurred in the conduct of activities outlined in Art. 4 (1) (a) ITA (trade losses) are deductible. A loss is recognized if, had it been a profit, it would have been taxable. However, losses incurred in activities generating exempt income are not considered. Trade losses incurred outside Malta are allowed, subject to taxation if retained within Malta.

Trade losses can be carried forward to subsequent years and offset against any income or capital gains. It's important to note that losses cannot be deducted against income allocated to the final tax account. Any losses resulting from activities whose profits would have been allocated to the final tax account are not eligible for deduction under Art. 14 (1) (g) ITA.

Expenditure on Scientific Research: (Art. 14 (1) (h) ITA):

Capital expenditure related to scientific research is deductible, provided it benefits activities outlined in Art. 4 (1) (a) ITA. However, this deduction is subject to approval by the Commissioner. Scientific research expenditure not eligible for wear and tear or initial allowance is spread over the year it was incurred and the subsequent five years. No deduction is permitted for scientific research expenditure on plant machinery or premises already granted wear and tear or initial allowance.

Promotional and Marketing Expenditure (Art. 14 (1) (i) ITA):

Tax deductions are allowed for expenses incurred by individuals engaged in activities outlined in Art. 4 (1) (a) ITA for promoting such activities. This includes expenditures on market research, advertising, soliciting business, providing samples, and participating in fairs and exhibitions.

Expenses Incurred in the Production of ANY Income

The following expenses incurred in generating income are **deductible for tax purposes**:

1. **Interest payments** (**Art. 14(1)(a) ITA**): Interest paid on borrowed money is deductible if the Commissioner verifies that it was payable on capital used to acquire income.

2. **Rent payments** (**Art. 14(1)(b) ITA**): Rent paid by a tenant for land or buildings used to generate income is deductible.

3. **Election campaign expenses** (**Art. 14(1)(k) ITA**): Sums or expenses paid by or on behalf of a candidate for election to the House of Representatives for conducting or managing the election are deductible, subject to Commissioner approval.

4. **Expenditure on intellectual property rights** (**Art. 14(1)(m)** ITA): Capital expenditure on intellectual property rights incurred by individuals engaged in Article 4(1)(a) ITA activities is deductible if proven to benefit such activities to the Commissioner's satisfaction.

5. **Risk capital expenses** (**Art. 14(1)(o) ITA**): Sums aimed at approximating neutrality between debt and equity financing, as prescribed by the Minister, are deductible.

6. **Qualifying intellectual property income** (**Art. 14(1)(p) ITA**): A prescribed percentage of qualifying income derived from qualifying intellectual property is deductible, subject to prescribed terms, conditions, and determinations.

Traditional Capital Allowances

While the income tax return does not explicitly specify these expenses, a closer look at Art. 14 reveals references to **deductions resembling capital allowances**.

Assets classified as **Industrial Buildings or Structures**, or **Plant & Machinery** fall under Art. 14, which encompasses three forms of **capital allowances**:

- **Repairs**: Any expenditure incurred for repairs is deductible for tax purposes. This includes all expenses incurred.
- **Wear and Tear Allowances**: Tangible assets depreciate over time, and for tax purposes, deductions are allowed based on this depreciation. The law provides a schedule detailing the depreciation rates for various assets over the years.
- **Initial Allowance**: In certain cases, a deduction can be claimed on a percentage of the asset's purchase price as an initial allowance.

These traditional capital allowances provide **tax relief for expenditures related to the maintenance and acquisition of assets used in income-generating activities**. These expenditures are subject to special tax treatment under the law, providing guidelines on deductions applicable for tax purposes when acquiring these assets.

Plant & Machinery:

Capital allowances can be claimed for expenditures on plant and machinery. While definitions for these terms rely on case law, **Art. 2 ITA** provides a clear definition for industrial buildings or structures.

CASE LAW: ***Yarmouth v. France***
In this case, plant and machinery were defined as "**whatever apparatus a businessman utilises for conducting business operations — excluding stock-in-trade acquired for sale; encompassing all permanent fixtures, whether movable or immovable, utilised in the business**."

Characteristics of Plant & Machinery include:

Revenue Generation: The machinery must serve a revenue-generating purpose; its primary function is to generate income and contribute to the business's activities.

Not for Sale: The asset should not be intended for sale as part of the business's stock-in-trade. It is not acquired for the purpose of buying and selling.

Permanent Employment: The asset is intended for the ongoing and permanent use of the business. The level of permanence varies depending on the asset and the nature of the business. For instance, knives may not qualify as Plant and Machinery depending on their usage, and there have been discussions in cases involving farm animals regarding their classification.

CASE LAW: ***BSC 5/62***
Here, the Board determined that wine concrete vats used by a Maltese vintner constituted Plant and Machinery for legal purposes.

Industrial Buildings or Structures:

The term 'Industrial Building' typically refers to structures used for industrial purposes, such as **manufacturing**, **assembly**, **processing**, and related activities. Over time, this definition has evolved to accommodate changes in the Maltese economy. It now includes hotels and, more recently, office spaces meeting specific criteria outlined in the Capital Allowances Rules.

Repairs of Premises, Plant, and Machinery (Article 14(1)(c)):

The first traditional capital allowance pertains to expenses incurred for repairing premises, plant, or machinery utilised in income generation, as well as for the renewal, repair, or alteration of any equipment used for this purpose.

Wear and Tear of Plant and Machinery (Article 14(1)(f)):

The second traditional capital allowance covers wear and tear on plant and machinery, as well as on premises classified as industrial buildings or structures. The rules governing wear and tear deductions are outlined in Art. 14(1)(f) of the Income Tax Act (ITA) and the Deduction for Wear and Tear of Plant and Machinery Rules. This allowance is applicable when the relevant assets are utilized in income production, even if the property is not owned by the user but the wear and tear burden falls on them.

