PBL3003
GENERAL INTRODUCTION TO PRINCIPLES OF TAXATION

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MALTA

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INTRODUCTION

Tax law is a subject which has become much more topical than it used to be. Nowadays, everyone speaks of tax law, tax evasion, and tax matters. This was not the case in the past but nowadays there is a lot of attention on taxation.

What is taxation?
Taxation is defined as a form of expropriation. Taxation is **a compulsory contribution towards the revenue of a State**. The Government expropriates from one's hands a percentage from the revenue one will derive from their work. It is a form of confiscation, therefore, expropriation.

Some types of tax include Income Tax and Value Added Tax. Indeed, there are different types of taxes, namely direct and indirect. **Income Tax is a direct tax whereby the Government confiscates a percentage of your earnings**. On the other hand, VAT is different since in VAT, the **Government charges a tax on supplies of goods and services and whenever a consumer buys a taxable asset, he has to pay tax**. In this way, you avoid Income Tax by not working at all, but you avoid VAT by not buying at all. So, Income Tax and VAT follow two different philosophies: The former taxes earning while the latter taxes consummation. So, in a way Income Tax discourages people from working more and VAT discourages people from purchasing.

It will be seen how governments are constantly basing their decisions on these two sides of the coin: taxing **revenues** or taxing **consummation**. A State which increases Income Tax is telling people not to work because the more you work, the more you pay. Conversely, a tax which makes people pay a lot of VAT tells people to buy less. From an economic aspect there is a very fine line which must be maintained. There is no formula, but again different governments will bear this economical distinction between the two taxes in mind. For instance, in Malta for many years we didn't have VAT. We shall see how there are some taxes which are good for an economic ecosystem and those which are good for another economic system. A very delicate balance must be met.

What is national insurance? And is it a tax?
National Insurance is mandatory like tax, but it is **a pension scheme**. Indeed, one is supposed to pay NI so that when that person reaches retirement age, their NI contribution will be refunded to him/her in some form of pension. **It is not a tax** because legally when one pays one's taxes, one does not expect to receive anything in return. A tax is a compulsory contribution towards the revenue of a State and there is no legal expectation for a return. So, it is different. Legally, paying tax doesn't give you any rights. There is no right under the Constitution or under any law which is linked to taxation. You can be a person who is not paying tax and still vote, receive free healthcare and so on.

The jurist Austin used to describe taxation as a compulsory payment imposed by a political superior on a political inferior. We are all tax subjects. We must pay tax because we exist. If we do not pay tax, there is even a possibility that we might be sent to prison. There is the private good and the private good. The former regularly expropriates from the private person to fund public projects. In democratic countries, the funds collected from taxation go to schooling, hospitals and so on. That is to say, for local projects. However, there are also those countries where the revenue is put to less noble purposes. With that being said, the taxpayer legally does not have a right to refuse to pay tax because government is using his/her money to fund something he/she disagrees with. Politically you might take certain decisions but legally this is not so.

Taxation is a mandatory payment towards the revenues of a State. Keep this in mind even when they tell you that tax evasion is theft. Legally it is not theft. Of course, tax evasion isn't correct but describing it as a theft is just as incorrect since it is a different wrongdoing. You are not taking something which belongs to someone else.

What type of law is tax law?
Tax Law is a type of Public Law because the relationship between the individual and the State is paramount. Nonetheless, tax law has elements of other laws too. You will find in Tax Law an element of Criminal Law which nowadays is becoming very predominant. You will find elements of Administrative Law, International Law (both public and private) etc. In this way, it is evident that Tax Law permits all areas of law including, for instance, Family Law. Tax comes into play whenever important decisions are taken.

Take for instance, drug trafficking. It is very difficult to prove that a person is a drug trafficker, but it is very easy to prove that he is evading tax. They just go to his house or investigate his lifestyle and say you have certain goods; from where did you get the money? If he is unable to explain his source of work, then they will try him for tax evasion. Very often you will hear of prosecutions of tax evasion since it is easier to prove. In terms of Family Law, in a separation deal, there are always tax considerations to keep in mind. So, you need to have a basic background in taxation to be a decent lawyer. Otherwise, you will not be providing correct advice to clients.

What are the different types of taxation?
(1) **Income tax**
Regulated by the Income Tax Act, Chapter 123 of the Laws of Malta.

This was introduced in 1948 but if you had to see the Income Tax Act, Chapter 123 of the Laws of Malta, this was the law which was amended most often. It gets amended every year with the Budget. So, since 1948, this law has been subject to significant changes. In 1948, it was created as a tax on income (an element of profit). It is a tax on profit. In 1948, it was perceived as a tax on the rich, a tax on businessmen. Not only, even employees, but whoever made a profit. The concept was that if you do not make a profit, you do not pay tax. It was introduced to provide for social security. Over the years, it was subject to significant changes and the remit of the tax was augmented/enhanced.

In 1993, the tax was extended to include a **tax on capital gains**. In fact, if one reads the current article 5 of the Income Tax Act, one will see that there is a tax on capital gains. In 2006, there was a further change where the remit of the tax was extended to incorporate **property transfers tax**. If one had to consult article 5A one would find that within the income tax, there is a property transfers tax.

As of fact, the income tax comprises three distinct taxes: (1) **income tax on income**, (2) **income tax on certain capital gains** and (3) **property transfer's tax**. So, in reality, one will find three taxes within the Income Tax Act.

Income tax is a very vast law. The primary law is Chapter 123 of the Laws of Malta but then, there is the administrative component in the law found in the Income Tax Management Act, Chapter 372 of the Laws of Malta and many legal notices (subsidiary legislation). So, income tax is a very vast law, not to mention judgements and guidelines (documents explaining the law). Judgements are not always published since they are subject to the duty of official secrecy.

(2) **Value Added Tax**
Regulated by the Value Added Tax Act, Chapter 406 of the Laws of Malta.

This tax law was introduced in 1998. VAT is **a tax on supplies of goods and services**. It's not a tax on income, but a tax which the seller/service-provider must charge in his supplies. Eventually, it is the final consumer/buyer who pays it. Indeed, the seller is like an intermediary/tax-collector who must charge the tax and pay it to Commissioner for Revenue.

In 1997 and 1998, there was a whole issue about this tax and there was a change in Government because of this tax. VAT is **the tax of the European Union**, so it is harmonised across the EU. It is a tax on supplies of goods and supplies of services. The nature of tax is important. VAT is paid by consumers. So, we all pay VAT since whenever you buy something, you pay VAT. Ultimately, such money will go to the Government of Malta. Our VAT Act is based on the EU VAT Directive. Member States are allowed certain derogations/liberties such as establishing rates of VAT, but it is more or less the same across Member States.

(3) **Duty on documents and transfers**
This is what we call 'stamp duty'. It is a transactional tax. When you enter into certain transactions, you must pay duty. For example, when you buy immovable property, or shares, you must pay duty on documents and transfers.

Typically, stamp duty used to take the form of a stamp. Notaries carry out searches and have visibility of old contracts and when these are seen, these contracts have a stamp affixed to them because traditionally, that was the way tax was paid, via the purchase and fixing of a stamp on a document. This was at a time when the postal services belonged to the Government. As time went by, stamp duty was paid by going to a department and physically getting a document stamped. Over the years, the procedures have more or less evolved.

Upon the execution of contracts involving the sale of immovable property, notaries have an obligation, besides to collect income tax, to collect duty on documents and transfers. This is typically a tax which is borne by the buyer because it is considered to be an expense of the contract. All expenses of the contract must be borne by the buyer.

CHAPTER 1
THE MALTESE INCOME TAX SYSTEM

The Maltese Income Tax Law is a special law, but it exists in a constitutional and administrative system which govern it. Violations of the Maltese Tax system are punishable as acts of fraud and evasion, and many provisions have a penal nature which must be interpreted and applied with the guarantees of due process which are applied in the criminal law contest. General principles of law, customary principles of international tax law especially, are part of the system too.

Sources of Income Tax Law
The main sources are the **Income Tax Act (Chap. 123)** and the **Income Tax Management Act (Chap. 372).** Both acts incorporate rules which empower the Minister of Finance to prescribe regulations which create subsidiary rules to those contained in the acts.

The ITA contains substantive rules determining taxable profits, the rules on jurisdiction to tax, deductions, exemptions, rates of tax, taxable receipts and taxable persons.

The ITMA is meant to be the law which contains the administrative component of the legal system, containing the rules on judicial review and principal rules on tax compliance obligations.

In reality, the Income Tax Act comprises three taxes –
1) A tax on **Income** (art. 4. It was introduced in 1948 and is the main law),
2) A tax on **Capital Gains** (Art. 5 and some pieces of subsidiary legislation including the Capital Gains Rules), and
3) **Property Transfers** tax (in 2006, through article 5A, this specific form of tax was introduced).

So, in reality, in the Income Tax Act one finds three distinct taxes. The main rules governing these three distinct taxes are comprised in article 4 dealing with Income, article 5 dealing with Certain Capital Gains and article 5A dealing with Property Transfers Tax.

1) **The Taxation of Income**
Article 4 ITA stipulates that the following shall constitute income –
   a. Gains from a trade, business, profession or vocation;
   b. Gains from any employment or office;
   c. Dividends, Premiums, Interest or discounts;
   d. Pensions, Charges, Annuities or Annual payments;
   e. Rents, Royalties, Premiums and any profits arising from property;
   f. Income from gains not mentioned above (catch all clause)

In article 4, one finds a non-exhaustive definition of income. It's a descriptive definition and in article 4(1)(g), the law provides blanket provision; a capture all section reading *"any other income".* So, income, regardless of its classification, is taxable because you have an article in the law which says this.

2) **Taxation on Certain Capital Gains**
Article 5 ITA is the most important article regulating capital gains and it sets out the rules relating to the tax treatment of Capital Gains listing chargeable assets, establishing deductions and exemptions and creating a number of computational rules.

Whilst all Income is taxable, only Capital Gains derived from the disposal of taxable assets give rise to taxable Capital Gains.

So, one must contrast article 4 ITA with article 5 ITA. Article 5 provides that tax on capital gains is chargeable whenever there is a session of rights or transfer of rights over certain capital assets. Here, the law incorporates an exclusive list of chargeable assets, referring to **immovable property**, **securities**, **goodwill**, **trademarks**, **tradenames**, **beneficial interest in a trust** and situations involving **value shifting** and **de-grouping**. So, capital gains, unlike income, aren't always taxable.

So, all income is taxable, while conversely, only certain capital gains are taxable, i.e., only capital gains falling under the list of chargeable assets in article 5.

Let's say I were to inherit immovable property from my father, and I sell the property. When I sell this capital asset, I derive a capital gain and must pay capital gains tax. From my father, I didn't only inherit this property, I also inherited a box of valuable watches. The value of the watches exceeded the value of the property. I sold the watches deriving a capital gain. Will I be taxed on the sale of the watches? That is to say, will the sale of the watches be subject to tax under article 5? The sale of the watches will not give rise to a taxable capital gain for the simple reason that watches are not on the list in article 5. **If an item is not on the list, then its transfer does not give rise to a chargeable capital gain**. So, I will pay tax on the property but not on the watches, assuming that we are dealing with a capital asset and not income.

3) **Property Tax Transfers**
Article 5A ITA speaks of Property Transfers with 'Property' meaning **any immovable property situated in Malta and any right over such property**.

Property Transfers Tax is not a tax on profit but a tax on turnover. It applies only to transfers of immovable property situated in Malta. Property Tax Transfers and Tax on Capital Gains are mutually exclusive (they cannot both apply together).

PTT applies by default and in a number of cases established by law, a person can opt out of it and pay tax on the transfers in terms of the capital gains rules.

CHAPTER 4
TAXABLE RECEIPTS

The Concept of Chargeable Income
Taxable persons are taxable on their chargeable income. **Art. 2 ITA** defines 'chargeable income' as *"the **total income** of any person for one year."* In broad terms, it can be defined as all the income and certain capital gains, left after taking certain exemptions and deductions into consideration and computed by reference to certain provisions. Thus, the ITA charges, in principle, all income, certain capital gains and transfer of immovable property situated in Malta.

Although the tax is one and the same (both types of receipts must be reported in the same tax return), the process required to determine the income which is chargeable to tax is different from the exercise which leads to the determination of taxable capital gains.

Drawing the distinction is important for the following purposes –

a. **Determining tax liability** – whereas all gains of an income nature (saving the exemptions) are taxable, only the capital gains derived from the transfers listed in art. 5(1)(a) ITA are taxable.
b. **Computational purposes** – the exercise leading to the determination of the gains or profits which are taxable for income purposes is different from the exercise leading to the determination of taxable capital gains.
c. **Exemptions and Deductions** – some of them apply exclusively to capital gains.
d. **Treatment of Losses** – the tax treatment of losses of revenue nature is different to that of capital losses.
e. **Jurisdictional rules** – differences in gains of a capital nature and of an income nature. Whereas income arising abroad to a person who is domiciled in Malta but not ordinarily resident in Malta is taxable in Malta if received in Malta, capital gains arising abroad to persons who are domiciled in Malta but not ordinarily resident in Malta are not taxable in Malta at all (irrespective of remittance).

So, it is important to distinguish between income and capital gains. There are a number of reasons for this. One of these reasons is the distinguishing between whether it is taxable and how. Whereas all income is taxable (article 4(1)(g)), not all capital gains are taxable, only those listed in article 5. Furthermore, the computational rules to determine Income Tax treatment are different from the computational rules to determine Capital Gains treatment. In addition, rules on jurisdiction to tax are also different and a different treatment is applied in loss making scenarios to the extent that there is a different treatment from trade losses and capital losses.

Capital, Income and Capital Gains
Given that Malta does not tax capital, taxes income, but taxes only certain capital gains, distinguishing receipts of a capital nature from receipts of an income nature is key.

The hallmark of capital is its permanence; capital is static. Income is recurring and circulating. Capital, when utilised, can generate income. Our Courts have referred to Silke on the subject, who holds that:

"In ordinary cases the determination of whether a receipt or an accrual is of an income, or a capital nature creates no problem. Thus, amounts received for allowing the use of an asset to some other person, e.g., rents, interest, royalties, all partake of the nature of income and fall within the definition of gross income. It is true that there is no definite test that can always be applied to determine whether a gain or profit is income or not, but it may safely be asserted that ***the revenue or profit which is derived from a thing without changing owners is rather to be considered as income than capital****."*

The profit on disposal of a revenue generating source of capital gives rise to a capital gain but payments derived from the exploitation of capital are of a revenue (income) nature. Our Courts have consistently referred to British case law, including the doctrine of **badges of trade** on the matter. These badges of trade can be considered as rebuttable presumptions relating to the existence or otherwise of trade. If there is this existence of trade, the yield from such an activity would be of an income nature and not of a capital gains nature. Nonetheless, this must be analysed on a case-by-case basis.

So, the question here is how do you distinguish between income and a capital gain? Think of in terms of an analogy whereby income is the fruit and capital gain is the three. Capital is static, it doesn't move, whereas income is recurring, it is generated from capital. The transfer of capital gives rise to a taxable capital gain. In order to identify whether an item represents income or capital, we use what are known as **badges of trade**. This is a creature of English law.

BSC 23/02

The BSC delivered one of its best decisions on badges of trade in BSC 23/02. The Board in this case used several badges of trade to determine that the company's transactions in immovable property amounted to adventures in the nature of trade and that income derived from the transactions was of an income nature. In this case, the Board applies several badges of trade (**interval of time between purchase and re-sale**, **supplementary work on the properties**, **organisation of the business**). The Board also attributed an element of importance in the manner in which an asset is recorded in the company's accounting records. The classification of an asset as trading stock clearly indicates that profits derived from the sale of an asset are of a trading nature.

***Rutledge v. CIR* – CS 1929, 14 TC 490**

In order to appreciate badges of trade, one needs to analyse the Court's conclusion in *Rutledge v. CIR* – CS 1929, 14 TC 490, a case known as the *Great Toilet Paper case* since it involved the purchase and sale of toilet paper. In brief, Rutledge was an international entrepreneur who got to know that there was a company which manufactures toilet paper which was about to be bankrupt and that it was selling its stocks at very low prices. Rutledge purchased all its stocks for a very low price, below cost, millions of rolls of toilet paper, bought them in bulk and sold them in bulk, that is, in one transaction, deriving a profit. He did not report this profit in his return and when he was investigated, he claimed that he didn't report this profit because he had derived a capital gain. Conversely, the Inland Revenue disagreed, saying that what he had derived was trading income. In answering the question, in order to resolve the dispute, the Court developed the badges of trade concept, identifying badges of trade which serve to distinguish income from capital gains. Was the profit a capital gain or was it trading income? Were there badges of trade in this transaction? The Court said that this is stock in trade and not a capital asset.