Since **2002**, the **straight-line method** has been used to calculate this deduction, replacing the reducing balance method.

Initial Allowance:

The third traditional capital allowance pertains to the acquisition of industrial buildings or structures. This allowance applies to such properties first utilised in the year preceding the assessment year. It allows for a deduction equivalent to 1/10th of the capital expenditure incurred on these buildings or structures.

Art. 24 ITA introduces the concept of a balancing statement, which complements the rules concerning capital allowances. When an initial allowance or wear and tear allowance has been claimed on an asset, and the asset is subsequently sold, transferred under onerous title, destroyed, or deemed obsolete, the taxpayer must submit a balancing statement to the Commissioner along with their tax return.

For instance, if a business owner decides to sell chairs for which capital allowances were previously claimed, they are obligated to prepare a balancing statement. This statement accounts for the capital allowances claimed and the transfer value of the asset sold. If the statement shows a profit on disposal, taxes must be paid on that profit. Conversely, if it shows a loss on disposal, the taxpayer can claim this loss as a tax-deductible expense.

The balancing statement may result in either a "**loss on disposal**," which qualifies as a balancing allowance and is tax-deductible, or a "**profit on disposal**," considered a balancing charge and treated as taxable income.

Art. 24 (3) ITA stipulates that if an asset for which capital allowances have been claimed is replaced by the owner, resulting in a balancing charge in the balancing statement, the owner has the option to deduct this balancing charge from the cost of the new asset.

Expenses Incurred by Employers

Two deductions are exclusively available to employers:

> **Art. 14(1)(e) ITA** permits deductions for any contributions made by employers to pensions, savings, provident funds, or other approved societies or funds, as prescribed by the Commissioner.
>
> **Art. 14(1)(n) ITA** allows deductions for fees paid by employers to licensed or registered childcare centres for childcare services provided to the children of their employees. This deduction is capped at a maximum of €935 per child and must be proven to the satisfaction of the Commissioner.

Expenses in respect of Immovable Property

The Deduction of Expenses in Respect of Immovable Property Rules prescribe a special tax deduction which is colloquially referred to as the Maintenance Allowance.

Expenses of a Private Nature Expressly Deductible

Private expenses are **generally NOT deductible**, but there are exceptions outlined in Art. 14A to 14H ITA, which allow individuals to claim certain deductions.

One such deduction is for **alimony payments**, as stipulated in Art. 14A. This provision **permits deductions for alimony payments**, including those granted by foreign courts, subject to approval by the Commissioner. It is important to note that this deduction applies not only to separation but also to divorce situations.

To prevent excessive deductions that could deplete capital, Art. 14A imposes a cap on the maximum deduction allowable in a year for alimony payments. Therefore, the deduction is limited to the actual amount of alimony paid, ensuring that the taxpayer does not receive a tax benefit greater than the amount paid.

In practice, the individual making the alimony payment can claim the deduction, while the recipient should report the received alimony as income in their tax return. Failure to do so may result in a mismatch detected by the Revenue's computerised system, especially in cases where one spouse claims the deduction while the other fails to report the income received.

The Income Tax Act applies distinct treatment to maintenance payments for spouses and financial support for children. While the Civil Code refers to maintenance without differentiation, tax law delineates between alimony for a spouse and financial assistance for a child's maintenance.

For tax purposes, alimony, aimed at the spouse's maintenance, is deductible by the payer and taxable for the recipient. Conversely, financial assistance for a child's maintenance does not offer a tax deduction for the payer. However, the recipient of such support is exempt from paying taxes on it. This divergent treatment stems from the view that spousal maintenance represents income substitution.

The deduction for **school fees** applies specifically to fees paid to schools designated by the Minister of Finance. This includes fees for registered private kindergartens since 2007. Notably, the designated schools are primarily Maltese independent schools.

It's crucial to differentiate between school fees and donations. Only fees paid to the specified independent schools are tax-deductible, subject to an annual cap. This deduction excludes donations made to these schools.

Additionally, since 2006, individuals paying fees for a facilitator for a child with special needs at one of the designated schools can deduct these fees from their income, up to a maximum of **€9,320**.

The rationale behind allowing deductions for fees paid to independent schools is based on the understanding that unlike government and church schools, which burden the government financially, independent schools do not impose such costs.

Art. 14C allows individuals to deduct childcare fees paid to a genuine **childcare centre for their children**. The deduction is limited to the lesser of two amounts:

SL 123.121 outlines conditions that must be met to qualify for this tax deduction.

Other deductible expenses include:

- **Fees related to homes catering to the elderly and disabled**
- **Sports fees**
- **Studies at a recognized tertiary education institution**
- **School fees paid to cultural and creative teaching institutions**
- **School transport fees**

Other Deductions

Other deductible expenses include:

- **Expenditures under Art. 74 of the VAT Act**.
- **Donations** as per the Donations (National Heritage) Rules.
- **Tax credits for women returning to work**.
- **Pre-Trading Expenditure Regulations of 2002**.

Art. 26, ITA

Art. 26 ITA enumerates expenses that are **ineligible for tax deduction**, complementing the allowances outlined in Art. 14 ITA, albeit in a **negative sense**. While Art. 14 provides the "positive test," identifying allowable deductions, Art. 26 serves as the "negative test," specifying disallowed expenses for tax purposes.

Art. 26 (a) disallows private/domestic expenses for tax deduction. For instance, employing a maid to clean an office is deductible because it contributes to revenue generation. Conversely, home cleaning expenses are considered private and non-deductible.

Under **Art. 26 (b)**, **capital expenses are typically ineligible for tax deduction**. However, exceptions exist, notably for **capital allowances**, as stipulated above. Costs associated with **improvements are NOT deductible**.