So, badges of trade help us distinguish between capital assets and trading stock. A badge of trade which was very indicative in this case is **subject matter** of the goods, that is, the toilet paper. He didn't buy the toilet paper for personal use; toilet paper does not give pride in possession. He bought to toilet paper to resell it. That was an important badge of trade – **quantity of the goods** and **nature of the goods**. The nature was a typology which doesn't lend itself to giving pride in possession like jewellery, gold, shoes and so on. It was in itself an indication that Rutledge was trading.

These badges of trade are like symptoms, helping one identify the existence of a trade.

Various Badges of Trade –

1. Supplementary work

The case of *Martin v. Loriee*, another British badges of trade case, involved a British person who purchased a military vessel, converting it into a fishing trawler. So, he also changed the destination of the property, converting it from the remains of a military vessel to a fishing trawler, selling it at a profit. There was the badge of trade of **supplementary work**, that is, when you convert the asset. He didn't just buy it and sell it, but he carried out work to make it more sellable, more marketable. He converted its nature which is an important badge of trade.

In Malta, one will find this badge of trade very often being applied in cases involving property. On this point, see the case in the Malta which was the scene of a crime where the husband murdered his wife. The husband was sent to prison for murder. Whilst in prison, he met the love of his life, a prison warden. He decided to marry her. After serving his sentence, he married the prison warden with the intention of establishing a matrimonial home with her. He decided to set up his home elsewhere to the home he murdered his wife in. The question was what to do with his Marsaskala house which had a substantial value. He tried to sell the property but couldn't find a buyer. He dropped the villa down, converted it into units, and sold it in pieces and eventually sold it all. When he came to reporting this transaction in his return, he reported the profit as a capital gain. The Inland Revenue disagreed saying that it was income.

Was this income or capital gain? The original intention was not to buy stock in trade but to live in it as his home. So, **profit seeking motive**, as a badge of trade was absent. Had he sold it and purchased it as bought, the case would have been clear cut. This is the key issue.

Badges of trade are non-cumulative, they are merely symptoms, and subject the judgment, one would thing that because of the presence of this important badge of trade, the Tribunal should have said that this was clearly a trading transaction. Nonetheless, the Tribunal said that despite this badge of trade, most, if not all badges of trade are missing, not to mention the very particular circumstances of this case. The Tribunal concluded that here, you didn't have a trade. What is surprising is that the Revenue didn't appeal. What conditioned the conclusion must have been the very particular circumstances of this case.

2. Incidence of Transactions
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

To use an example, I am a lawyer, I owned a car for 20 years and I sell it. My car happens to be a collectable car and when I sell it, I make a profit. Is that profit income or capital gain? The lawyer used it for many years, it was bought for personal use. When he sells it, he does not need to pay tax. Moreover, he is a lawyer by profession. Now, say a car dealer purchases the car, sells it and makes a profit. Is the car dealer taxable? In this case, the tax is income for a number of reasons. There are a number of badges of trade present – **organisation of the business**, **profit seeking motive**, but besides these badges of trade, more importantly there is the **interval of time between purchase and resale**. The car dealer sold the car immediately. It was short and that is an indication of trade.

Incidence of transactions is another badge of trade. Whereas when the lawyer bought and sold the car, one car in 20 years, the dealer buys and sells cars every day. So, in the case of the dealer, there would be many incidents of transactions. On this point, see a Maltese case which dealt with a Maltese employee of the Government and used to be involved in buying and selling properties, claiming that the profits he was making were a capital gain. When he was subjected to an investigation, they discovered that he was involved in multiple transactions. He was also a trader in property. So, the Maltese Courts concluded that he was a trader.

Classification of Income
Once it is established that a given taxable receipt (gain or profit) is classified as income, such receipt would need to be sub-classified in terms of **Art. 4 ITA**, in one of the 6 categories laid down. This is important for reporting purposes, but also due to the specificities of deductions and computation. For example, whilst bad debts are only allowed in the course of an adventure in the nature of trade, maintenance allowance is only allowed against rental income.

> **4.** (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 -

(1) **Trading Income (Art. 4(1)(a))**

(*a*) gains or profits from any trade, business, profession or vocation, for whatever period of time such trade, business, profession or vocation may have been carried on or exercised including the profit arising from the sale by any person of any property acquired by him for the purpose of profit-making by sale, or from the carrying on or carrying out of any profit-making undertaking or scheme;

A gain is charged under this article if it is derived in the course of an activity of an independent nature. The existence of a trade is **determined via badges of trade.** Trade losses arise in trade. Moreover, gains of a trading nature are subject to specific computational rules and even illegal trades are, in principle, taxable under this article.

(2) **Employment Income (Art. 4(1)(b))**

(*b*) gains or profits from any employment or office, including the value of any benefit provided by reason of any employment or office; and -

(i) for the purpose of this paragraph the Minister responsible for finance may by regulations prescribe the circumstances in which a person shall be treated as receiving a benefit from another person provided by reason of an employment or office and the value of any such benefit;

(ii) where in terms of the said regulations a person is treated as receiving a benefit provided by virtue of an employment or office after the termination thereof and that benefit has the nature of a pension the benefit shall be treated as a pension and the value determined in accordance with the said regulations shall constitute income

This implies an employer-employee relationship, i.e., where the latter is dependent on the former for income.

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

(*c*) dividends, premiums, interest (which includes any gains from any sum of money in whatever currency deposited with a person carrying on the business of banking under the Banking Act in any account whatsoever) or discounts:

Provided that, notwithstanding any other provision of this Act, such income of a company from an offshore banking subsidiary company shall constitute income chargeable to tax under paragraph (*a*) and the provisions of article 56(6) shall apply to such income;

<u>Dividends</u> represent a return on an investment in shares, paid by the company to its shareholders. In other words, they are a portion of a company's earnings distributed *pro rata* to its shareholders. **Art. 2 ITA** defines 'dividend' as including –

1) Bonus shares;
2) Any distribution made by a company, to its partners or shareholders, as the case may be, and any amount credited to them as partners or shareholders as the case may be; and
3) Any distribution made by a co-operative society to its members and any amount credited to them as members, including any patronage refund, bonus certificate or bonus share, made, paid or allotted in accordance with the law regulating such societies for the time being in force in Malta;

In this way, this definition is not restricted to returns from a company but is extended to include distributions made by a partnership en commandite which has both general and limited partners, with its capital divided into shares. This is so because it falls under the definition of 'company'. Moreover, dividends also include bonus shares, so it isn't limited to cash distributions and distributions made by a cooperative society to its members are also encompassed.

Art. 47 ITA stipulates that the **distributions made by the liquidator when winding up a company** to the extent which they represent income derived by the company or partnership are deemed to be dividends for income tax purpose.

The taxation of dividends amounts to taxation of taxed profits, which gives rise to economic double taxation but in Malta, double taxation is eliminated via the **full imputation system** which applies when profits are distributed from the foreign income account to the Malta taxed account. This system could give rise to a situation where **an individual may be entitled to a refund of the tax paid by the company**.

<u>Premiums</u> refer to a sum of money in addition to a regular price salary or other amount; it is a bonus. **Only premiums of a revenue nature** are taxable under article 4 and not those derived from immovable property.

<u>Discounts</u> are gains granted to financial institutions on the maturity of bills of exchange. In other words, it is the difference between the cost of acquisition of the bill of exchange and the amount actually received upon the maturity of the bill. Tax is paid on **the amount written in the bill of exchange** and not the amount when the maturity date closes, that is, when the discount is imposed. Tax is paid on the **full amount**.

<u>Interest</u> refers to a fee paid by a borrower of assets in compensation for use of such assets. The Japanese Bond case confirmed that Interest Income should only be taxed if and when received. Moreover, interest received from sources outside of Malta is taxable in Malta and does not benefit from an exemption related to income from participating holdings.

(4) **<u>Pension, Charges, Annuities or Annual Payments (Art. 4(1)(d)</u>**

(*d*) any pension, charge, annuity or annual payment;

These are payments of a recurring nature.
<u>Pensions</u>, as a general rule, are taxable. State pensions include those in respect of invalidity, disability, injury, unemployed benefit, widowhood, retirement, age, carers etc. **Art. 12(1)(g) and (h) ITA** exempt from income tax wound disability pensions granted in respect of those caused by war and any pensions granted to dependent relatives of members of the armed forces of the Commonwealth killed on war service. Moreover, the **exempt taxes on state pensions** are social assistance, age pensions, marriage grants, children's allowance, foster care allowance, amongst others.

<u>Annuities and Annual Payments</u> here refers to annuities of an **income nature** and not those of a capital nature. In case 17 of 1950 it was confirmed that the annual payment imposed on a legatee as a condition in his inheritance of the family business was an annuity of an income nature and consequently, taxable.

Annuities are always taxable except when they are set for a definite period and when they consisted of payments by instalments of an ascertained capital sum. This is the case when, for example, a person buys an annuity that assures him of an amount of income until his death. It becomes a simple sale by instalments.

Alimony payments are payments made to a separated spouse, as required by separation agreements, by the husband. In case 55 of 1964, the Courts confirmed that **alimony payments** made by a husband to his estranged wife constituted income and **had to be taxed as an annuity**. These payments are chargeable in the hands of the party receiving them. The problem with this term is that it is not defined within the ITA and the Civil Code uses the term 'maintenance'. So, the question that inevitably arises is whether or not these two terms should be construed as being one and the same.

(5) **<u>Rents, Royalties, Premiums and any other Profits arising from Property (Art. 4(1)(e))</u>**

(*e*) rents, royalties, premiums and any other profits arising from property;

<u>Rents</u> includes both lease and emphyteusis. Moreover, rental income is taxable under this provision on the condition that it is **not of a trading nature**. Thus, a person who rents out his holiday flat must report his rent as rental income in his return, while persons who are in the property leasing business must report rents received as trading income under Art. 4(1)(a) ITA and not Art. 4(1)(e). This is important for computational purposes.

<u>Royalties</u> can be divided into two – royalties which are recurring, such as those which are paid in return for permission to use a trademark or a patent and royalties paid upon an outright transfer of an intellectual property right. The former are taxable under Art. 4(1)(e) ITA since they are of an income nature while the latter comprise capital gains and are taxable under Art. 5 ITA. Essentially, a royalty is a payment to an author or an inventor for each copy of a work sold under a copyright or patent.

(6) **<u>Gains or profits not falling under any of the foregoing paragraphs (Art. 4(1)(g))</u>**
This provision catches all income from property which is of a revenue nature.

CHAPTER 6
JURISDICTION TO INCOME TAX

This is the equivalent of article 5 of the Criminal Code being applied in a tax context. We are going to see in what circumstances a person becomes liable to tax in Malta. The Income Tax Act, unlike other laws, considers some people to be 100% Maltese, and others to be 50% Maltese. So, some people are taxable on their worldwide income and other people are not.

The rules relating to the jurisdiction of the Income Tax are contained in **Art. 4(1)(g) ITA** –

> (*g*) gains or profits not falling under any of the foregoing paragraphs:
>
> Provided that:
>
> (i) in the case of income arising outside Malta to a person who is not ordinarily resident in Malta or not domiciled in Malta, the tax shall be payable on the amount received in Malta;
>
> (ii) no tax shall be payable on capital gains arising outside Malta to a person who is not ordinarily resident in Malta or not domiciled in Malta or to a person who is charged to tax at the rate of fifteen cents (0.15) in the euro as laid down in article 56(11);
>
> (iii) in the case of any person who is charged to tax at the rate of fifteen cents (0.15) in the euro as laid down in article 56(11), the tax shall be payable only on any income or capital gains arising in Malta and on any amount of income arising outside Malta and received in Malta.
>
> Sohowever that items (i) and (ii) of this *proviso* shall not apply to an individual who is a long-term resident, or who holds a permanent residence certificate or a permanent residence card, in respect of any income derived by such individual in the year of being granted long-term resident status or the right of permanent residence and in subsequent years. The terms "long-term resident", "permanent residence certificate" and "permanent residence card" shall have the meaning assigned to them respectively in the Status of Long-Term Residents (Third Country Nationals) Regulations and the Free Movement of European Union Nationals and their Family Members Order.
>
> Sohowever also that paragraphs (i) and (ii) of this proviso shall not apply to an individual whose spouse is ordinarily resident and domiciled in Malta.

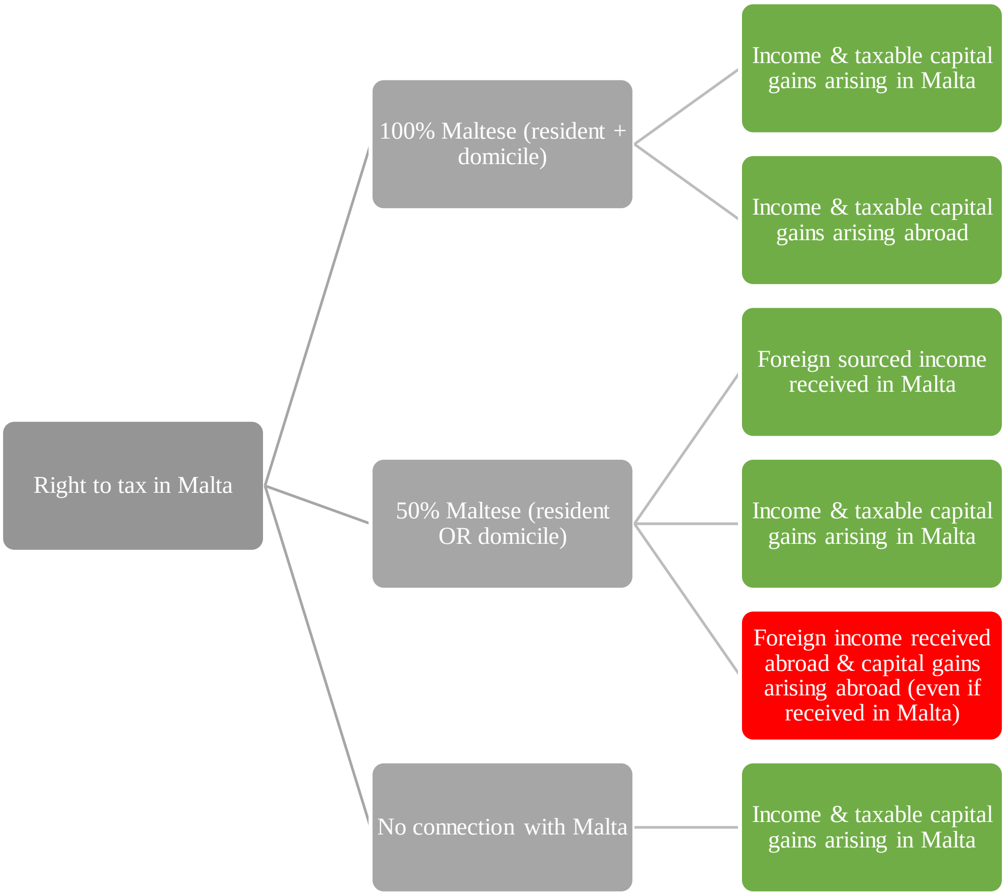
Malta asserts the jurisdiction to tax on the basis of **territoriality**, **ordinary residence**, **domicile**, and **remittance**. In essence, Malta has the right to tax –

(i) Income and **taxable** capital gains **arising in Malta**;
(ii) Income and taxable capital gains **arising abroad**, to persons who are **ordinarily resident** and **domiciled in Malta**;
(iii) Foreign source income derived by persons who are **ordinarily resident** but **not domiciled in Malta**, when such **income is received in Malta**;
(iv) Foreign source income derived by persons who are **not ordinarily resident** but are **domiciled in Malta**, when such income **is received in Malta**.

Thus, persons who are both ordinarily resident and domiciled in Malta are subject to unlimited or full liability but persons who are **either** not ordinarily resident or not domiciled in Malta are subject to limited liability.

So, we need to be aware of basic rules which are contemplated in article 4. As seen above, income and chargeable gains arising in Malta are always taxable in Malta, **regardless of the person deriving such income**. Conversely, when it comes to foreign source income and foreign source capital gains, we go into the extent of how Maltese a person is, and we say that **persons who are both ordinarily resident and domiciled in Malta are taxable on their worldwide income**. But persons who are either not ordinarily resident or not domiciled in Malta, are not subject to tax on worldwide income. These are subject to tax on a remittance basis. So, when it comes to foreign source income, if you happen to be either not ordinarily resident or not domiciled in Malta, **foreign source income is taxed in Malta if it is physically received in Malta**. If it is received in Malta, it is taxed in Malta and if it is not, then it is not taxed in Malta.

So, persons who are either not ordinarily resident or not domiciled in Malta are subject to tax on their foreign source income on a remittance basis meaning that they are taxed in Malta only if they receive their foreign source income here and are **not subject to tax on their foreign source capital gain**.



Interestingly, the difference tax treatment is based on the axiom that a resident uses the amenities of a State more than a non-resident.

Practical example
I am ordinarily resident and domiciled in Malta and I derive the following four sources of income: (1) employment income arising in Malta, let's say €10,000. I also have a flat in London, I sell it and derive (2) a capital gain of €100 and this capital gain is received in my British bank account and not in Malta. Then, I have this English bank account which accumulates interest, and (3) I received this interest income in Malta. So, to summarise, I have local source employment income, foreign source capital gain and foreign source interest income received in Malta. Do I have to declare all the three items in my return? In this case, I would have to pay tax on all three. All the items are taxable in Malta because **I am an ordinary resident and domiciled in Malta and I am taxed on my worldwide income and capital gains**.

However, you could have persons who are either not ordinarily resident or not domiciled in Malta. So, they have one of these elements missing. Let us say that the recipient of the items aforementioned, were to be a person who is either not ordinarily resident or not domiciled in Malta. **With respect to employment income arising in Malta, it is taxable in Malta, regardless of who the recipient is**. Then there is a foreign source capital gain. This is not taxable in Malta since **foreign source capital gains derived by persons who are either not resident or not domiciled in Malta are not taxable in Malta, regardless of whether such capital gains are received in Malta**. With respect to the interest from the English bank account, it will be taxed in Malta if it is received in Malta, that is, if it is remitted to Malta. If the foreign source interest is not received in Malta, then it is not taxed here. **Capital gains derived in Malta are taxed regardless of whether they are received in Malta or not**.

Temporary Residents
Art. 13 ITA

> **13.** Tax shall not be payable in respect of any income arising outside Malta to any person who is in Malta for some temporary purpose only and not with any intent to establish his residence therein and who has not actually resided in Malta at one or more times for a period equal in the whole to six months in the year preceding the year of assessment.

This is another important jurisdictional rule which is contained in Article 13 ITA, and which refers to temporary residents. This creates a special regime applying only to persons referred to as temporary residents, whom are person **neither ordinarily resident, nor domiciled** in Malta but who spend a very short period of time in Malta.

Temporary residents are residents who meet the following three criteria **cumulatively**:
(1) Physical presence in Malta for less than 183 days;
(2) Present in Malta only for a temporary purpose;
(3) They do not establish a home/permanent residence in Malta.

Persons who meet all three are **taxed in Malta only on income arising in Malta**. These persons are not taxed on foreign source income, even if received in Malta, and are not taxed on their foreign source capital gains.
The notion of temporary purpose was discussed in the *Gaines-Cooper case* –

Agricultural, Manufacturing and other Productive Undertakings
Art. 4(3) ITA includes special jurisdictional rules relating to the income of certain undertakings. The general rule is that income derived by the said undertakings from the sale in a wholesale market of products grown or produced in Malta is taxable in Malta, even when the wholesale market is situated outside of Malta, or the contract of sale is executed outside of Malta. Nonetheless, the proviso to the article creates an exception to the rule where the Commissioner is satisfied that the profits have been increased through treatment of the product outside Malta other than handling, grading, blending, sorting, packaging or disposal. This increase will not be subject to Maltese tax. So, when treatment abroad significantly increases the saleability of the **product grown or produced in Malta**, income derived from the profit attributable to the foreign activity is excluded from liability to Maltese tax.

Shipping and Air Transport
Article 28 ITA contains special rules relating to profits arising from the carriage of passengers, mails, livestock or goods to non-resident shipowners. Profits derived by non-resident ship owners from the said activities are taxable in Malta, **when Malta is a port of call**.

Act I of 2010 introduced Art. 29(2) ITA which says that income derived by an owner, lessor, or operator of one or more aircraft or aircraft engine (irrespective of their country of registration) engaged in the international transport of passenger or goods is deemed to arise outside of Malta, notwithstanding the fact that the aircraft may have called at or operated from any airport in Malta.

The concept of Income Arising in Malta

As already said, income and capital gains arising in Malta are taxable in Malta irrespective of the characteristics of the person who receives such income or gain. Therefore, income arising in Malta is taxable in Malta even if the recipient of such income is a non-resident, a non-domiciliary or even a temporary resident.

"Income arising in…"

Malta tends to follow the British doctrine of trading in/trading with to determine the source country of a receipt. *Wilock v. Pinto & Co* determined that only income with a substantial link with a jurisdiction falls to be considered as a 'trade in' income which is taxable in that jurisdiction. Income which only has a tenuous connection with a particular jurisdiction is a 'trade with' and is not deemed to arise in that particular jurisdiction.

In light of international transactions, determining a precise source of income can be tricky. The Commission of Inland Revenue is expected to consider the following guidelines in order to determine whether income is deemed to arise in Malta –

- Income derived from immovable property situated in the territorial confines of a State is considered as arising in such State;
- Income from services physically exercised in that State is deemed to arise in that State;
- Passive income such as dividends, royalties, and interests are deemed to arise in the country where the payer resides;
- Income from intangible property rights is deemed to arise in the country where such intangible property rights are exploited;
- Revenue derived from the disposal of tangible property is deemed to arise where the asset is situated and where the sale takes place at law;
- Employment income of sportsmen and artists is deemed to arise in the place of performance of such work.

A great deal of importance is attributed to the so-called **activities test** which holds that earned income arises in the country where the activities which yield the income are physically exercised. **Income is taxable in the country in which it is produced**.

Further principles –

- Income arises in Malta when the activities which give rise to such income are exercised in Malta;
- Income derived from a contract is taxable in Malta if it is executed in Malta;

"…Malta."

The ITA envisages a meaning of the term Malta in Art. 2 stating that, *""Malta" means the Island of Malta, the Island of Gozo and the other islands of the Maltese Archipelago, including the territorial waters thereof and the continental shelf."*

The Concepts of Ordinary Residence and Domicile when applied to individuals

Ordinary residence

The tax concept of ordinary residence has evolved independently from the Civil Law concept which uses the tool of 'ordinary abode'. Instead, the Maltese tax concept has been drawn directly from the decisions of British Courts. Moreover, although the ITA does not include a definition of 'ordinary residence', it does provide a definition of 'resident'. With that being said, the two terms do not have the same meaning. Indeed, a person can be a resident of Malta without being an ordinary resident of Malta.

Ordinary residence requires more than mere residence, it connotes residence in a place with some degree of continuity; normally it is part of a person's everyday life. While residence is established by **physical presence**, ordinary residence is established through **legalistic facts and circumstances.**

So, two tests are used to define it 'ordinary residence'–

1) A physical presence test; and
2) A facts and circumstances test.

It is necessary to take into account the duration of an individual's presence in a country, the regularity and frequency of his visits, his family and business ties and nature of a person's visits to a country to determine whether a person is an ordinary resident or not. In this way, ordinary residence is distinguished from **occasional or temporary residence**.

Ordinary residence requires –

(i) The person to stay in Malta for **more than 183 days in a calendar year**; or
(ii) The person has to, **over three years, on average, spend more than 90 days per calendar year in Malta**.

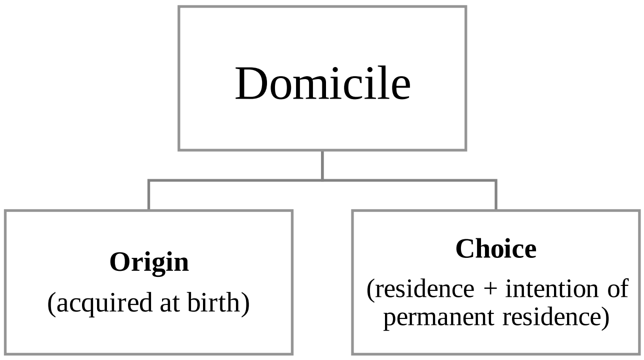
But a person is treated as ordinary resident of Malta if that person has a **fixed regular presence in Malta**, that is, if a person visits Malta regularly, if there is a regularity of presence, year in, year out.

In order to understand this principle, refer to the case involving a Maltese person who went to work abroad. There was this young man who got married and decided to go to work somewhere in North Africa. His family was in Malta, but **he didn't own a house in Malta** since the plan was to make enough money in Africa to buy a home in Malta. When in Malta, this person used to live at the home of his mother-in-law. He spent 10 years aboard **visiting Malta 33 times**, always spending his leave in Malta. **He was receiving his salary in a foreign bank account** so; he hadn't remitted any of his income in Malta. He was subject to tax evasion and when confronted by the investigators of the Inland Revenue he said he didn't declare his income since he wasn't an ordinary resident in Malta. He received foreign source income, so he is subject to the remittance basis of taxation and didn't have to report any income in Malta. So, the question was whether he was ordinarily resident in Malta.

When the case went to Court, it concluded that this person was ordinary resident in Malta because he was **visiting Malta regularly** and had a **home in Malta**. Although he didn't own the house, he established a habitual abode in Malta. Albeit he didn't meet a physical presence test, his personal connections with Malta indicated that he was an ordinary resident in Malta.

<u>Domicile of individuals</u>
Ordinary residence is not the only connecting factor referred to in Art. 4 ITA since it also refers to the concept of domicile, which is a concept of Private International Law, of Common Law. Think of it like being some form of guardian angel which follows individuals wherever they are; it is their personal law, the law which governs them as individuals vis-à-vis personal matters, such as inheritance, marriage and so on. It is the law of your domicile.

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



One must keep in mind that a person can only have one domicile. So, whereas a person can have multiple ordinary residences, **a person can only have one domicile at one moment in time**. Upon birth, a person acquires the domicile of his parents because nobody can be without a domicile. If, at the time of your birth, the identity of your parents is unknown, then you acquire the domicile of where you are found. In an English case <u>*IRC v. Bullock*</u>, certain rules regarding domicile were laid down –

i. Every person must have a domicile;
ii. You can only have one domicile at one point in time;
iii. You acquire the domicile of your father at birth;
   a. If father unknown, you acquire the domicile of your mother.
   b. Children of unknown parents: where child is found.

The domicile you acquire at birth is called your **<u>domicile of origin</u>** which clings onto you, which follows you for life, but it can be supplanted/changed to a **<u>domicile of choice</u>**.

So, you can change your domicile of origin with a domicile of choice. For instance, if you happen to be a dependant, your domicile changes with the domicile of the person you depend on. You can also change your domicile if you are of age. Indeed, if you emigrate with **an intention to stay in that country as an inhabitant** of it, so it is a combination of physical stay + an intention – *animus manendi e nom reduendi*, and therefore without the intention to return to your country of domicile of origin). If you leave a country with the intention of remaining there, in the new country, then you change your domicile. Those who emigrate with an intention of returning, say in their old age or in the case of a change in political environment, would not have changed their domicile.

In order to change your domicile, you must stay in a new country and stay there with the **intention of never going back to your domicile of origin**. If you are undecided, then your domicile of origin clings onto you and it doesn't change.

The English authors Dicey & Morris laid down the following rules-

- Residence means very little more than physical presence, but it does mean more. For the purpose of domicile, residence in a country is physical presence in that country as an inhabitant of it (and not as a tourist, for example);
- Every independent person can acquire domicile of choice by the combination of **residence and intention of permanent or indefinite residence**, but not otherwise.
- Any circumstance which is evidence of a person's residence or of his intention to reside permanently must be considered in determining whether he has acquired a domicile of choice in that country.

The GAINES-COOPER case

Facts

Mr Cooper had connections in a number of jurisdictions. He was born in Reading England to British parents and grew up and studied there. He started a successful business and bought a large residence in Reading in 1964. In 1971 he sold his shares in his company but remained an employee of it. It was still beneficially owned by him.

In 1973 he travelled to the Seychelles in Africa and decided to establish his permanent home there. In 1974 he resigned from his company and established a property development company in canada. In 1975 he applied for a residence permit to live in the Seychelles and established a plastic factory there. Whenever he visited the Seychelles he stayed at a hotel, and his visits were very regular and frequent. He even acquired a house there but sold it shortly after.

In 1979 he got married to a Dutch citizen, Dilona Lantang and they lived in a house California. In 1981 he moved to Reading willing to live there on a permanent basis. He entertained his guests at Reading and received all his correspondence there.

He left Dilona and the sold the house in 1986 and went to live in another property in the UK and married another woman, Laye-Sion who was a Seychelles citizen. She applied for naturalisation as a british subject.

The point at issue was whether Gaines Cooper was resident, ordinarily resident and domiciled in the UK

<u>Temporary residence</u>
The Special Commissioners held that a temporary purpose is a purpose lasting for a limited time: a purpose existing or valid for a time, a purpose which is not permanent but transient, a purpose which is to supply a passing need. Temporary purpose has been defined as a causal purpose as distinguished from the case of a person who is in a country in pursuance of his regular habits of life.

Thus, when Mr. Cooper visited the UK, he did so for a limited time, but he did it to be with his family and friends. The BSC took the view that travelling to a country to visit family and friends is a permanent purpose in pursuance of the regular habits of a person's life and not a transient purpose. Just because the visits are short does not mean that they are for a temporary purpose. In other words, a decision to visit a country on a large number of days a year to be with family is not a temporary purpose.

<u>Ordinary residence</u>
The question was whether a person could be ordinarily resident in a country without be a resident of that country. The Court held that Cooper was ordinarily resident in the UK because his residence there was **continuous from year to year**. It was part of his everyday life. He would still be an ordinary resident even if there were occasional years where he was not resident in the country.

<u>Domicile</u>
It was held that domicile of choice is a conclusion or inference which the law derives from the fact of a man fixing voluntarily his sole or chief residence in a particular place, with an intention of continuing to reside there for an unlimited time.

The Court described **domicile of origin** as particularly adhesive but confined that there is, at least in theory, a particular moment in time at which domicile of origin is shed in favour of domicile of choice. It held that although Cooper let out his residence in the UK at one time, his chief residence remained in England just the same. His continuous connection with England made it impossible to say that he had acquired a domicile of choice in the Seychelles. **Therefore it confirmed that Cooper had never abandoned his domicile of origin in England.**

Concept of Ordinary Residence and Domicile when applied to Bodies of Persons

<u>Ordinary Residence</u>
Lastly, one must always remember that not all taxpayers are individuals, some are legal persons. The distinction between the notions of residence and ordinary residence does not seem to hold in the world of bodies of persons. Unlike individuals, bodies of persons do not have families and personal ties, they do not commute and do not keep wives and lovers. Thus**, the definition of residence in Art.2 ITA must be taken to be a definition of the term 'ordinary residence' for the purposes of Art. 4 ITA, as far as companies are concerned**.

This concept of ordinary residence when applied to a body of persons, is a Common Law concept. It was developed over the years, the leading cases being the <u>*Egyptian DELTA case*</u>

and the *Cesena Sulphur case*, two cases which explain that **a company is managed and controlled where the board of directors meets**.

Art. 2 ITA

"resident in Malta" when applied to an individual means an individual who resides in Malta except for such temporary absences as to the Commissioner may seem reasonable and not inconsistent with the claim of such individual to be resident in Malta; when applied to a body of persons, means any body of persons the control and management of whose business are exercised in Malta, provided that a company incorporated in Malta on or after 1st July 1994 shall be resident in Malta and any other company incorporated in Malta shall be resident in Malta from 1st January 1995 where the management and control of the business of the company is exercised outside Malta;

The definition of Art. 2 ITA applies to both an Incorporation Test and a Management and Control Test. The Incorporation Test basically outlines that any company **incorporated** in Malta is deemed a resident of Malta, whilst the law then conveniently applies the Management and Control Test for companies incorporated outside of Malta, stating that, *"a company incorporated abroad is considered to be a resident of Malta if it is **managed and controlled** in Malta.*

Management and Control under Common Law
The notion of **management and control** in Britain developed outside of the realm of taxation. It mainly arose for British Courts to assert its jurisdiction over a foreign company.

The leading tax case on management and control is *The Calcutta Jure Mills Co Ltd v. Nicholson* heard with *The Cesena Sulphur Co Ltd v. Nicholson* (1876). 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.** It held that –

*"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 saying that *"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 went on to establish the place where the company's real and substantial business was carried on, the place where the company's centre point was situated. The Court held that once it was the directors who 'called the shots' and the directors met in London, the company's centre point was in London, even though manufacturing took place in Italy. The main place of business is determined on the basis of where the administrative part of the business is carried out.