Expenses incurred to **establish a business**, like feasibility studies or formation expenses, are capital in nature and therefore **NOT deductible**. Case law supports this, considering such expenses as one-time capital outlays rather than ongoing expenditures for income production.

In fact, the Court of Appeal, in one of its judgements, has stated that:

"Biex spiża titnaqqas jeħtieġ skond din il-liġi illi oltre li ma tkunx ta' natura kapitali, ħlief kif provvdut fl-artikolu 14, tkun saret "għal kollox u biss għall- produzzjoni tal-income" (Art. 26(b)). Dan ifisser li jrid ikollok relazzjoni bejn l-ispiża pretiża bħala deduzzjoni u l-income li tkun saret biex tipproduċi..."

An expense qualifies as capital in nature if it introduces something new or enhances an asset's value. Conversely, recurring expenses for asset maintenance are not considered capital.

According to **Art. 26 (d)**, expenses like **improvements**, **insurable loss recovery**, **non-business-related rent payments**, **voluntary contributions**, and certain interest payments are deemed **capital expenses**.

For instance, while repair costs are deductible, expenses for improvements are not. For example, routine maintenance in a cinema, like painting and plastering, qualifies as deductible repairs due to their repetitive nature. However, installing a new sound system in a specific year constitutes an improvement and is not deductible, although capital allowances can be claimed for the asset acquired.

Art. 26 (h) of the ITA **prohibits tax deductions** in cases where:

- The **creditor and debtor have a related-party relationship**.
- The **loan**, for which the interest is paid, is **intended for property improvements** within Malta.
- The **lender is a non-resident enjoying tax exemption**.

Classification of Taxpayers and Tax Rates

The ITA classifies taxpayers into different categories, affecting their tax compliance obligations and overall treatment for tax purposes. **Tax computation varies based on taxpayer classification, determining the applicable tax rate**. For instance, while the standard Maltese tax rate stands at 35%, there's also a 5% rate, alongside specific income taxed at 15%, or even exempt from taxation. Although seemingly conflicting, these rates are all valid, reflecting diverse tax obligations for different taxpayer types.

Art. 56 ITA governs this classification, distinguishing between two main taxpayer categories: companies and individuals.

Bodies of Persons

> "body of persons" means any body corporate, including a company, and any fellowship, society or other association of persons, whether corporate or unincorporate, and whether vested with legal personality or not;
>
> **Art. 2**, *ITA*

Companies, often referred to as "**opaque**" entities in tax terminology, are defined under the ITA based on specific criteria.

Companies, as defined under the ITA, encompass a broad spectrum, including limited liability companies, limited partnerships, and partnerships that opt for treatment as companies. This expanded definition, introduced by Act XIII of 2015, notably includes election partnerships.

For tax purposes, **companies are considered opaque entities**, distinct from their shareholders. This distinction is fundamental, with the ITA treating companies as separate taxpayers, independent of their shareholders. Several specific rules apply to entities classified as companies:

- **Special residence rules are exclusively applicable to companies**.
- **Only companies are eligible to utilise the ACIT tax accounting system**.
- **Groups of companies are subject to special tax treatment** outlined in the ITA.
- The full **imputation system is specifically designed for dividend distributions by companies**.
- Companies have **distinct compliance obligations specified by tax laws**.
- A special tax rate of 35% is applicable solely to companies, as well as bodies corporate established by law and ecclesiastical undertakings engaged in trading activities.

Under these regulations, legal entities typically face a flat tax rate of 35% on all their income.

Group Relief

Group relief is a provision within the ITA that **facilitates the transfer of losses between companies within the same group, allowing for a more efficient allocation of resources and tax burden**. This mechanism permits companies to offset losses incurred by one member against the profits of another, thereby reducing the group's overall tax liability.

For companies to be eligible for group relief, they must meet specific criteria outlined in the ITA:

- **<u>Residency and Ownership</u>**: Both companies must be resident in Malta and not resident for tax purposes in any other country. Additionally, one company must be a 51% subsidiary of the other, or both companies must be 51% subsidiaries of a third company resident in Malta.
- **<u>Losses Eligible for Surrender</u>**: Only certain types of losses are eligible for surrender under group relief. These include losses defined in Art. 14(1)(g) ITA, excluding specific allowances related to wear and tear of plant and machinery (Art. 14(1)(f) ITA) and initial capital allowances (Art. 14(1)(j) ITA).

Group relief operates by allowing losses incurred by one company to be transferred to another within the same group. However, there are limitations to this provision:

- **<u>Restrictions on Multiple Claims</u>**: Relief may only be claimed once for a particular loss, preventing duplicate claims across multiple companies.
- **<u>Loss Transfer Mechanism</u>**: Losses are surrendered from the tax account of one company to the equivalent tax account of another company within the group.

It is important to note that forming part of the same group does not automatically entitle companies to avail themselves of group relief; additional conditions and compliance requirements must be met to qualify for this tax benefit.

Companies Registered in Malta

The **2007 amendments** to the Income Tax Acts introduced a distinct category known as the "**company registered in Malta**," marking a significant development in tax legislation. This classification is closely tied to the implementation of the **Accounting Compliance and Taxation (ACIT) regime**, representing a nuanced approach to tax compliance and regulation.

The definition of a "company registered in Malta" encompasses a broad spectrum, extending beyond traditional Maltese resident entities. It encompasses non-resident companies that are not only incorporated outside Malta but also lack residency in the country. Despite their foreign origin, these companies engage in business activities within Malta, which includes the operations of overseas company branches within Maltese territory.

This expanded classification acknowledges the evolving landscape of global business operations, recognising the presence and economic impact of non-resident entities within Malta's jurisdiction.