In *Swedish Central Railway Company v. Thompson* (1925), the plot thickened as this was a company with a **divided management**. In the first years, its board met in the UK, and subsequently moved to Sweden. However, the company's' seal, bank account, and transfer books where all kept in the UK. Furthermore, the company's accounts were maintained and audited in London as was the place from where dividends were paid out. It was held that the residence was still in the UK even though there was some management and control in Sweden. Also, it was held that a company can have **more than one residence for the purposes of Income Tax Acts**.

Later case law explained that the matter is one of **substance and not of form**. So, if you find within this body of persons a decision-making body other than the board of directors, then the company is managed and controlled where this other decision-making body resides. For instance, there was an important case, *Bullock Case* (1960) where the Court explained that in a company where all decisions were taken by the shareholders instead of the directors, with the board of directors being merely a sham, the British courts held that determining management and control is an issue of substance and not of form. Consequentially, if the decisions are taken by the shareholders and not the directors, then the company is managed and controlled where the shareholders meet, **regardless of the name you give to a decision-making body**. So, management and control resided where this body is located, regardless of nomenclature.

In *Regina v. Allan* & *Regina v. Dimsey* (2004), you had a UK entrepreneur who felt that he was paying too much tax in the UK. So, he had a revenue generating asset which he shifted outside of the UK because he understood that if the asset remained located in the UK, showing as its proprietor a UK resident, then revenue from the asset would have generated tax in the UK which he didn't want to pay. So, he manipulated the British tax base, that is, he eroded the British tax base, shifting his profits (profit shifting) to a company resident in a tax haven. So, he shifted his revenue generating asset to new company located in a tax haven where the tax was nil.

On the face of the records, this revenue generating asset was not owned and located in the UK, so the UK did not have a right to tax because the asset showed on the books of a company incorporated in a tax haven where the tax was zero. But the UK Tax Authorities suspected foul play and in the course of a tax investigation, they raided/seized the records of this entrepreneur, they obtained access to his flat, seized his fax machine and in his fax machine, they found faxes wherein from the UK this man was giving instructions to his directors located in the tax haven.

So, as a matter of fact, although on paper the company in the tax haven was incorporated and managed and controlled in the tax haven, in reality, the contents of the tax machine showed that instructions were leaving from the UK, they were being giving by the UK resident. On the face of the records, the company in the tax haven had non-UK directors, non-UK offices, everything was outside but in reality, there was this individual who formally was neither designated as a director nor as a shareholder, but the Courts concluded that given that this company was in reality, being administered remotely from the UK and that the decision-making was being taken in the UK, the company was resident in the UK even though on paper, the records showed otherwise. You look at substance and <u>NOT</u> form. This was treated as a case of tax evasion.

<u>Domicile</u>

The ordinary residence of a body of persons is established by reference to judge made rules which refer to the complex principle of central management and control, but the domicile of a body of persons is **determined, conclusively, by reference to the body's place of incorporation.**

Maltese law makes an exception to the general common law rule that a body of persons cannot change in domicile of origin. The exception refers to bodies of persons which have the **characteristics of limited liability companies**. Maltese law provides for inbound and outbound 'flighting' of companies. Companies established in Malta are allowed to relocate their base to another jurisdiction, an operation often referred to as **re-domiciliation**. Legal Notice 344 of 2002, the Companies Act, Continuation of Companies Regulations prescribes that a body of persons of a similar nature to a company as known under the Laws of Malta may, if certain conditions occur cease to be registered under the foreign jurisdiction and be continued under the Laws of Malta. The said legal notice also provides for an inverse scenario where a company registered under the Laws of Malta may continue under a foreign jurisdiction.

In conclusion, **companies are domiciled where they are incorporated,** and a company's ordinary residence is determined either on the basis that it is **incorporated in a country** or if it is **managed and controlled in a country.**

Recapitulation
Last week we concluded with a position which is that **income arising in Malta is always taxable in Malta**. When it comes to foreign source income, we differentiate between persons who are both ordinarily resident and domiciled in Malta and persons who are either resident or domiciled in Malta. Persons who have one of these elements missing, they either miss residence or domicile, are taxable only on for foreign source income on a remittance basis. The latter means that foreign source income is taxable in Malta only if it's received in Malta. If it is not received in Malta, it is not taxed in Malta. Foreign source capital gains derived by persons who are either not resident or not domiciled in Malta are not taxed at all.

Also, we began discussing the meaning of domicile and the meaning of residence. We did **domicile of individuals**, **domicile of origin**, and **domicile of choice**. Domicile of individuals is determined by reference to their lifestyle. For legal persons, it is a bit different. Legal persons are domiciled where they are incorporated. Another concept which is used for the purposes of establishing jurisdiction to tax is that of **ordinary residence**. Ordinary residence means fixed regular presence which endures for some time. Visiting a country regularly makes you ordinary resident in that country. Ordinary residence is created by reference to a physical presence test. Staying in Malta for 183 days in Malta or on average of 90 days a year over a 3-year period. It has to do with regularity of presence.

Domicile and residence are similar but are not the same because the former is your chief residence; the country where you feel you belong, wherein you want to stay in forever. Where are legal persons ordinary resident? Where they are either incorporated (registered) or where they are managed and controlled, that is, where the most important decisions are taken. Where there is the mind and management of the company. Where the decision-making process occurs. Where the company keeps its books, where its major bank accounts are held, where the most senior employees reside and where the board minutes are kept.]

TAX RETURNS

There is a form which all taxpayers must fill in. There is a form for individuals and a form for companies. The simplest form is the former which all individuals, saving exceptions, must submit by the 30th of June.

On the top left corner, there is a logo of Commissioner for Revenue. The Commissioner is the administrative authority which manages the tax functioning. He receives or returns and examines. In the middle there is a description of the form which is 'income tax return' and on the right-hand side, the individual must report his contact details, his ID, mobile and so on. The details are pre-printed by the Department so, the returns are aimed to individuals. You are required to fill in the right-hand side only if the records they have about you are obsolete or requiring correction. Remember that the obligation to keep the Department informed of changes in residence is on the taxpayer and we have had many cases involving notification. The Revenue is bound to notify a taxpayer at the last known address available to him. many problems have arisen because certain people change their address and do not notify the Revenue. The Return is an opportunity to inform the Revenue of a change in status.

There is a second block where there are details whether a person is married or not (marital status). The fact that a person is married has a bearing on the way this person is taxed. In the past, the law tended to discriminate against women. Now, as from last year, women have certain rights relating to filing their returns separately. It wasn't always so. Then there are more details on marital status, you tick whether you are single, married, in a civil union and living together (treated like married couples for tax purposes). Then, there is reference to whether a person is separated or divorced, widow, or single parent.

The fourth box speaks of residence and domicile. One has to tick whether he/she is subject to the worldwide basis of taxation or otherwise.

The taxpayers must sign the return and if they do not fill the return to the best of their knowledge, then they commit an offence. Spouses are jointly and severally liable.

Then there is another paragraph saying whether certain decisions have been taken pursuant to professional advice, in which case, the professional advice must be attached to the income tax return.

When we spoke of the distinction between income and capital, we read of a list in article 4, listing items of income, such as trading income, employment income, annuities, pension, rents, royalties and so on, including all income. That was a clear indication that all income is taxable. Whereas all income is taxable, only certain capital gains are taxable, those which are listed in article 5. In the tax return, we see a reflection of article 4 where you have to report your employment income. One will see that in the tax return, you must indicate your private employer number, then you declare your gross emoluments. You declare income from a trade, business, profession, or vocation, self-employment income. You must declare your income per VAT number. If you are self-employed, you have a VAT number and you declare your income by reference to it.

There is a block where to declare pensions because contrary to popular belief, pensions are taxable. In reality, pensioners benefit from certain reliefs and certain tax concessions, ending up not paying tax on their state pension. In item 3, when there is a reference number to a pension, there is a pre-printed number since they are governed by a particular number.

Item 4 deals with overseas employment. There is a particular regime applicable to overseas employment.

In items 6 and 7, there is a place where to report allowable deductions because there are expenses which you can deduct for tax purposes and there are exemptions, there are items/profits which are not taxed at all. There is a subtraction exercise.

There are more items of income: investment income, foreign investment income, rental income, capital gains income (this reminds us that our capital gains tax is a tax which exists within our income tax).

Then we have income in respect of an alimony.

The return then starts referring to deductible expenses in more detail. You are allowed deductions against chargeable income and the law governing deductions is article 14 of the Income Tax Act and article 26 of the Income Tax Act. With respect to the former, this is known as the positive test and the latter is known as the negative test. Article 14 tells you what is not deductible and article 24 tells you what is deductible.

In items 16, 17 etc one will find a reflection of article 14 and 26. Article 14 lists expenses which can be deducted for income tax purposes and if you see article 14, you will see that in article 14 there is a big preamble explaining that you deduct for tax purposes income which is wholly and exclusively incurred in the production of the income.

What does 'wholly and exclusively incurred in the production of the income' mean? There must be a relationship between the expense and the income generating activity. There must be this link of cause and effect. An expense is deducted for tax purposes if it is incurred in a business revenue generating context, such as, salaries and wages, such as examples provided for in the law itself, interest on monies borrowed to acquire capital, rents on commercial premises. So, in order to understand how this return works, one needs to put himself in the shoes of a small lawyer running a very simple business. Let's say this return is being filled by a person after becoming a lawyer who is a sole practitioner. You will report your annual profits, but then you would claim allowable deductions and you would determine what expenses you can claim for tax purposes. For instance, it's not mentioned in the law but it is clearly an allowable expense, the water and electricity bills of your office, fees received from your own suppliers, say an accountant, rents paid on your office are deductible (rental deductions item 16), interest payable on capital employed in acquiring income, such as buying your office subject to a bank loan and you are paying bank interest which is deductible, an overdraft whereby the interest is deductible.

Many persons are exempt from filling this income tax return, for example, employees, persons whose income is completely from employment, are dispensed from filing this return.

CHAPTER 7
TAX DEDUCTIONS

In the context of an income return, Art. 14 ITA gives examples of expenses which are deductible. In the return, you will find a reflection of the law. You should take note that in the return there is also a reference to other allowable deductions and in the law, you find a list of what these other allowable deductions are.

Rules on deductions

The principal rules which govern deductions which are allowable for income tax purposes ('tax deductions') are contained in **Articles 14 ITA-14H ITA** and **Article 26 ITA.** Furthermore, other important rules relating to tax deductions are contained in subsidiary legislation such as –

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

Important rules on tax deductions are found in the **Income Tax Deductions Rules Subsidiary Legislation 123.07** containing rules relating to tax deductions in respect of vehicles and deductions in respect of emoluments (such as payment from office which is a fee in addition to wages).

<u>Tax deductions may be classified under the following categories –</u>

i. Expenses incurred in the production of **Art. 4(1)(a) ITA** income;
ii. Expenses incurred in the production of **any** income;
iii. Traditional Capital Allowances;
iv. Expenses Incurred by Employers;
v. Expenses in respect of Immovable Property;
vi. Expenses of a Private Nature which are expressly deductible;
vii. Other Deductions.

Tax Profit & Accounting Profit

Tax profit is <u>not</u> equivalent to accounting profit and therefore, certain expenditure which is deducted for accounting purposes must be added back for tax purposes. Thus, whereas generally an expense is allowed for tax purposes provided it is **wholly and exclusively incurred in the production of the income**, accounting purposes do not impose the wholly and exclusively incurred test to recognise an expense.

Similarly, the accounting concept of depreciation is similar but not identical to the tax concept of wear and tear allowance. Depreciation is calculated by reference to accounting standards, but capital allowances are calculated by reference to ad hoc tax rules.

Provisions are added back for tax purposes but are generally accounted for accounting purposes. Similarly, unrealised losses which are deducted for accounting purposes are added back for tax purposes. Certain items which are accounted for as a profit for accounting purposes are removed from the computation and consequently, not subjected to tax for tax purposes. Thus, unrealised gains, which are deducted for accounting purposes, are added back for tax purposes. Moreover, the tax concept of a **bad debt** is not quite the same as the accounting concept of a bad debt. Also, **donations** are accounted for by accounting standards but are, saving recent exceptions, not deducted for tax purposes.

Outgoings and Expenses incurred wholly and exclusively incurred in the production of the Income

Art. 14 ITA contains a preamble,

> **14.** (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 -

"…outgoings and expenses incurred…"

The leading judgement on the interpretation of the words 'outgoings and expenses incurred' is *F.C of T v. James Flood Pry. Ltd* (1953) when the British Courts explained that the word outgoing or expense might suggest *"that there must be an actual disbursement"* but the Court acknowledged that such interpretation would *"produce very strange and anomalous results."* In *Elder Smith & Co Ltd v. C. of T* (1932), the word 'incurred' was defined as the 'contracting of a debt'.

"…wholly and exclusively incurred…"

In brief, the term 'wholly and exclusively incurred in the production of the income' means that an expense is allowed provided that such expense is incurred for the purposes of earning income. There must be a **'distinct and link between the expenditure incurred and the actual earning of the income.'**

With respect to employment income, only income which is wholly, exclusively and necessarily incurred in the production of the income is deductible. So, when it comes to employment income, there is an additional test for a person to claim a deductible expense which is that the expense must be necessarily incurred in the production of the income.

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

In principle, expenditure which has a dual nature, **partly in the production of the income and partly not in the production of the income** is not deductible.

In *Mallalieu v. Drummond* (1983), a barrister sought to claim expenditure on the black attire for court use. The expense was disallowed on account of the fact that the expenditure on black suits had a dual purpose, i.e., that of clothing the taxpayer and that of serving as court attire.

Nonetheless, when **apportionment of expenditure is possible** (the expense itself allows for apportionment. The private and domestic component of the expense can be extrapolated from the total expense), and **such expenditure does not run counter to the spirit of the**

law, it is allowed. If an expense is partly incurred for a business purpose and partly incurred for a private (disallowable) purpose, that part of the expense which represents the business purpose can be deducted from the tax return.

In **BSC 16/1971**, the Board held that, *"The 'wholly and exclusively' rule does not prevent certain types of expenditure from being apportioned, and part only of them allowed, so long as it can be shown that the part allowed was wholly and exclusively incurred for business purposes…it cannot in theory be apportioned on the ground that it was partly, as opposed to wholly, incurred for business purposes."*

"…in the production of income…"

An expense is allowed if it is incurred in the production of income. **Art. 14 ITA** emphasises the **direct relationship** that must exist between the expense and the revenue derived from such an expense.

In Case 69 of the Court of Appeal, the CoA noted that,
"To rank as a deduction the expenditure must not only have been incurred for the purposes of earning income as defined but there must be a sufficiently distinct and direct link between the expenditure incurred and the actual earning of the income."

With respect to deductions, the CoA has followed Hannan and Farnsworth observing that an expense *"must have been incurred for the purpose of earning profit."*

It is not that in order to be allowable, an expense must be directly attributable to an income earning activity but that there is **a link of cause and effect between expenditure incurred and production of income**. Indeed, a medical expense claimed by a taxpayer was disallowed because it was *"one of the clearest examples of an expense which is not incurred wholly and exclusively in the production of the income."*

In Case 36 the CoA suggested that judicial expenses incurred in defending a trademark, which yielded income, could be, in certain cases, allowed even though such a case did not 'per se' directly give rise to income.

In Case 154 (24/06/1987), the CoA allowed the deduction of damages paid by a tax consultant to his client because of an error in managing the client's affairs.

Fines incurred in the production of income are not allowed because fines are of a deterrent nature. The payment of a fine for an infringement of law committed in the production of income is not deducted even if the act which gives rise to the fine yields income.

Case 31 Rules

Case 31 of the CoA established that the deduction of an expense can be made only against income to which such an expense refers to.

Strict Literal Interpretation

The CoA and the Board explained that the Articles dealing with deductions must be strictly interpreted, *"the only safe rule is to look at the words of the enactments and see what is the* *intention expressed by those words."* Consequentially, **an expense is only allowed if it gives rise to income**. In a series of judgements, the Board refused to allow expenses which amount to an application of the income, rather than an expense in its production.

Proportionality
An expense is allowed provided that such an expense 'was reasonable to allow.' The Board tends to accept expenditure provided that such expenditure is reasonable and proportional. For instance, in one case a sales commission paid by a trader to his son was not allowed because it *"was considered to exceed what was reasonable."* For such a salary to be allowable, such salary must be proportionate to the services rendered.
In another case, the Board allowed the deduction of a reasonable amount of expenditure of travelling expenses which consisted in *"promotional travelling required by the nature of the business and to develop relations of a commercial nature."*

In one case, the Board held that travelling expenses incurred in the trip from home to work were not allowable but travelling expenses incurred on trips from one patient to another were allowable. Regarding the former it said, *"where a man lives is at his own discretion and travelling from where he lives to where he discharges his duties is not in the performance of his duties."*

Insurance premiums are allowable if incurred in respect of assets employed in the trade. Thus, insurance premiums paid on policies insuring fixed assets, stock in trade, plant and machinery and capital used for the production of income appear to have been allowed by way of allowable deduction.

Expenses Incurred in the Production of Income from a Trade Business Profession or Vocation

The following expenditure is allowed against income which is derived from **Art. 4(1)(a) ITA** activities, income which is colloquially referred to as **trading income**

1) Bad debts (**Art. 14(1)(d) ITA**)

The Commissioner has been granted discretion in relation to what should constitute a bad debt for the purposes of tax law.

The Commissioner considers a debt to be a bad debt for tax purposes if -

1) The debtor has died without assets in the case of an individual or the debtor has been wound up in the case of a company; or
2) The debtor has become insolvent; or
3) The debt is time barred (preskritt); or
4) The creditor took all the necessary steps to secure his debt (e.g. issued a judicial letter, warrants etc)

If a debt which had been previously written off as a bad debt in a return is subsequently recovered, the bad debt must be reported as an Article 4(1)(a) ITA receipt in a subsequent return.

Bad debts are tax deductible for tax purposes. There is a revenue guideline as what is to be treated as a bad debt – a debt which is time barred or referring to a debtor who has gone bankrupt. Any sum contributed by an employer to a pension. All employers pay social security. The portion paid by him is deductible for tax purposes.

2) Losses (**Art. 14(1)(g) ITA**)

Losses incurred by any person, solely or in partnership in the exercise of Art. 4(1)(a) ITA activities (trade losses) are allowed as a tax deduction. A loss is considered as such provided that, had such loss been a profit, such a profit would have been taxable. Thus, a loss incurred in the course of an activity which could have yielded exempt income is not taken as a loss.

Trade losses incurred outside Malta are allowed, provided that if such losses had been a profit and had been retained outside Malta, would have been chargeable to tax.

Trade losses can be carried forward to subsequent years and may be used to set off any income. Trade losses may also be used to set off any capital gain.

However, a loss cannot be deducted against income which stands to be allocated to the final tax account and any loss resulting from activities or sources, the profit derived from which would have been allocated to the final tax account, are not considered to be a loss to which Art. 14(1)(g) ITA applies.

3) Expenditure on scientific research (**Art. 14(1)(h) ITA**)

Capital expenditure incurred on scientific research is, by way of exception, deductible, **provided that such expenditure is incurred and is for the benefit of an Art. 4 (1)(a) ITA activity**. Moreover, this has to be proved to the satisfaction of the Commissioner.

Scientific expenditure which is not subject to the wear and tear allowance and the initial allowance, is spread equally over the year in which it has been incurred and 5 succeeding years.

No deduction is allowed in respect of scientific research in the case of any such expenditure on plant and machinery or premises, in respect of which any deduction in respect of wear and tear and the initial allowance is granted.

4) Promotional and marketing expenditure (**Art. 14(1)(l) ITA**)

A tax deduction is provided in respect of any expenditure incurred by a person engaged in Art 4(1)(a) ITA activities for the purpose of promoting such activities including any expenditure on market research and obtaining market information, advertising or other means of soliciting business, providing samples, and participating in fairs and exhibitions.

Expenses Incurred in the Production of Any Income

The following expenditure incurred in the production of any income is deductible for tax purposes –

i. **Art. 14(1)(a) ITA** expenditure – sums payable by such person by way of interest upon any money borrowed by him, where the Commissioner is satisfied that the interest was payable on capital employed **in acquiring the income**.

ii. **Art. 14(1)(b) ITA** expenditure – rent paid by any tenant of land or buildings occupied by him **for the purpose of acquiring income**.

iii. **Art. 14(1)(k) ITA** expenditure – any sum or expenses proved to the satisfaction of the Commissioner to have been paid or incurred by or on behalf of a **candidate for election** as a member of the HoR on account of or in respect of the conduct or management of such election.

iv. **Art. 14(1)(m) ITA** expenditure – expenditure of a capital nature on **intellectual property rights** incurred by a person engaged in Art. 4(1)(a) ITA activity and proved to the satisfaction of the Commissioner to have been incurred for the use and benefit of such activity.

v. **Art. 14(1)(o) ITA** expenditure – such sums in respect of risk capital as are aimed at approximating neutrality between debt and equity financing, as the Minister may prescribe.

vi. **Art. 14(1)(p) ITA** expenditure – a % amount of qualifying income as may be prescribed derived from qualifying intellectual property subject to the satisfaction of such terms and conditions and to obtaining such determinations as may be prescribed.

Traditional Capital Allowances

In article 14, you will see, for example, a reference to any sum expended for repairs in sub-article (c), any sum paid for wear and tear in sub-article (f), and expenditure in sub-article (h) etc. **The point is that in the ITA, one finds certain deductions which are of a capital allowances nature**. The Income tax return doesn't single out these expenses but if you had to squeeze Art.14, you will see that article 14(1)(c), (g), and (i) refer to expenditure of a capital allowances nature. So, remember that for tax purposes, **you are allowed capital allowances as a deduction**.

The fact that an asset constitutes an Industrial Building or Structure, or Plant or Machinery means that the expenditure thereon falls under Art. 14 which incorporates 3 forms of capital allowances –

Traditional capital allowances can be sub-divided into 3 categories –

1) Deductions allowed in terms of Art. 14(1)(c) ITA – **Repairs**;
   (So, whatever you incur by way of an expense is tax deductible)

2) Deductions allowed in terms of Art. 14(1)(f) ITA – **The Wear and Tear Allowances**;

(All tangible assets depreciate with time. The value of an asset decreased with time and for tax purposes, you are allowed a tax deduction in respect of the depreciation in the value of the asset. The law allows you a deduction with respect to tax depreciation. So, in the law there is a list of assets with a percentage of how they deprecate over the years).

3) Deductions allowed in terms of Art. 14(1)(j) ITA – **The Initial Allowance**.
(In certain cases when you buy the asset you can claim a deduction on a percentage of the price of the asset).

What are capital allowances? These are **expenditures incurred on a specific type of item** known as **Plant and Machinery and Industrial Buildings or Structures**. So, when it comes to expenditure on Plant and Machinery and Industrial Buildings or Structure, the law incorporates a special tax treatment so when you buy and therefore, invest in these assets, there are special rules on what you can deduct for tax purposes.

In plant and machinery, definitions are based on case law, but when it comes to industrial buildings or structures, we find a definition in Art.2 ITA.

Plant and Machinery
So, capital allowances may be availed of on plant and machinery.

In the absence of a proper statutory definition of the term, reference must be made to common law precedents. In *Yarmouth v. France* (1887), Plant and Machinery was defined as, *"In its ordinary sense it (Plant) includes whatever apparatus is used by a businessman for carrying on his business – not his stock-in-trade which he buys or makes for sale; but all goods and chattels, fixed or movable, live or dead, which he keeps for permanent employment in the business."*

Practical Example
For example, granted some iron mongers sell tools but other iron mongers, besides selling tools, also provide services. Traditionally, iron mongers used to cut keys. In our case, we are going to use the example of an iron monger who is selling tools of every shape or form but then, on his desk, he keeps a special tool which is not for sale because he uses it to provide services to clients. He has tools of all shape and form, some of which are bigger, and some are smaller. Some are less expense, and some are more. But then, he has this key cutting machine which is special.

Is the machinery he has for sale 'Plant and Machinery' for the purposes of the law? And is the key cutting machine 'Plant and Machinery' for the purposes of the law? In other words, can he claim a deduction over the key cutting machine and can he claim a deduction for the stock-in-trade?

The items which are for sale are not 'Plant and Machinery' of the purposes of the law, therefore, expenditure relating to stock-in-trade is not deductible. Conversely, the machine he uses to work with is 'Plant and Machinery', therefore, expenditure incurred on it is deductible for tax purposes by way of capital allowances.

Elements of 'Plant and Machine' –

1) **Revenue generating purposes** – the machine must be a revenue generating asset; it is there to generate revenue. So, the asset must be part of the apparatus employed in carrying on the activities of the business.
2) **It is not for sale** – the asset must not be held by way of stock in trade. So, it is not being purchased and sold.
3) **The asset is kept for the permanent employment of the business** – It has a degree of permanence. What is permanent varies from asset to asset, from trade to trade. For example, one case says that knives are not Plan and Machinery, depending on their usage. There are cases involving farm animals discussing whether they are Plant and Machinery.

One of the very Maltese cases which discussed the technical meaning of the terms 'Plant and Machinery' is BSC 5/62 when the Board held that wine concrete vats used by Maltese vintner in his business constituted Plant and Machinery for the purposes of the law. Furthermore, our Courts held in Case 45 of the CoA that a vehicle constituted Plant and Machinery for the purposes of the law.

Industrial Buildings or Structures

Art. 2 ITA

"industrial building or structure" includes a building used as a hotel or a car park or offices, as may be prescribed. For the purpose of this definition:

(*a*) the word "hotel" includes any number of constructions suitably furnished and equipped, with accommodation in single or double bedrooms, provided that such constructions are grouped together and have in common ancillary hotel services and amenities within a single and defined parcel of land and are operated by a common management for the accommodation and for the use of guests against payment;

(*b*) the word "car park" refers to a structure of a commercial nature available to the general public, which is the main income generating activity of any person claiming any deductions in its respect under article 14(1)(f) or (j), or whose operation by any such person involves substantial activity, having regard to the capital employed, the organisation of the operation and the income that it generates, and which is first used for this purpose after the 1st January 2012;

The term 'Industrial Building' typically means a factory, a building which is used for industrial purposes, a building which is used for purposes such as manufacturing, assembly, repairing, processing, and activities which are connected with industry.

It is interesting to note that over the years, this definition was tweaked in line with the exigencies of the Maltese economy. The definition of Industrial Building or Structure was **extended to include hotels** and more recently, **office space** meeting certain criteria included in the Subsidiary Legislation 123.173, the Industrial Buildings and Structures (Capital Allowances) Rules.

Repairs of premises Plant and Machinery (Art. 14(1)(c))
The first 'traditional' capital allowance refers to any sum expended for repairs of premises, plant or machinery employed in acquiring the income, or for the renewal, repair or alteration of any implement, utensil or article so employed.

Wear and Tear of any Plant and Machinery (Art. 14(1)(f)
The second 'traditional' capital allowance is an allowance granted in respect of wear and tear of plant and machinery and any premises being an industrial building or structure.

The principal rules which govern the wear and tear allowance are contained in Art. 14(1)(f) ITA and the DWTPM Rules. **Wear and tear deduction is allowed provided that the relevant plant and machinery is used in the production of the income**. This applies even when the property does not belong to the person making use of it, but the burden of wear and tear falls on him.

From 2002, the straight-line method has been employed in order to calculate the deduction as opposed to the reducing balance method.

Initial Allowance (Art. 14(1)(j))
The third 'traditional' capital allowance is an allowance which is allowed upon the acquisition of premises being industrial buildings or structures. The deduction is taken in respect of industrial buildings or structures first used and employed in the year immediately preceding the year of assessment. The deduction is equivalent to 1/10th of the capital expenditure thereon.

Article 24 ITA – Balancing Statement
The rules discussed above in relation to capital allowances must be read in conjunction with the rule contained in Art. 24 ITA relating to the obligation to draw up a balancing statement.

<u>When an initial allowance or wear and tear allowance has been allowed on an asset and such asset –</u>

i. Is sold or transferred under onerous title; or
ii. Is destroyed; or
iii. Is put out of use as being worn out or obsolete or otherwise rendered useless or is no longer required, and the event in question occurs before the source of income in respect of which the deduction has been allowed has ceased to exist or to belong to the said person the person benefitting from the allowance is bound to render to the Commissioner a balancing statement with his return.

<u>Selling the asset practical example</u>
Say I am a business owning a theatre and I have chairs over which I have been claiming capital allowances and I decide to sell them. The law binds me with the obligation to fill in what is known as a **balancing statement**. In other words, when an asset in respect of which you would have claimed capital allowances is either disposed, lost or destroyed, then the

law provides that you have to prepare what is known as a balancing statement. In this statement, you must give an account of the capital allowances claimed and the transfer value of the asset sold. If this account gives you a profit on disposal, then tax must be paid and reported on the profit on disposal. Conversely, if the balancing statement gives you a loss on disposal, then you can claim the loss on disposal as a tax-deductible expense.

The balancing statement would either yield a 'loss on disposal', a balancing allowance (a tax deductible) or a 'profit on disposal', a balancing charge (treated as income).

Roll-over relief, capital allowances
Art. 24(3) ITA prescribes that, when an asset in respect of which capital allowances have been taken is replaced by the owner and the asset transferred gives rise to balancing charge in the balancing statement, the owner may elect to deduct the balancing charge from the cost of the new asset.

Deductions Available to Employers

There are two deductions which apply exclusively to employers –

i. **Art. 14(1)(e) ITA** – any sum contributed by an employer to a **pension**, saving, provident or any other society or fund which may be approved by the Commissioner as may be prescribed.
ii. **Art. 14(1)(n) ITA** – any sum proven to the satisfaction of the Commissioner to have been paid by an employer to **a licensed or registered childcare centre** as fees in respect of childcare services for the children of his employees, up to a maximum of €935 per child.

Expenses in Respect of Immovable Property

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

Expenses of a Private Nature which are Expressly Deductible

Expenses of a private nature are, generally, not deductible but the law contains some exceptions. Articles 14A-14H ITA provide that **individuals** may avail themselves of a number of special deductions.

After 2002, a number of articles were introduced, in particular Articles 14A-14G ITA which list down certain **private expenses** which are, by way of exception, allowed as a tax deductible.

A. **Alimony payments**
Art. 14A ITA grants a deduction in respect of alimony payments. This includes alimony payments granted by foreign courts, provided that the Commissioner approves. Moreover, this provision does not only cater for separation, but also for divorce.

Given the risk that alimony payment may erode into capital, **Art. 14A ITA** caps the maximum deduction available for a year in respect of alimony to the amount of such alimony payment. Thus, **the most beneficial tax treatment a taxpayer may obtain through the utilisation of this deductible expense is a tax neutral situation**.

So, is **alimony paid** is another important deduction. Maintenance is tax deductible. In tax, whoever paid maintenance can claim a deduction, but whoever receives it should report the income received under heading 13 of the Return. What happens in practice is that who paid claims the deduction and who received does not declare it in his/her return. You will have a freshly separated couple with a spouse having claimed a deduction for alimony paid, but then whoever received the alimony does not report it in the return and the computerised system of the Revenue immediately captures the mismatch.

The Civil Code speaks of maintenance without distinguishing maintenance for the spouse or for the children. Income tax law uses different phraseology whereby it distinguishes between alimony and financial assistance for the maintenance of a child. For tax purposes, alimony, maintenance for the spouse, is deductible by who pays it and taxable for who receives it. but financial assistance for the maintenance of a child is different. The person who pays out the maintenance is not allowed a tax deduction for it. Whoever receive the maintenance is exempt from paying tax on the financial assistance for the maintenance of a child. This is because the maintenance of the spouse is taken to mean some form of income substitution.

B. **School fees**

The deduction applies to school fees to any of the schools named by the Minister of Finance, and as from 2007, fees paid in respect of a registered private kindergarten.

The schools which have been named by the Minister for the purposes of **Art. 14B ITA** are invariably Maltese **independent schools**.

Make a distinction between a school fee and a donation. Those allowable are only those of the independent schools named by the Minister. It is those school fees which are tax deductible, and the deduction is capped to a certain amount which changes from year to year.

As from 2006, any individual who pays fees to one of the schools named by the Ministers in respect of a facilitator for a child with special needs is allowed as a deduction against his income the fees so paid up to a maximum of €9,320.

The thought process behind the deduction for the independent schools was that unlike government and church schools which are a financial burden to government, independent schools are not.