Transparent Entities

Partnerships en commandite with undivided capital formed prior to 2015, along with *partnerships en collectif* and *partnerships en commandite* that have not opted to be treated as companies, are considered **transparent entities under the law**. As such, **they do NOT have the status of taxable persons**.

These transparent entities, often referred to simply as partnerships, **are not taxed as separate entities**. Instead, the **income generated by a partnership is regarded as the income of the individual partners**, and it is taxed accordingly. This principle is enshrined in **Art. 27 of the Income Tax Management Act (ITMA)**, as amended in **2015** and **2016**.

While a company's losses are distinct from those of its shareholders, any losses incurred by individuals or partnerships in their trade, business, profession, or vocation are automatically attributed to the individual partners. However, capital allowances, unlike losses, are retained within the partnership as they are linked to the trading activities to which they pertain.

Unlike companies**, partnerships do not pay taxes in their own right, but they are still required to file tax returns**. This reflects the unique tax treatment of partnerships as compared to other entities.

Individuals

Individual taxpayers are subject to a more nuanced tax structure compared to legal entities. The key distinction lies between residents and non-residents, with different tax rates applying to each category. Art. 56 of the ITA delineates these distinctions based on the duration of stay in Malta.

Residents are individuals who reside in Malta for more than 183 days in a calendar year, whereas non-residents are those who stay in Malta for less than 183 days within the same period. Unlike the categorisation of companies, the ITA does not explicitly refer to ordinary or non-ordinary residents; rather, it focuses on the duration of stay to determine tax residency status.

For residents, taxation follows a progressive rate structure, meaning that tax rates increase with higher income levels. This progressive system is designed to impose a greater tax burden on individuals with higher incomes, reflecting principles of fairness and ability to pay.

Joint and Separate Computations

For residents, **tax rates vary based on marital status**, with recent changes offering more flexibility in tax filing. Since 2013, the definition of married individuals has expanded to include those in civil unions under the Civil Union Act, broadening the scope of tax options for couples.

Married individuals now have three filing options:

Full Aggregation (**Option 1**): Under **Art. 49(2) of the ITA**, couples can opt for a **joint tax return**. This involves consolidating all their income and filing one tax return together. By aggregating their income, they benefit from married tax rates.

Split Computation (**Option 2**): According to **Art. 50 of the ITA**, couples can **file one tax return but compute taxes separately**. This allows for **two computations**, applying single rates to earned income. Earned **income can benefit from tax-free rates twice**. However, unearned income, which includes all income apart from income from trading, past employment, and pensions, is taxed based on the higher earner's income. The **remainder is added to the income of the higher earner**.

These tax systems, while seemingly equitable on the surface, proved to be prone to complications in practice. For example, married couples are legally responsible for tax liabilities jointly and severally. However, there were cases where one spouse, often the wife, only discovered fiscal issues related to marital property after separation. Typically, this scenario involved a negligent husband, often a businessman, failing to file tax returns, with the wife remaining unaware until later, making it challenging to rectify the situation.

To address such issues, a third option was **introduced in 2022**:

Two Separate Tax Returns (**Option 3**): Under Art. 49A of the ITA, **married individuals now have the choice to file two separate tax returns as if they were not married**. This option is particularly advantageous for couples where both spouses are professionals or self-employed individuals, allowing each person to assume their own tax responsibilities.

Additionally, progressive tax rates apply in these situations as well.

Married Rates

Art. 56(1)(a) of the ITA outlines the tax rates applicable to a married couple residing in Malta when opting for a **joint computation**. Under **Art. 49(1) of the ITA**, the income of a married couple, where both spouses reside together, is **to be taxed in the name of the responsible spouse**. The selection of the responsible spouse is a joint decision by the spouses. However, if no selection is made, the Commissioner determines the responsible spouse. It's important to note that any tax return or declaration should be signed by both spouses. If only one spouse signs on behalf of the responsible spouse, it's presumed to have been made with the consent of both.

Art. 49(2) of the ITA states that when a joint return is required from a married couple, **both spouses are jointly and severally responsible for fulfilling all obligations**. In case of default, the Commissioner may enforce performance against either or both spouses.

Contrary to common belief, the joint computation is not exclusive to married individuals. Unmarried individuals may apply married rates in specific circumstances.

Single Rates

The rates specified in **Art. 56(1)(b) of the ITA** are applicable to any other individual residing in Malta, including each spouse when the responsible spouse chooses a separate computation or opts for a separate return altogether.

Parental Computation

Act V of 2012 introduced **new tax rates specifically for parents** under Art. 56(1)(b) second proviso.

When it comes to tax rates, the **law makes a clear distinction between residents and non-residents**.

For **non-residents**, the **rates are more severe**.

For residents, there's a **tax-free bracket of around €9,000**, while for **non-residents**, this **amount is only €900**. Consequently, **non-residents reach the 35% tax rate threshold much sooner than residents**. In essence, non-residents are subject to higher tax rates compared to residents, meaning they pay more tax as their income increases.

Furthermore, unlike married residents, **married non-residents do NOT have the option to prepare a separate tax computation**.

The Refundable Tax Credit System

The **1994 amendments** to the ITA and the ITMA brought about a specific tax accounting system wherein profits earned by a company are allocated to various tax accounts, closely tied to the refundable tax credit system. However, this system underwent **changes in 2007**.

Over time, **flat tax rates for specific types of income were introduced**. It began with Art. 32 of the ITA, which included the "investment income provisions," allowing taxpayers to opt for a flat tax rate of 15% on their investment income, such as interest income. Alternatively, taxpayers could instruct their banks to withhold tax on interest income at this rate. Additionally, part-time rules were introduced, with the rate being reduced to 10% from 15% as of this year. These rates, along with others, are specified in Art. 56, 33, and 90A of the ITA. As of this year, income from creative and artistic activities is taxed at 7.5%, and even football players are subject to a 7.5% tax rate.

Various tax rates apply in different situations. One commonly used reduced tax rate is outlined in Art. 31(d) of the ITA, allowing individuals to opt for a 15% tax rate on rental income. Overall, there exists a diverse spectrum of applicable tax rates.

In Malta, there is a **standard 5% tax rate**. However, **all companies are subject to a tax rate of 35%**, although they benefit from tax accounting, and their shareholders may take advantage of the **Refundable Tax Credit System**.

The **Tax Accounting System (TAS)** in combination with the **Refundable Tax Credit System** indeed results in an **effective tax rate of 5%**. Although companies pay tax at the nominal rate of 35%, the **majority of this tax is refunded to the shareholders**, resulting in a much lower effective rate. However, **this system is NOT applicable to all companies and is limited to specific beneficiaries**.

Under this system, **companies must allocate their profits to various tax accounts based on their classification and where they belong**. This ensures that profits are labelled and categorised correctly according to their nature and source.

However, the **Refundable Tax Credit System has faced international scrutiny and criticism**, with pressures mounting for its removal due to **concerns of it being used for international tax avoidance**. Therefore, its relevance and future viability are subjects of debate, with some suggesting that it may no longer be suitable in the current international tax landscape.

The 2007 Tax Reform

Act II of 2007 was a significant development for Malta, especially in response to **pressures from the European Union regarding harmful tax practices**. Prior to joining the EU, Malta faced scrutiny for potentially breaching EU norms on harmful tax practices and state aid rules. **In 2006, Malta was formally requested to abolish these tax regimes**.

The main features of the 2007 tax reform included:

- **Retention of the Full Imputation System**, which ensures that corporate shareholders are entitled to a credit for any tax paid by the company on distributed profits.
- Enhancement of the tax accounting system with the **addition of two new tax accounts, improving the tracking and allocation of profits**.
- **Retention of Art. 48(4) ITMA refunds**, including full refunds and partial refunds.
- Introduction of a **Participation Exemption**, allowing certain dividends and capital gains derived from qualifying holdings to be exempt from tax.
- Introduction of **anti-abuse provisions** to prevent abusive tax practices.
- Introduction of the concept of **Advance Company Income Tax (ACIT)**, aimed at providing a simpler and more efficient tax payment mechanism.
- Introduction of **two new refunds of ACIT**, available for profits allocated to the Foreign Income Account and the Maltese Taxed Account.
- **Extension of the Refundable Tax Credit** system to branches of companies.
- **Abolition of the ITC regime**, which was deemed to be an offshore tax regime.
- **Tightening of rules related to the Flat Rate Foreign Tax Credit** to ensure compliance and prevent abuse.

Overall, the 2007 tax reform aimed to modernise Malta's tax system, align it with EU standards, and address concerns regarding harmful tax practices and state aid rules.

Tax Accounting

The Tax Accounting system under Maltese law requires companies to allocate their distributable profits to five different tax accounts. These accounts are:

1. **The Final Tax Account**: This account is for profits that are subject to final taxation, such as interest income and certain royalties, which are taxed at a flat rate.
2. **The Immovable Property Account**: Profits derived from immovable property situated in Malta are allocated to this account.
3. **The Foreign Income Account**: Profits earned from foreign sources are allocated to this account.
4. **The Malta Tax Account**: This account includes profits that are subject to tax in Malta, excluding those already allocated to other specific accounts.
5. **The Untaxed Account**: This account covers profits that have not been allocated to any of the other specific tax accounts.

Detailed rules regarding the allocation of profits to these tax accounts are provided in subsidiary legislation known as the Tax Account Rules. These rules govern how profits are classified and allocated, ensuring compliance with tax regulations.

Understanding the allocation of profits to these tax accounts is essential for determining the tax consequences for the company, including eligibility for preferential tax regimes such as the 5% tax rate. Additionally, it facilitates accurate reporting in the company's tax return and ensures compliance with tax obligations.

1. The Final Tax Account

The Final Tax Account (FTA) serves as a **repository for income that has already been subjected to a final tax**. This includes income that has been taxed at a flat rate or under specific tax provisions where no further tax is applicable upon distribution. For example, income from investment provisions, rental income taxed at a final rate, and profits from property transfers taxed under Art. 5A of the Income Tax Act (ITA) are allocated to the FTA.

According to **Art. 5A(10)(d) of the ITA**, distributable profits taxed under Art. 5A ITA are specifically allocated to the FTA. This ensures that income subject to final tax is appropriately classified and managed within the tax accounting system.

Profits allocated to the FTA are not subject to further taxation upon distribution, and no tax credit is available for such distributions. Therefore, the FTA provides a clear delineation for income that has already fulfilled its tax obligations and does not require additional taxation upon distribution.

2. The Immovable Property Guide

The Immovable Property Account (IPA) serves as a **designated category for profits derived directly or indirectly from immovable property located in Malta**. The rules governing the allocation of profits to the IPA are outlined in the Tax Account Rules (TAR), which also govern the allocation of profits to other tax accounts such as the Final Tax Account.

Profits allocated to the IPA include income generated from immovable property as well as income deemed to arise from immovable property. For example, banks lending money for property purchases in Malta allocate revenues from home loans to the IPA, while insurance companies insuring Maltese property allocate income from gross premiums to this account.

Additionally, companies that own and occupy property in Malta are required to allocate profits to the IPA before allocating profits to other accounts. The amount of profits allocated to the IPA for such companies is determined based on the square meterage of property owned and occupied in Malta, with a specified amount per square meter set at €250. This provision ensures that companies with significant property holdings or involvement in the Maltese property market appropriately classify their income as IPA income.

3. The Foreign Income Account

Certain forms of foreign source income stand to be allocated to the foreign income account.