C. **Childcare fees**

Art. 14C ITA prescribes that an individual who proves to the satisfaction of the Commissioner that he has paid fees in respect of childcare services for his children to a bona fide childcare centre he is, for each child, allowed as a deduction against his income the lesser of these amounts –

i. The amount actually paid as confirmed by official receipts;
ii. €2000

Subsidiary Legislation 123.121 Deduction (Childcare Fees) Rules provide for a number of conditions governing eligibility to the tax deduction.

D. **Fees in respect of homes for the elderly and the disabled**

The deduction is capped to lesser of the following amounts –

i. The amount actually paid;
ii. €2500

E. **Sports Fees**

F. **Studies at a recognised tertiary education institution**

G. **School fees paid to cultural and creative teaching institutions**

H. **School transport fees**

<u>Other Deductions</u>

Other deductible expenses were recently introduced.

A. **Article 74 VAT Act**

B. **The Donations (National Heritage) Rules (DNHR)**

C. **Tax credit for woman returning to work**

D. **The Pre-Trading Expenditure Regulations of 2002 (PTER)**

<u>Expenses Which Are Not Allowed For Tax Purposes</u>

<u>Art. 26 ITA</u>

In Art. 26 ITA, we find a list of the expenses which are **not allowed for tax purposes**. Till now we have seen what you deduct, and Art.26 ITA tells us what you cannot deduct. In this way, **Art. 14 ITA** and **Art. 26 ITA** have a Yin and Yan relationship. The former has been described as the 'positive test' because it prescribes expenditure which is allowed for tax purposes whilst the latter has been described as 'the negative test' because it lists expenses which are not allowed for tax purposes.

26. For the purpose of ascertaining the total income of any person no deduction shall be allowed in respect of -

(*a*) domestic or private expenses other than those specifically allowed by this Act;

(*b*) any outgoings and expenses to the extent to which they are not wholly and exclusively incurred in the production of the income and, in the case of gains or profits chargeable under article 4(1)(*b*), not being furthermore necessarily incurred in the performance of the duties of the relative employment or office;

(*c*) any loss, diminution, exhaustion or withdrawal of capital, any sum employed or intended to be employed as capital or any expenditure for a capital purpose or of a capital nature save as provided in article 14 and 23;

(*d*) the cost of any improvements;

(*e*) any loss or expense which is recoverable under any insurance or contract of indemnity;

(*f*) rent of any premises or part of premises not paid for the purpose of producing the income;

(*g*) any payments of a voluntary nature;

(*h*) any interest, discount or premium paid or payable to a person not resident in Malta where -

(i) the person not resident in Malta derives or benefits from the said interest, discount or premium, directly or indirectly, from the granting of loans or from any form of credit to finance the acquisition, development, construction, refurbishment, renovation of immovable property situated in Malta or any right thereon including professional fees related thereto (including fees related to the acquisition of finance) and any other matter which increases or enhances the value of such immovable property or any right thereon; and

(ii) the said interest, discount or premium is exempt from tax under the provisions of article 12(1)(*c*)(i); and

(iii) the payor of the interest, discount or premium is a person related to the person not resident in Malta.

For the purpose of this paragraph a person is deemed to be related to a person not resident in Malta if:

(i) that person and the person not resident in Malta are, directly or indirectly, controlled or beneficially owned to the extent of more than 10% by the same persons; or

(ii) that person owns, directly or indirectly, more than 10% of the ordinary share capital or voting rights of the person not resident in Malta;

(*i*) any payment the making of which constitutes a criminal offence or, in the case of a payment made outside Malta, would constitute a criminal offence if made in Malta.

According to sub-article (a), **private/domestic expenses are not allowed for tax purposes**. Let's say if you employ a maid to clean your office, is her fee tax deductible? Yes, because **keeping your office clean is important to generate revenue**. Conversely, if you employ someone to clean your home is a private expense and it is not deductible. Normally, these are not deductible.

Sub-article (c) refers to the fact that **expenses of a capital nature are not deductible**. Normally, expenses of a capital nature are not tax deductible, but you will find within the law that an exception is made for capital allowances. The cost of an improvement is not deductible for tax purposes.

Expenditure incurred as part of the outlay necessary to put the business in a position to earn profits is not deductible. In BSC 35/1974 (1975), the Board held that expenses incurred in the formation of a business such as investments in feasibility studies could not be deducted. Such expenses were held to be of a capital nature as they were not incurred in the production of income but in the preparatory acts undertaken to create a source of income. Similarly, in BSC 2/1976, the Board disallowed a deduction for formation expenses, and contractual expenses incurred upon the acquisition of immovable property for re-sale.

Case law has established that **expenditure is considered to be expenditure for a capital purpose o of a capital nature for the purposes of the law if such expenditure is incurred 'once-and-for-all.'**

In Case 8 of 2003, the CoA held, *"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 which brings something new into being or which augments an asset by increasing the value of such asset is an expense of a capital nature. On the other hand, an expense related to an asset is not of a capital nature if it is an expense of a recurring nature which is incurred to maintain an asset in its general working order.

Improvements, loss which is recoverable under any insurance, rent of any premises or part of premises not paid for the purpose of producing the income, payments of a voluntary nature and certain interest payments are all of a capital nature.

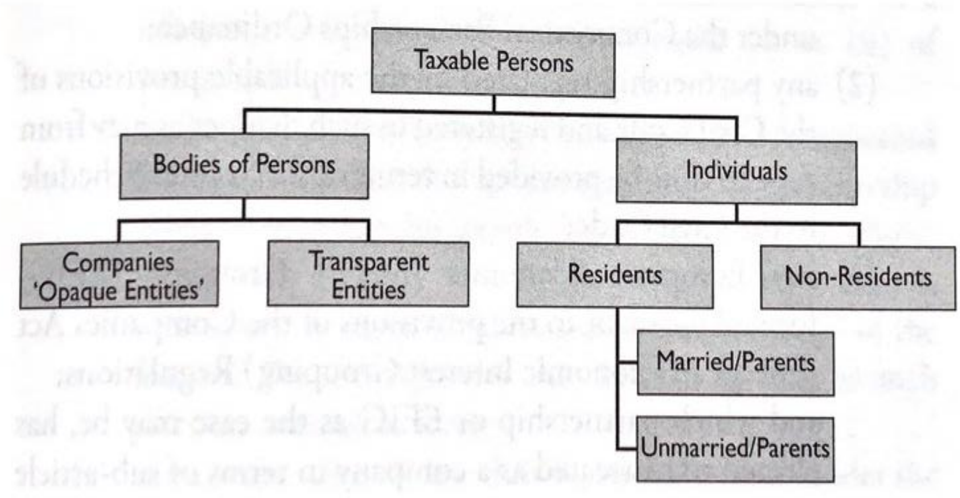
On the basis of sub-article (d), it is clear that **whereas a repair is tax deductible, an improvement is not**. For example, a cinema is operated on a commercial basis. Every year, they get workmen to paint the walls, replaster the place and so on. are these expenses repairs or improvements? They are repairs and are deductible because they have an element of recurrence/repetition. But say in a particular year they install a new sound system. That would be an improvement. The expense is not tax deductible, but you could always claim capital allowances on the asset bought.

<u>Sub-article (h) denies the tax deduction when –</u>

i. Creditor and debtor are related parties;
ii. The loan to which the interest refers is to be used for improvements of property situated in Malta; and
iii. Lender is a non-resident benefitting from the tax exemption under Article 12(1)(c)(i) ITA.

CHAPTER 5
CLASSIFICATION OF TAXPAYER/TAX RATES

The ITA categorises taxpayers under several categories and the classification of taxpayers has a bearing on the tax compliance obligations of taxpayers and their general treatment for tax purposes. Although the tax is one, **the manner such tax is computed depends on the classification of the taxpayer**. So, the rate of tax which applies to a taxpayer depends on such classification.



We have discussed the contents of the income tax return where you report your income, but the tax return illustrated was one that referred to individuals, when as seen in the illustration above, individuals are not the only type of taxpayer.

As a matter of fact, there are tax returns for different types of legal persons and this different treatment impacts the applicable rates of tax. For example, the Maltese tax rate is one of 35%. But then again, there is also a tax rate of 5%. Also, certain forms of income are taxed at the rate of 15% and some income is not even taxed at all. These may appear to be contradictory, but they are all correct, i.e., the bottom line is **there isn't one rate of tax but many rates applicable to different types of** taxpayers, including legal persons.

The matter is governed in **Art. 56 ITA** whereby the ITA distinguishes between two types of taxpayers: Taxpayers who are companies and everyone else.

1) BODIES OF PERSONS

Art. 2 ITA defines this term "body 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;

Companies, 'Opaque' Entities
A company qualifies to be considered as a company for the purposes of the ITA provided that it is any <u>one</u> of the following –

"company" means -

(*a*) (i) a limited liability company constituted under the Companies Act or under the Commercial Partnerships Ordinance; or

(ii) any other company constituted as such under any other law in force in Malta;

(iii) (1) any partnership *en nom collectif* and any partnership *en commandite* constituted under the Companies Act or under the Commercial Partnerships Ordinance;

(2) any partnership regulated by the applicable provisions of the Civil Code and registered in such manner as may from time to time be provided in terms of the Second Schedule to the Civil Code;

(3) any European Economic Interest Grouping (EEIG) formed pursuant to the provisions of the Companies Act (European Economic Interest Grouping) Regulations;

and which partnership or EEIG as the case may be, has elected to be treated as a company in terms of article 27(6) of the Income Tax Management Act and for as long as such election remains in force:
Provided that in the case of a cell company as defined in any regulations made in terms of the Companies Act (hereinafter in this proviso referred to as "the Regulations") as these may be amended from time to time, or in any other law or regulations replacing the Regulations, for all intents and purposes of the Income Tax Acts, every cell of a cell company and that part of a cell company in which non-cellular assets are held, shall each be deemed to be a separate company and any words and expressions in the Income Tax Acts which are relevant to a company shall be construed accordingly. The interpretation of such words and expressions insofar as applicable to a cell company shall be made on the basis of the relevant provisions of the Companies Act and of the Regulations:

Provided further that a partnership *en commandite* with its capital divided into shares constituted prior to the 1st of January, 2015 shall be deemed to have elected to be treated as a company in terms of article 27(6) of the Income Tax Management Act and for as long as such election remains in force;

(*b*) (i) any body of persons constituted, incorporated or registered outside Malta, and of a nature similar to a company referred to in sub-paragraphs (i) or (ii) of paragraph (*a*) above;

(ii) any body of persons constituted, incorporated or registered outside Malta and of a nature similar to any partnership referred to in sub-paragraph (iii) of paragraph (*a*) above, where such body of persons has elected to be treated as a company in terms of article 27(6) of the Income Tax Management Act and for as long as such election remains in force;

(*c*) any co-operative society duly registered as such under the appropriate law for the time being in force in Malta;

So, companies are defined as a limited liability company, a limited partnership or a partnership which has been elected to be treated as a accompany. The above definition of company was introduced by Act XIII of 2015. This is significantly wider than previous definitions, allowing for election partnerships.

Companies are taxpayers in the full sense of the word. Companies are **opaque entities**, single non-transparent entities for the Income Tax Acts. **The ITA treats companies separate and distinct taxpayers from their shareholders** – a clear distinction is maintained between the profits, deductions and losses of a company and the profits, deductions and losses of the shareholders of such company.

<u>The attribution of the status of 'company' to a body of persons carried with it the application of ad hoc rules under the ITA –</u>

i. The ITA incorporates a special residence rule that applies exclusively to companies;
ii. Only companies may apply the ACIT tax accounting system;
iii. The ITA contemplates a special tax treatment which applies exclusively to groups of companies;
iv. The full imputation system applies only to distributions of dividends made by companies;
v. Companies are subject to specific compliance obligations;
vi. The special 35% rate of tax applies only to companies, bodies corporate established by law and ecclesiastical undertakings exercising trading activities to be dealt with as a separate body of persons (**Art. 56(6) ITA**).

These legal persons, normally, pay tax at a flat rate of 35% on all their income.

<u>Group relief (**Art. 16-22 ITA)**</u>

This is a special mechanism that allows the surrendering of losses between companies that are deemed to be part of the same group. So, in certain instances, the ITA envisages scenarios whereby members of a group of companies may surrender trade losses (capital losses may not be surrendered – Art. 18 ITA) to one another.

Two companies are considered to form part of the same group only if –

1) They are **both resident in Malta** and not resident for tax purposes in any other country; and
2) One is the 51% subsidiary of the other or both are 51% subsidiary of a third company resident in Malta.

The ITA recognises direct and indirect groups as well as horizontal and vertical groups. Forming part of the same group of companies does not automatically imply that losses may be surrendered between members of the same group, further conditions apply.

Moreover, the losses that may be surrendered are losses under the definition of losses in Art. 14(1)(g) ITA, excluding allowances under Section 14(1)(f) ITA (wear and tear plant and machinery) and Art. 14(1)(j) ITA (initial capital allowance).

Relief may not be given more than once, and losses are surrendered from the tax account of one company to the equivalent tax account of the other company.

Companies registered in Malta
The 2007 amendments to the ITA created a special type of company and a new term in the Income Tax Acts, the *"company registered in Malta"*. This concept is directly linked to the application of the ACIT regime.

Art. 2 ITA

> "a company registered in Malta" shall mean a company which is resident in Malta or a company which, although not resident in Malta, carries on any activity in Malta and in the case of a company which is neither incorporated nor resident in Malta shall mean a company that is registered for this purpose with the Commissioner in such manner as may be prescribed;

This is wide enough to include non-resident companies which are neither incorporated nor resident in Malta, but which carry on an activity in Malta (i.e., including branches of oversea companies).

Transparent Entities
Partnerships En Commandite with capital not divided into shares constituted prior to 2015 and Partnerships En Collectif and Partnerships En Commandite that that do not elect to be treated as companies ('Partnerships') are transparent entities for the purposes of the law. Therefore, such transparent entities are not really taxable persons.

Partnerships which do not possess the status of companies are not full taxpayers for the purposes of the ITA. The income of a partnership is treated as the income of the partners and taxed in the partners' hands accordingly. This is laid down in Art. 27 ITMA as amended in 2015 and 2016.

Whereas in the ordinary course of events, the losses of a company are separate and distinct from the losses of the shareholders of such company, losses *'incurred by any person, solely* *or in partnership, in any trade, business, profession or vocation'* are automatically attributed to the individual partners (**Art. 14(1) ITA**). Capital allowances are not allocated to individual partners like losses but 'remain in the partnership' because capital allowances are tied to the trading activity to which such allowances refer to.

Partnerships, unlike companies, **do not pay tax in their own name** but are still required to fil a return.

2) INDIVIDUALS

Apart from legal persons, there are individuals where the situation is more complex. First of all, we distinguish between **residents**, and **non-residents** whereby there are rates which apply to residents and rates which apply to non-residents. Indeed, Art. 56 ITA speaks of residents and non-residents and <u>not</u> of ordinary or non-ordinary residents. So, it distinguishes between persons who stay in Malta for **more than 183 days in a calendar year**, and persons who stay in Malta for **less than 183 days in a calendar year**. The former persons are treated as residents whilst the latter are treated as non-residents. Moreover, individuals, unlike companies, are subject to tax at progressive rates of tax.

Residents

A definition of the term 'resident' is contained in Art. 2 ITA.

> "resident in Malta" when applied to an individual means an individual who resides in Malta except for such temporary absences as to the Commissioner may seem reasonable and not inconsistent
>
> with the claim of such individual to be resident in Malta; when applied to a body of persons, means any body of persons the control and management of whose business are exercised in Malta, provided that a company incorporated in Malta on or after 1st July 1994 shall be resident in Malta and any other company incorporated in Malta shall be resident in Malta from 1st January 1995 where the management and control of the business of the company is exercised outside Malta;

This isn't very helpful since it leaves the matter up to the Commissioner's discretion. However, the gap has been closed by the BSC which expressed itself on the matter in a judgement BSC13/63 when it applied a hard and fast physical presence test for the purpose of determining residence. It established that a person is considered to be a resident of Malta if such a person spends more than 6 months in Malta.

The tax rates which apply to resident individuals are contained in **Art. 56(1)(a) and (b) ITA**.

According to Art. 56(1) ITA, the income of individuals is taxable in a schedular format in the sense that there is a bracket which is taxed at 0%, a bracket which is taxed at 15%, a bracket which is taxed at 25%, and a bracket which is taxed at 35%.

So, unlike companies which are subject to tax at a flat rate of 35% (over €60,000), **the income of individuals is taxed at these progressive rates of tax**. For example, if you fall under the tax-free bracket, you aren't taxed. In this way, **the more income you derive, the more tax you pay**.