The Foreign Income Account (FIA) is designated for specific types of income derived from foreign sources. According to Art. 2 of the Income Tax Act (ITA), profits allocated to the FIA include foreign source passive income, foreign source capital gains, foreign source dividends, and profits derived from an overseas branch, agency, or permanent establishment.

Profits allocated to the FIA encompass various types of taxable income resulting from activities conducted outside of Malta, including:

- **Dividends**, **interest**, **royalties**, and **capital gains generated from sources outside Malta**, which may include income from participating holdings or the sale of such holdings.
- **Rental income** and **any other earnings derived from investments situated outside Malta**.
- **Trading profits attributed to a permanent establishment** located outside Malta.
- **Dividends distributed from the foreign income account of another company resident in Malta**.

Specific rules may apply to banks and insurance companies regarding the allocation of profits to the FIA, reflecting the unique nature of their business activities and income streams.

4. The Malta Tax Account

The Maltese Taxed Account serves as a category for distributable profits that have undergone taxation but have not been designated to the Final Tax Account, Immovable Property Account, or Foreign Income Account. Essentially, it functions as a catch-all account for profits that do not fall under the specific classifications of the other accounts.

When profits cannot be allocated to the Final Tax Account due to not being subject to final tax, and when they do not pertain to income from immovable property in Malta or foreign sources, they are directed to the Maltese Taxed Account. This ensures that all taxable profits are properly accounted for, even if they do not fit into the specialized categories outlined for the Final Tax, Immovable Property, or Foreign Income Accounts.

5. The Untaxed Account

The Untaxed Account serves as a reservoir for profits or losses that have not been designated to any of the other taxed accounts, such as the Final Tax Account, Immovable Property Account, or Foreign Income Account. It essentially acts as a clearinghouse for all remaining distributable profits or accumulated losses after allocations have been made to the other taxed accounts.

According to Art. 2 of the Income Tax Act, the Untaxed Account comprises the total distributable profits or accumulated losses, deducting the total sum of amounts allocated to other taxed accounts. It represents a balancing figure that accounts for the difference between a company's accounting profits and the profits subject to taxation in Malta.

Common items allocated to the Untaxed Account include:

- Depreciation added back
- Increases in provisions added back
- Decreases in provisions
- Accounting losses and gains on the sale of assets
- Balancing allowances
- Balancing charges and tax refunds

In essence, the Untaxed Account captures the residual profits or losses that do not fit into the specific categories of other taxed accounts, ensuring comprehensive accounting of a company's financial position for tax purposes.

Taxation of Dividends

The distribution of profits from different tax accounts within a company can have varying tax implications due to the application of different tax regimes. Here's how distributions from different accounts are treated:

Final Tax Account (FTA): Distributions from the FTA are not subject to the full imputation system. Instead, they may be subject to withholding tax in certain cases. The tax paid by the company from profits allocated to the FTA is not refundable to the shareholder. For example, if the company pays 15% tax on profits allocated to the FTA, the shareholder does not receive a refund of this tax.

Immovable Property Account (IPA): Profits allocated to the IPA are not eligible for the Refundable Tax Credit System. Therefore, the tax paid by the company from profits classified under the IPA is not refundable to the shareholder. Income derived from immovable property, such as rental income, falls under this category.

Foreign Income Account (FIA) and **Maltese Taxed Account** (MTA): Distributions from the FIA and MTA are eligible for the Refundable Tax Credit System. This means that shareholders may be entitled to a refund of the tax paid by the company on profits allocated to these accounts. However, certain distributions from these accounts may be tax exempt.

Untaxed Account: Profits allocated to the Untaxed Account do not qualify for refunds under the Refundable Tax Credit System. While there is no further tax imposed on distributions from this account, shareholders also do not receive a refund of the tax paid by the company.

In summary, distributions from the FTA and IPA are not refundable to shareholders, while distributions from the FIA, MTA, and certain exempt distributions may be eligible for refunds under the Refundable Tax Credit System. The tax treatment of distributions depends on the specific tax account from which the profits are allocated.

The Foreign Income Account and the Maltese Tax Account are subject to tax refunds, which vary depending on the nature of the profits:

Foreign Income Account (FIA): Refunds from the FIA may be of 100%, 2/3rds (in cases where double tax relief is availed), or 6/7ths by default. However, if the income is from passive interest and royalties, the refund is typically 5/7ths.

Maltese Tax Account (MTA): Refunds from the MTA are similar to those from the FIA. They may be 6/7ths by default, or 5/7ths if the income is from passive interest and royalties.

The tax treatment and refundability of income depend on whether it is sourced locally or from foreign activities. The complex tax accounting system aims to differentiate between locally sourced income and income derived from activities outside Malta. Essentially, the Refundable Tax Credit System applies to foreign-owned companies generating revenue from activities conducted outside Malta. Companies with significant operations or property ownership within Malta typically do not benefit from this system, as they are required to allocate profits to specific accounts, such as the Immovable Property Account, based on their local activities.

In summary, the Refundable Tax Credit System is designed to benefit companies engaged in foreign activities, while companies operating primarily within Malta are subject to different tax treatment based on their local presence and income sources.

Only non-resident shareholders actually benefit from the system because if Maltese residents were to seek to apply the system, there is a mechanism wherein not only they end up paying at tax at 5% but at 38%. So, it applies only to select taxpayers.

Tax Exemptions

Malta utilises tax exemptions as a **means to attract foreign investment**, alongside mechanisms like the Refundable Tax Credit System. These exemptions are outlined in **Art. 12 of the Income Tax Act (ITA)**.

While some exemptions apply to entities within Malta such as the Government, University of Malta, MATSEC, trade unions, political parties, and others, there are also **exemptions specifically aimed at encouraging foreign direct investment**.

For example, **collective investment schemes** and **pension funds** enjoy tax exemptions on their income, making Malta an attractive destination for such investment vehicles. These exemptions are part of Malta's broader strategy to create a favourable tax environment for both domestic and foreign investors, contributing to the country's economic growth and development.

Tax Exemptions for Non-Resident

Art. 12(1)(c) of the Income Tax Act (ITA) includes two significant tax exemptions applicable to non-residents. Both exemptions are accompanied by an **anti-avoidance provision** designed to prevent abuse.

1. **Interest, discount, premium, or royalties accruing to or derived by non-residents**: Article 12(1)(c)(i) ITA exempts from **tax interest**, **discount**, **premium**, or **royalties** accruing to or derived by non-residents. However, this exemption is contingent upon two key conditions:

   The non-resident deriving the income **must NOT be engaged in trade or business in Malta through a permanent establishment during the relevant tax year**.

   The royalties or the debt claim for which the interest, discount, or premium is paid **must NOT be effectively connected with such a permanent establishment**.

This exemption is subject to the anti-avoidance provision outlined in the ITA to prevent exploitation of the tax exemption for improper purposes.

The exemption under Article 12(1)(c) of the Income Tax Act does NOT apply if the non-resident is "***engaged in trade or business through a permanent establishment***" and if the relevant income is "***effectively connected with such permanent establishment***."

The term "*permanent establishment*" is **not explicitly defined in the Income Tax Ac**t. While one might attempt to reference definitions from tax treaties, doing so can be challenging due to inconsistencies among treaty definitions. Additionally, different treaties may have varying timelines for establishing permanent establishments, with some treaties referencing supervisory, stock, and consultancy permanent establishments.

One potential approach is to consider the **definition of permanent establishment** outlined in the current version of the **OECD Model Convention**, specifically **Art. 5**. However, this may not provide a definitive solution, and further clarification or interpretation may be required in specific cases.

> *"1. For the purposes of this Convention, the term "permanent establishment" means a fixed place of business through which the business of an enterprise is wholly or partly carried on.*
>
> *2. The term "permanent establishment" includes especially:*
>
> *a) a **place of management**;*
> *b) a **branch**;*
> *c) an **office**;*
> *d) a **factory**;*
> *e) a **workshop**, and*
> *f) a **mine**, an **oil or gas well**, a **quarry** or any other **place of extraction of natural resources**."*

Since Art. 12 of the Income Tax Act, similar to **Art. 11.4** and **12.3** of the current version of the **OECD Model**, refers to being "*engaged in trade or business...through a permanent establishment*," we can turn to the commentaries on **Art. 11** and **12** of the **OECD Model** for guidance and interpretation. These commentaries can provide valuable insights into the interpretation of the term "*permanent establishment*" and its application in the context of trade or business activities.

2. **Gains Derived by Non-Residents upon Transfers of Securities and Similar Interests**:

   Art. 12(1)(c)(ii) of the Income Tax Act **exempts non-residents from tax on gains or profits derived from certain transfers of securities**. These exemptions cover four distinct types of transfers:

   - **Transfer of units in a collective investment scheme**.
   - **Transfer of units** and similar instruments **related to linked long-term insurance business**.
   - **Transfer of shares or interests** in **partnerships that are NOT property partnerships.**
   - **Transfer of shares or securities** in **companies that are NOT property companies**.

The introduction of the concepts of "*property company*" and "*property partnership*" by Acts I of 2010 and IV of 2011 respectively clarified the scope of these exemptions. **Non-residents are therefore not liable to pay capital gains tax on disposals of shares in Maltese companies, providing another significant tax exemption**.

Anti-Avoidance Provision Applicable to Art. 12(1)(c)(i) and (ii)

The exemptions mentioned are contingent upon the claimant being a "***bona fide non-resident***." Additionally, they apply on the condition that the beneficial owner of the interest, royalty, gain, or profit is a person not resident in Malta, and such person is not owned, controlled by, or acting on behalf of individuals who are ordinarily resident and domiciled in Malta. These provisions aim to prevent abuse of the exemptions by ensuring they are legitimately claimed by non-residents.

Beneficial Ownership

The anti-avoidance provision in the **proviso of Art. 12(1)(c) ITA** refers to the topical concept of beneficial ownership. However, the ITA uses the term many times **without ever defining it**. In the absence of such a definition, one can draw a definition of the term from the **Commentary to Art. 10 of the OECD Model Convention**

The Commentary gives examples of persons who cannot be treated as beneficial owners, including:

1) **Agencies**;
2) **Nominees**;
3) **Conduits**;
4) **Fiduciaries**;
5) **Administrators acting on account of other persons**.

Thus, the concept of 'beneficial ownership' is about **substance**, and NOT about form.

Phillip Baker discusses the use of the term in international tax law and explains its meaning with reference to international tax jurisprudence. He points out that '**the precise meaning remains unclear' and that 'several fundamental issues remain unresolved about the interpretation of the beneficial ownership concep**t'.

The Participation Exemption

The Participation Exemption introduced in Art. 12(1)(u) ITA is indeed a significant tax exemption, particularly **instrumental in attracting multinational corporations to establish holding companies in Malta**. Originally focused on income and capital gains from participating holdings, its scope has expanded over time.

Initially, the exemption covered income and capital gains derived by a company registered in Malta from a participating holding or from its disposal. Subsequent amendments broadened its application, including shares in resident companies, provided they are not property companies. Moreover, the **exemption now extends to gains or profits derived from the transfer of such holdings**, further enhancing its reach.

The notable extension came with the **Budget Act 2013**, which expanded the participation exemption to encompass branch profits, thereby offering additional incentives for multinational corporations operating through branches in Malta. This continuous expansion underscores the government's efforts to bolster Malta's attractiveness as a hub for international business and investment.