Joint and Separate Computations

When it comes to residents, there are different rates depending on marital status. Recently, they changed the tax return in a very positive way. First of all, **Art. 56 ITA** and **Art. 49 ITA** give married people options in relation to filing their tax return and paying tax. And as from 2013, what is meant by married people, includes persons who are members in a civil union under the Civil Union Act.

As from last year, married people have 3 options –
Option 1 (**full aggregation)**: **Art. 49(2) ITA**: They can prepare a joint tax return. In this case, the married couple aggregate all their income under the sun and **file one tax return of both spouses together** and if they aggregate all their income, they apply the married rates.

Option 2 **(1 tax return – 2 computations)**: **Art. 50 ITA**: One tax return but two tax computations, applying single rates to what is known as earned income. So, treating separately, availing yourself of the tax-free rate twice, on what is known as earned income (employment income, trading income, and pensions for past employment). So, that you can prepare **one return** but for the purpose of the rate you can prepare **two computations**, benefiting from the tax-free rates twice. Unearned income which is all income other than income from trading, past employment and pensions, is taxed in the hands of the higher earner of the earned income. So, the rest is added to the income of the higher earner.

These systems have functioned for many years, but they were accident prone because on the face of it, they were fair but in practice, they weren't. For instance, married people are, in terms of law, jointly and severally liable for tax. But there were many instances where spouses, frequently wives, were becoming aware of fiscal problems pertaining to the marriage property, only after separation and typically, you had a husband who was a businessman and who is negligent, not filing his tax returns, his wife not knowing, becoming aware of these omissions later on, and finding it difficult to regularise the situation. So, as from last year a third option was added.

Option 3 **(2 separate tax returns)**: **Art. 49A ITA**: All married people have another option of preparing two separate tax returns as though they aren't married.

The new third option is beneficial when both parties which are professionals or self-employed persons. In this way, everyone carries his own responsibilities.

Moreover, **progressive rates of tax apply in these situations too**.

<u>Married Rates (Option 1)</u>
Art. 56(1)(a) ITA establishes that the following tax rates apply to a married couple resident in Malta when option for a joint computation –

> (*a*) in the case of a married couple resident in Malta in the year immediately preceding the year of assessment and to whom article 49 applies saving where an election has been made for a separate return for the purposes of article 49A or where the responsible spouse has opted for a separate computation for the purposes of article 50 -
>
> (i) Where the chargeable income does not exceed €12,700 the tax is to be determined by multiplying the chargeable income by 0%;
>
> (ii) Where the chargeable income exceeds €12,700 but is less than €21,201 the tax is to be determined by multiplying the chargeable income by 15% and then subtracting €1,905 from the result;
>
> (iii) Where the chargeable income exceeds €21,200 but is less than €28,701 the tax is to be determined by multiplying the chargeable income by 25% and then subtracting €4,025 from the result;
>
> (iv) Where the chargeable income exceeds €28,700 but is less than €60,001 the tax is to be determined by multiplying the chargeable income by 25% and then subtracting €3,905 from the result;
>
> (v) Where the chargeable income exceeds €60,000 the tax is to be determined by multiplying the chargeable income by 35% and then subtracting €9,905 from the result:
>
> Provided that in the case of an individual who is a national of a European Union or European Economic Area member state, such individual may qualify for the rates specified in this paragraph even where his or her spouse is not resident in Malta if the other conditions mentioned in this paragraph are satisfied and the Commissioner is satisfied that at least 90% of the couple's world-wide income is derived from Malta;

Art. 49(1) ITA prescribes that the income of a married couple, where both spouses are living together, is to be charged to tax in the name of the responsible spouse. The spouses select the responsible spouse jointly but when the spouses fail to make such selection, the Commissioner decides who the responsible spouse will be. Both spouses should sign any tax return or declaration but any tax return or declaration which is signed only by the responsible spouse or the other spouse on behalf of the responsible spouse is presumed to have been made with the consent of both spouses.

Art. 49(2) ITA provides that where a **joint return** is required to be filed by a married couple, **both spouses are jointly and severally responsible for the performance of all obligations**.

So, in case of default, the Commissioner may take such action to enforce performance of such obligations against either or both of the spouses.

Contrary to popular belief, the joint computation does not apply only to married persons. Unmarried individuals may apply the married rates in limited cases –

(i) wholly maintained under his or her sole custody a child who:

(A) was not over 18 years of age (or not over 23 years if receiving full-time instruction at any university, college or other educational establishment or serving an apprenticeship with a view to qualifying in a trade or profession), or

(B) was incapacitated by infirmity from maintaining himself or herself,

and who, in any case, was not in receipt of income, in his or her own right, in excess of €3,400;

(ii) where a children's allowance is payable in respect of that child under the Social Security Act, was recognised by the Director (Social Security) as the sole beneficiary of the children's allowance payable in respect of the said child;

(iii) was not in receipt of any financial assistance in respect of the maintenance of the said child from the other parent of the said child;

(iv) was not living or residing at the same house with the other parent of the said child:

<u>Single Rates (Options 2 & 3)</u>
The rates laid down in **Art. 56(1)(b) ITA** apply in the case of any other individual resident in Malta **including each spouse where the responsible spouse has opted for a separate computation or a separate return altogether** –

(i) Where the chargeable income does not exceed €9,100 the tax is to be determined by multiplying the chargeable income by 0%;

(ii) Where the chargeable income exceeds €9,100 but is less than €14,501 the tax is to be determined by multiplying the chargeable income by 15% and then subtracting €1,365 from the result;

(iii) Where the chargeable income exceeds €14,500 but is less than €19,501 the tax is to be determined by multiplying the chargeable income by 25% and then subtracting €2,815 from the result;

(iv) Where the chargeable income exceeds €19,500 but is less than €60,001 the tax is to be determined by multiplying the chargeable income by 25% and then subtracting €2,725 from the result;

(v) Where the chargeable income exceeds €60,000 the tax is to be determined by multiplying the chargeable income by 35% and then subtracting €8,725 from the result:

<u>Parental Computation</u>
Act V of 2012 introduced new tax rates applicable to parents – Art. 56(1)(b) second proviso.

Non-residents
When it comes to rates, the law distinguishes between residents and non-residents and for non-residents, as seen in **Art. 56(1)(c) ITA**, the rates are more punitive.

(*c*) in the case of any individual who is not resident in Malta during the year immediately preceding the year of assessment -

For every euro of the first €700.. 0c
For every euro of the next €2,400.................................. 20c
For every euro of the next €4,700.................................. 30c
For every euro of the remainder 35c:

For residents, the tax-free bracket is of around €9000, but for non-residents this is of €900. In this way, a non-resident arrives at the 35% tax rate quicker than a resident. So, in conclusion, the tax rates which apply to non-residents are more taxing than the rates applicable to residents. So, the more you earn, the more you pay tax and the rates for non-residents are such that they pay more tax than residents.

Moreover, unlike married residents, married non-residents do not have an option to prepare a separate computation.

CHAPTER 14
TAX ACCOUNTING AND THE REFUNDABLE TAX CREDIT SYSTEM

The 1994 amendments to the ITA and the ITMA introduced a specific tax accounting system in terms of which **profits derived by a company are allocated to a number of tax accounts**. Tax accounting is strongly linked to the refundable tax credit system. This was changed in 2007.

Context

Over the years, flat rates of tax on **certain forms of income** were introduced. In truth, began with **Art. 32 ITA**, which includes what were known as the 'investment income provisions', where taxpayers were given the option to pay tax on their investment income, on their interest income, at a flat rate of 15%. In fact, you can instruct your bank to withhold tax on your bank interest at the rate of 15%. If not, you have a right to declare your interest income in your tax return and then it depends on the applicable tax ban for how much tax you will pay. So, over the years, flat rates of tax started to be introduced. Investment income is a case in point, that of 15%. They also introduced the **part-time rules** which as from this year, the rate was reduced to 10%, from 15%. This is a flat rate. All these rates are found in **Art. 56**, **33** and **90A ITA**. As from this year, income from **creative activities**, artistic activities, is taxed at the rate of 7.5%, and even **football players** pay tax at the rate of 7.5%.

So, there are many tax rates applicable in different situations. A reduced tax rate used very often is the tax rate contemplated in Art. 31(d) ITA, which is tax on rental income where a person can opt to pay tax on rental income at the rate of 15%. So, **there is a whole spectrum of applicable rates**.

In Malta we have a 5% tax rate. All companies pay tax at the rate of 35% BUT companies are subject to **tax accounting** and their **shareholders may benefit from the Refundable Tax Credit System**.

How does this work?

The bottom line is that the combined effect of the TAS and the Refundable Tax Credit System results in a rate of tax of 5% because although the company pays tax at the rate of 35%, **6/7ths of the tax paid by the company is refunded to its shareholders**. In other words, the company pays tax at 35%, but **the Government refunds most of it to the shareholders**. So, in reality, the tax rate is not 35% but much less. In truth, the rules are much more complex, but this is what it is all about.

Certain companies pay tax at 35% with their shareholders getting a refund of most of the tax paid. It is 'certain' companies because **the Refundable Tax Credit System only applies in distinct situations**, meaning that it isn't always applicable. It applies to select beneficiaries. So, if you had to consider Maltese companies doing business here which are owned by Maltese residents, this refund system would not apply. This system applies only in specific situations.

By way of background, this system has come under attack. Internationally, pressures on Malta have been mounting for us to remove this system because it is said to be used for international tax avoidance to the extent that what was a very secretive system, suddenly was described in many international newspapers. It is debatable whether this system is going to remain relevant. The feeling is that the system is past its expiry date.

What happens is that **all companies must allocate all their profits to different tax accounts**. So, all companies must label their profits according to where they belong, to how they are classified.

The Tax Reform of 2007

The tax reform of 2007 had been in the pipeline even before Malta joined the EU. In 2003, certain offices of the EU questioned the compatibility of the International Trading Company (ITC) and the Companies with Foreign Income (CFI) regime with EU norms relating to harmful tax practices in terms of the Code of Conduct and the State Aid Rules. In 2006, Malta was formally requested to abolish the tax regime for Maltese CFI and the ITC regime under EC Treaty state aid rules.

They were described as being, *“offshore tax regimes…The schemes provide sizable aid to companies that are owned by non-Maltese and produce revenues outside of Malta and are therefore highly distortive without promoting growth of the Maltese economy.”*

The main features of the 2007 tax reform consisted in –

1) A retention of the Full Imputation System;
2) An enhancement of the tax accounting system via the addition of two new tax accounts;
3) A retention of Article 48(4) ITMA refunds (full refund and 2/3 refund);
4) An introduction of a Participation Exemption;
5) An introduction of certain anti-abuse provisions;
6) The introduction of the notion of Advance Company Income Tax (‘ACIT’);
7) The introduction of 2 new refunds of ACIT which are available, in respect of profits which are allocated to the Foreign Income Account and the Maltese Taxed Account, indiscriminately;
8) An extension of the Refundable Tax credit system to branches;
9) Abolition of the ITC;
10) A tightening of rules relating to the Flat rate Foreign Tax Credit.

The implementation of the Agreement reached with the EU

The agreement which Malta reached with the EU was implemented via a number of legislative instruments namely, Act II of 2007, Act IX of 2007, the Tax Refunds and Registration Procedure Rules, 2008 and the Tax Accounts (Income Tax) Rules, 2008 (‘TAR’). Salient changes included the introduction of the **Final Tax Account** and the **Immovable Property Account** and **the creation of a second pillar within the refundable tax credit system, Art. 48 (4A) ITA.**

Tax accounting

The Tax Accounting system is created via a number of rules contained in the interpretative provisions of the ITA. An important rule relating to tax accounting is enshrined with the definition of the term 'distributable profits' contained in Art. 2 ITA,

> "distributable profits" shall mean the total profits which are available for distribution by a company registered in Malta under the laws for the time being in force in Malta, and the distributable profits shall, for the purposes of this Act, be allocated to the following accounts, that is to say, final tax account, immovable property account, foreign income account, Maltese taxed account, and untaxed account, and for the purposes of this definition these accounts shall comprise the distributable profits as set out in the respective definitions:

A company's distributable profits are thus allocated to 5 different tax accounts and **must be reported accordingly in the company's tax return**. Important tax consequences are linked to tax accounting.

Companies must keep 5 tax accounts –
1) The Final Tax Account;
2) The Immovable Property Account;
3) The Foreign Income Account;
4) The Malta Tax Account; and
5) The Untaxed Account.

Detailed rules on what you allocate where are contained in subsidiary legislation known as the **Tax Account Rules**. We are seeing how you classify profits, then we will see what happens upon a distribution, i.e., how you arrive at 5% and how you determine eligibility to the 5% regime.

1) The Final Tax Account

The Final Tax Account would include income which has been subject to a final tax. The distribution of such income is not subject to further tax and no tax credit is available upon its distribution.

A reference to the FTA is contained in Art. 5A(10)(d) ITA which prescribes that distributable profits which are taxed under Art. 5A ITA are allocated to the FTA.

Companies allocate to the final tax account **profits which have be subject to final tax**, for instance, income which was subject to tax at a final rate of tax. Think of your income investment provisions, your tax on rental income where the rate of tax would have been final, as well as profits taxed in terms of the property transfers tax regime of article 5Awhich contemplates a flat rate of tax on the sale of immovable property. Those profits are allocated to the FTA.

2) <u>The Immovable Property Account</u>

The immovable property account includes gains or profits derived directly or indirectly from immovable property situated in Malta.

The rules relating to the allocation of profits to the Immovable Property Account are contained in the same set of rules which prescribes the profits which are allocated to the Final Tax Account, the TAR. The profits which stand to be allocated to the Immovable Property Account are described and listed in Rule 5 of the TAR.

Immovable Account Profits are profits which, by definition, have been derived, directly or indirectly, from immovable property situated in Malta.

Companies allocate income which **arises from immovable property** as well as income which is **deemed to arise form immovable property**.

<u>Examples –</u>

- Banks which lend money to people who use that money to purchase property in Malta must allocate all their revenues from the home loans to the immovable property account.
- Similarly, insurance companies which insure Maltese property must allocate their income from the gross prima to this immovable property account.

Companies which own and occupy property in Malta must allocate profits to this account before allocating profits to the other accounts and the amount of profits allocated to this account is of €250 per square metre of property which is owned and occupied in Malta. What we are saying is that certain companies which either have a big footprint in Malta or deal in property, must classify their income as IPA income.

3) <u>The Foreign Income Account</u>

Certain forms of foreign source income stand to be allocated to the foreign income account. Only foreign source passive income, foreign source capital gains, foreign source dividends, and, by way of exception, *"…profits derived from an overseas branch, agency or permanent establishment."* are allocated to the FIA. The profits that are allocated to the FIA are listed in Art. 2 ITA.

<u>To the extent that they result from taxable income, the profits that are to be allocated to the foreign income account are –</u>

- Dividends, interest, royalties and capital gains arising outside Malta, including income derived from a participating holding or from a disposal of such holding
- Rents and any other income derived from investments situated outside Malta
- Trading profits attributable to a permanent establishment situated outside Malta
- Dividends paid out of the foreign income account of another company resident in Malta

Further rules apply in the case of banks and insurance companies.

4) <u>The Malta Tax Account</u>

Distributable profits that are subject to tax but are not allocated to the final tax account, immovable property account and the foreign income account, are to be allocated to the Maltese taxed account.

This is where you allocate profits not allocated in other accounts.

Art. 2 ITA

"Maltese taxed account" means any of those profits of a company that are not included in the foreign income account and:

(*a*) which have suffered tax; or

(*b*) which have been exempt from tax under the provisions of any Maltese law and where the distribution of such profits by the company is also exempt from tax in the hands of the shareholders:

Provided that this paragraph shall cease to apply with effect from year of assessment 2008;

5) <u>The Untaxed Account</u>

Profits that are not allocated to the other taxed accounts, including negative balances, are to be allocated to the untaxed account. In most cases, the untaxed account is a balancing figure representing the difference between a company's accounting profits and its profits which would have been subject to tax in Malta. The profits of a cooperative society are allocated to its untaxed account.

Art. 2 ITA prescribes that the untaxed account shall consist of those profits (or losses as the case may be), which represent the total distributable profits (a positive amount) or the total accumulated losses (a negative amount) as the case may be and deducting therefrom the total sum of the amounts allocated to other taxed accounts. Thus, the Untaxed Account is made up of a balancing figure.