Eligible Persons

The participation exemption is selective in its application, targeting specific types of income derived by companies registered in Malta. It pertains to **3 distinct revenue streams**:

3. **Income from Participating Holdings**: This includes income generated from holdings in other companies that meet the criteria of a participating holding.

4. **Capital Gains from Participating Holdings**: Capital gains realised from the disposal of participating holdings are also eligible for exemption under this provision.

5. **Income from Branch Profits**: The exemption extends to income earned from branches, further incentivising multinational corporations operating through branches in Malta.

The common thread across these streams is the **notion of a participating holding**, which serves as a qualifying criterion for the application of the exemption. This targeted approach ensures that the benefits of the participation exemption are directed towards specific types of business activities, aligning with Malta's strategic objectives in fostering economic growth and attracting investment.

A **participating holding** (PH) under Maltese law encompasses specific criteria that a company must meet to qualify for certain tax exemptions. To be a participating holding, a company must satisfy **2 tests**:

Equity Holding: The holding must represent equity, meaning ownership in the form of shares or similar instruments that confer ownership rights in the company. This implies a direct investment in the share capital of another company.

Criteria of a Participating Holding: To qualify as a participating holding, the equity holding must meet certain conditions outlined in Maltese tax law. These conditions typically include:

> Holding of **at least 5% or more of the equity shares in the non-resident company**.
>
> The holding of shares entitles the shareholder to at least one of the following:
>
> > **Voting rights** in the non-resident company.
> > **The right to profits available** for distribution to shareholders.
> > **The right to assets** available for distribution upon winding up of the non-resident company.

Meeting these criteria establishes the equity holding as a participating holding, making it eligible for tax benefits such as the participation exemption. This exemption allows the Maltese company holding the participating holding to potentially avoid taxation on income or capital gains derived from the participating holding, subject to meeting certain conditions and requirements.

Both the **definition of equity and PH are found in Art. 2 ITA**. If income or capital gains is classified as income from a PH, then subject to something, it may be eligible to the participation exemption and the company may not be paying tax at all.

Test #1: Equity

The concept of a participating holding (PH) in Maltese tax law is closely tied to the notion of equity and certain participation rights. The following is a breakdown of the **criteria for determining an equity holding**:

1. **Rights to Profits**: The equity holding must confer upon the shareholder the right to receive a share of the profits of the company. This could include dividends or other distributions of profits.
2. **Rights to Vote**: Shareholders holding equity must have the right to participate in the decision-making process of the company by voting on important matters such as the election of directors or major corporate actions.
3. **Rights to Liquidation Proceeds**: In the event of the winding up or liquidation of the company, equity holders should have the right to receive a proportionate share of the remaining assets after all debts and obligations have been settled.

For a holding to qualify as a participating holding, **it must fulfil AT LEAST 2 out of these three criteria**. This means that the shareholder must have significant influence and participation rights in the company, as evidenced by possessing two of these three rights.

It is important to note that shares in property companies are excluded from the definition of equity holdings, indicating that the participation exemption and related tax benefits do not apply to investments in such entities.

Test #2: Participation Holding

To qualify as a participating holding (PH) beyond merely meeting the criteria for an equity holding, specific conditions outlined in Art. 2 of the Income Tax Act (ITA) must be satisfied:

Quantitative Requirement: The shareholder must hold at least 5% of the equity shares in the company. Alternatively, if the shareholder does not meet this threshold, they must hold shares with a value of at least €1,160,000.

Qualitative Requirement: In addition to the quantitative criteria, the shareholder must also meet certain qualitative requirements. This could include rights such as pre-emption rights, rights to appoint directors, or other similar rights that confer significant influence or control over the company.

Duration of Holding: The shares must be held for a certain period, typically over 183 days, to qualify as a participating holding.

Meeting these conditions allows the shareholder to benefit from the participation exemption, whereby dividends and capital gains derived from the participating holding may be exempt from tax. This exemption extends to dividends distributed by subsidiaries of the Maltese company, provided they also qualify as participating holdings.

The Anti-Abuse Provision

To qualify for the participation exemption on income, a body of persons in which the participating holding (PH) is held must meet one of the anti-abuse conditions outlined in the Income Tax Act. These conditions are designed to prevent abuse of the exemption:

EU Residence or Incorporation: The body of persons must be resident or incorporated in a country or territory that is part of the European Union. Alternatively, if it's a foreign company, it must be registered in an EU member state.

Foreign Taxation: The body of persons must be subject to a foreign tax of at least 15% on its income.

Passive Income Limitation: The body of persons should not derive more than 50% of its income from passive interest or royalties.

If NONE of these three conditions are met, there are still two additional conditions that, **if both met, may allow for the exemption**:

Foreign Taxation (Alternate): The body of persons, if not resident in Malta, or its passive interest or royalties, must be subject to a foreign tax of at least 5%.

Non-Portfolio Investment: The equity holding by the Maltese company in the non-resident body of persons must not be considered a portfolio investment.
These conditions ensure that the participation exemption is granted appropriately and not abused for tax avoidance purposes.

Optional Exemption

The **participation exemption is optional**. The latter limb of **Art. 12(1)(u) ITA** contemplates a waiver of the exemption.

Royalty Exemption

Art. 12(1)(v) ITA contemplates an exemption in respect of royalties and distribution of profits. The remit of royalty exemption was extended to apply to other forms of Intellectual Property, besides patents.

Retirement Schemes

Art. 12(1)(d) ITA applies to any **retirement fund** or **retirement scheme licensed**, **registered**, or otherwise **authorised** under the Special Funds (regulation) Act.

EU Tax Exemptions

Income tax exemptions are contemplated in **EU Tax Directives**. These have been **transposed into Maltese law**.