<u>Items that are typically allocated to the untaxed account include –</u>

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

<u>The Taxation of Dividends</u>

The full imputation system applies to distributions from the Immovable Property account, the foreign income account and the Maltese tax account but not to the distributions from the Final Tax Account. Distributions from the FTA are, in certain cases, subject to withholding tax. **<u>The refundable tax credit system applies to distributions from the Foreign Income Account and the Maltese taxed account</u>**. Certain distributions are tax exempt.

Different tax effects which are special effects, will occur when there is a distinction of profits from these accounts. **Some accounts are not subject to the Refundable Tax Credit System**. Profits from certain untaxed account is not refunded when there is a distribution, there is no further tax, but there isn't a refund either. So, the tax which the company pays is not refunded to its shareholder.

So, for example, with the final tax account, the tax paid by the company is not refundable to the shareholder, so, if the company pays 15%, then the shareholder doesn't get the tax back. Similarly, with profits allocated to the immovable property account. Profits which are taxed, classified as immovable property account are not subject to the Refundable Tax Credit System. The tax is not subject to refunds under the Refundable Tax Credit System. Income from property is not subject to the Refundable Tax Credit System.

But then we start seeing that foreign source income, that is, income which is allocated to the Foreign Account, is **subject to tax refunds depending on the nature of the profits**. In certain cases, the refund is of 100%, and in other cases it is of 2/3rds (when the company would have availed itself of double tax relief). In most cases, by default, the amount of the refund is of 6/7ths. But if the income is from passive interest and royalties, the refund is of 5/7ths.

Then there is the Malta Tax Account and even with respect to it, the tax is refundable if the income is from passive interest and royalties, it is 5/7ths, in all other cases it is 6/7ths. then there is the non-taxed account.

The key takeaway is that there **is a complex tax accounting system which differentiates between locally sourced income and income which is not locally sourced**. With only foreign source income, which is not attributable to property in Malta, which is subject to this refund regime. So, the way the rules were designed was to exclude certain activities from the 5% regime. So, companies with a big footprint in Malta do not benefit because they must allocate to the immovable property account according to the amount of property they own and occupy in Malta. Similarly, companies which derive income from property do not benefit from the system.

In brief, the Refundable Tax Credit System **applies to foreign owned companies who are deriving revenues from activities performed outside Malta**. Income which is derived from foreign customers. Because companies which are actually doing business in Malta, who are competing in the local market, are normally caught by the system through the rule that they must allocate profits to the immovable property account, etc. Needless to say, the system is complex.

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.

How the system works in practice (PowerPoint example)
Company A is going to distribute profits to its shareholder, company B. Company A is going to receive trading income and passive foreign interest. What happens both at the level of the company as well as at the level of the shareholder? Here we have a distribution from company A to company B. Company B, the foreign shareholder of company A, is going to receive a net dividend from the company but on top of that, the company is also going to receive a refund from the Government of Malta. So, the tax paid by company A is going to be refunded to company B. Company B will receive a dividend from company A and will also receive a tax refund from the Government of Malta of the tax previously paid by company A. So, it will receive two things. The amount of the refund depends on whether it is passive interest on royalties or not. In the case if the distribution from the FIA, it was of passive interest and royalties, so the refund will be of 5/7ths. When it comes to the profits from the trading income, the refund is going to be of 6/7ths. Remember the profit derived from company A was of €1000 and the only unrefunded tax paid by company A is of €50. So, the only tax paid from the profits deriving by Malta in the case of the MTA profits was of 50/1000. So, the effective tax rate is only of 5%. Had company B be owned by Maltese the rate of tax would have been 38%. This is intended to dissuade the Maltese from applying this scheme.

Although companies pay tax at 35%, in this system, companies fulfilling certain criteria as a matter of fact get most of the tax back, ending up not paying tax at 35% but paying tax at the rate of 5%. Based on a recent parliamentary question, the revenues which the Government of Malta derives from this annually are of around €100M a year. Now we are living in time where the beneficial tax system may be removed.

CHAPTER 11
IMPORTANT TAX EXEMPTIONS

Malta attracts foreign investment, besides with the Refundable Tax Credit System, through tax exemptions. For example, we mentioned the participation exemption which is an important tax exemption. All exemptions are contemplated in **art. 12 ITA**.

For example, the income of the Government of Malta, the income of University of Malta and MATSEC, the income of trade unions, political parties and so on are all tax exempt.

But in art. 12, one will also find exemptions which render Malta attractive to foreign direct investment. For instance, you will find an exemption which applies to **collective investment schemes**. Their income is exempt from tax, as is the income of pension funds.

Exemptions for Non-Residents

Art. 12(1)(c) ITA contemplates two important tax exemptions, both referring to non-residents. Both are subject to an anti-avoidance provision which applies to both limbs of the sub-article

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**. The exemption is subject to two important provisos.

The exemption applies provided that the non-resident who derives the income –

1) Is not in the relevant year engaged in trade or business in Malta through a **permanent establishment** situated therein; and
2) Where the royalties or the debt claim in respect of which the interest, discount or premium, is paid are NOT effectively connected with such permanent establishment.

The exemption discussed above is subject to the anti-avoidance provision.

An Indigenous Concept of Permanent Establishment?

The exemption does not apply if the non-resident is *"engaged in trade or business through a permanent establishment"* and relevant income is *"effectively connected with such permanent establishment."*

The ITA does not contain a definition of the term 'permanent establishment'. Trying to use the definitions contained in our treaties can pose problems since because the definitions of permanent establishment contained in our treaties are not aligned and treaties contemplate different timelines for project permanent establishments with some treaties referring to supervisory, stock and consultancy permanent establishments.

The question arises as to whether the definition in the current version of the OECD Model Convention should be used – **article 5** –

"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."

Like art. 12 IT, articles 11.4 and 12.3 of the current version of the OECD Model speak of engaged *"in trade or business…through a permanent establishment."* Therefore, we can rely on the commentaries to Articles 11 and 12.

2) **Gains Derived by Non-Residents upon Transfers of Securities and Similar Interests**
Article 12(1)(c)(ii) ITA exempts from tax *"any gains or profits"*, capital gains and gains of an income nature included, derived by non-residents upon certain transfers of securities.

It exempts from tax 4 distinct types of transfers. It exempts non-residents from **tax on gains** and **profits** derived –

i. On a transfer of any units in a collective investment scheme as defined in article 2 of the Investment Services Act; and
ii. On a transfer of units and such like instruments relating to linked long term business of insurance (including the surrender or maturity of linked long-term policies of insurance and of any shares or securities in a company including redemption, liquidation or cancellation);
iii. Any transfer of shares of:
   (a) Any interest in a partnership which is not a property partnership; and
   (b) Any shares or securities in a company (which for the avoidance of doubt includes redemption, liquidation or cancellation) which is not a property company.

Act I of 2010 introduced the concept of 'property company' and Act IV of 2011 introduced that of property partnership.

Non-residents are exempted from paying capital gains tax on disposals of shares in Maltese companies. Non-residents don't pay tax on capital gains from the transfers of shares in Maltese companies and this is another important tax exemption.

"Property Company"

"property company'' shall mean a company which owns immovable property situated in Malta or any real rights thereon or a company which holds, directly or indirectly, shares or other interests in any entity or person, which owns immovable property situated in Malta or any real rights thereon where five percent or more of the total value of the said shares or other interests so held is attributable to such immovable property or rights:

Provided that where a company, entity or person carrying on a trade or business owns immovable property situated in Malta or any real rights thereon, consisting only of a factory, showroom, warehouse or office used solely for the purpose of carrying on such trade or business, such company, entity or person shall, for the purpose of this definition, be treated as not owning immovable property if not more then fifty percent of the value of its assets consist of immovable property situated in Malta or any rights over such property and it does not carry on any activity the income from which is derived directly or indirectly from immovable property situated in Malta;

"Property Partnership"

"property partnership" shall mean a partnership as defined in article 5(1)(b) which owns immovable property situated in Malta, or any real rights thereon, or a partnership which, directly or indirectly, holds shares or other proprietary interests in any entity or person, which owns immovable property situated in Malta, or any real rights thereon, where five percent or more of the total value of the said shares or other proprietary interests so held is attributable to such immovable property or rights:

Provided that where a partnership, entity or person carrying on a trade or business owns immovable property situated in Malta, or any real rights thereon, consisting only of a factory, showroom, warehouse or office used solely for the purpose of carrying on such trade or business, such partnership, entity or person shall, for the purpose of this definition, be treated as not owning immovable property if not more then fifty percent of the value of its assets consist of immovable property situated in Malta, or any real rights over such property, and it does not carry on any activity the income from which is derived directly or indirectly from immovable property situated in Malta;

This is a restriction to the exemption – the exemption does not apply to property partnerships.

The Anti-Avoidance Provision which Applies to 12(1)(c)(i) and (ii) ITA

Provided that the beneficial owner of the interest, royalty, gain or profit, as the case may be, is a person not resident in Malta and such person is not owned and controlled by, directly or indirectly, nor acts on behalf of an individual or individuals who are ordinarily resident and domiciled in Malta;

The exemptions above are subject to an anti-avoidance provision. The exemptions apply provided that the claimant is a "*bona fide non-resident.*"

The exemptions apply provided that *"the beneficial owner of the interest, royalty, gain or profit, as the case may be, is a person not resident in Malta and such person* ***is not owned***

and controlled by, directly or indirectly, nor act on behalf of an individual or individuals who are ordinarily resident and domiciled in Malta.”

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

The Commentary gives examples of persons who cannot be treated as beneficial owners, these include –
1) Agencies;
2) Nominees;
3) Conduits;
4) Fiduciaries; and
5) Administrators acting on account of other persons.

The concept of ‘beneficial ownership’ is about substance and not 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 concept’. There exist a number of cases.

The Participation exemption

Act II of 2007, the legislative instrument which implemented the agreement reached between the Maltese Government and the EU, added paragraph **(u)** to Art. 12(1) ITA which envisages an exemption known as the Participation Exemption. This exemption a very important tax exemption since it is the reason why in Malta you find so many holding companies belonging to large multinationals.

Art. 12(1)(u) is an exemption specific to **income** and **capital gains from particular sources**. Art. 12(1)(u) ITA exempts from tax income and/or capital gains derived by a company **registered in Malta** from a **participating holding** or from the disposal of such holding.

Act I of 2010 extended the remit of the participation exemption to shares in resident companies. The participation exemption applies to holdings in companies only when such companies are not property companies. Furthermore, in respect of PHs in companies resident in Malta, the exemption applies only to gains or profits derived from the transfer of such holdings.

Budget Act 2013 extended the remit of the participation exemption in a material way by extending the exemption to branch profits.

Eligible persons
The participation exemption is not an exemption which applies to all persons, generally. The exemption applies exclusively to a taxpayer that is a 'company registered in Malta'. **Only companies registered in Malta are eligible to benefit from the exemption**.

So, adding these two points together, the participation exemption **applies to all companies registered in Malta** on 3 types of income streams.

<u>It is not all the income which is exempt but **income from certain revenue streams** –</u>

i. Income from a participating holding;
ii. Capital gains from a participating holding;
iii. Income from branch profits.

You will note that the first two limbs of the exemption refer to the concept of a participating holding.

What is a participating holding?
Maltese law contemplates an important tax exemption; it applies to foreign companies which hold and **when the foreign companies send money to the Maltese companies, that money can be tax exempt provided it satisfies certain conditions**. The foreign company must first and foremost, fall under the definition of PH.

<u>To be a participating holding, a company must meet 2 tests –</u>

1) The holding must be **equity**, and
2) The equity holding must fulfil the criteria of a **participating holding**.

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.

<u>Test 1: Equity</u>
The participation exemption applies to PHs which, by definition, must fall under the definition of 'equity'. Equity holding is defined as meaning (**Art. 2 ITA**) –

> "equity holding" shall mean a holding of the share capital in a company which is not a property company, when the shareholding entitles the shareholder to at least any two of the following rights (hereinafter referred to as "equity holding rights"):
>
> (i) a right to votes;
> (ii) a right to profits available for distribution to shareholders; and
> (iii) a right to assets available for distribution on a winding up of that company,

So, to be a PH, the company must satisfy the test of 'equity holding' whereby it must fulfil 2/3 of these criteria. The rights conferred by the participating holding must be **equity**.

<u>In order to have a PH you must have an equity holding and equity holding means 2 of the following 3 rights:</u>
1) Rights to profits;
2) Rights to vote;
3) Rights to liquidation proceeds.

The concept of equity holding, and participating holding are linked to participation rights. Participating holding rights are **shareholding rights** which give you significant influence in a company because you must have 2/3 of the above. **If you have 2 of the rights, then you have equity rights**.

The definition of 'equity' excludes shares in property companies.

<u>Test 2: Participating Holding</u>
But the above is not enough to fulfil the conditions to own a participating holding because besides ticking the box of equity holding, you must also have a participating holding as defined in **Art. 2 ITA**.

The general rule is that **a PH arises upon the holding of shares held in a company** as defined in Art. 2 ITA. Given that this definition includes partnerships en commandite with capital divided into shares but excludes partnerships en commandite with capital which is not divided into shares, a need to extend the remit of the application of the PH was felt. Thus, Act II of 2007 added a proviso to the definition of PH which prescribes that in certain cases, even the latter qualifies as a PH.

So, the equity holding must either have a qualitative or quantitative requirement. For instance, the law mentions that you have a PH if you hold at least 5% shareholding or rights of pre-emption, or rights to appoint a director. You can still have a PH if you don't have these rights, but the value of the shares is of €1,160,000 and this held over 183 days.

E.g., Say we have a Maltese company which owns Maltese companies all over the world and all these companies are distributing dividends. <u>**All these dividends from all over the world are not going to be taxed, provided that the companies distributing them are participating holdings**</u>.

The Anti-Abuse Provision
With respect to dividends, the application of the participation exemption is linked to an anti-abuse provision. In order to claim the participation exemption on income, as opposed to capital gains, the body of persons in which the PH is held must satisfy any one of the anti-abuse conditions.

<u>**One** of the following 3 conditions –</u>
1) It is resident or incorporated in a country or territory which forms part of the EU/The foreign company must be registered in an EU Member State; or
2) It must be subject to any foreign tax of at least of 15%; or
3) It does not have more than 50% of its income derived from passive interest or royalties.

There is still a safety valve in cases where none of these 3 conditions are met. So, the exemption may be still granted if although these are not met, the following two conditions are met **cumulatively** –

1) The body of persons not resident in Malta or its passive interest or royalties have been subject to any foreign tax of not less than 5%; and
2) The equity holding by the company registered in Malta in the body of persons not resident in Malta is **not a portfolio investment**.

Optional Exemption

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

The 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 which have been transposed into Maltese law.

CHAPTER 15
THE ELIMINATION OF INTERNATIONAL DOUBLE TAXATION

The principal rules which deal with the phenomenon of double taxation are contained in articles 74-95 ITA, not to mention the legal notices which incorporate Malta's double tax treaties.

How is double taxation eliminated?

You can have a situation when **the same income is taxed in one or more jurisdictions**. Remember your lecture on jurisdiction to tax and we said that most jurisdictions establish taxing rights on the basis of source, on the basis of residence and so on and so forth. But we learnt that different jurisdictions have different concepts of residence and different jurisdictions apply different sourcing rules. The fact that as yet **there is no tax harmonisation** implies that the same income or the same person may be taxed in one or more jurisdictions, and you can have a problem of double taxation.

How does the problem arise and what are its solutions?

First of all, double taxation arises because you can have a –

i. **Source-source conflict** because two jurisdictions lay claims over the source of such income.
ii. **Source-residence conflict** where a jurisdiction taxes income on the basis of residence and another jurisdiction levies taxation on the basis of source. For instance, I am a Maltese resident and I go to work abroad and there I am charged tax because my income arises there. I am taxed in Malta too because I am a Maltese resident.
iii. **Residence-residence conflict** because you are considered to be a resident by more than one country.

Earlier on we learnt that some countries apply a **physical presence test** to establish residence while other countries apply a **facts and circumstances** test to establish residence. In some countries, having a home makes you a resident while in other countries, staying 180 days in a calendar year makes you a resident. So, in essence you can be considered to be a 'resident' of two countries.

These conflicts give rise to the problem of **international double taxation** which is that you end up paying tax in two countries on the same income. These creates a disincentive for people to move freely, export capital and so on. It is an obstacle to free trade.

We have a set of articles which on top of other exemptions, provides for **tax credits for tax paid abroad** under Art. 74 where you can deduct the tax paid abroad against the tax payable in Malta.

The Maltese tax system contemplates 4 mechanisms which may be used to eliminate international double taxation. The said mechanisms are listed in Art. 74 ITA and consist in the following –

i. **<u>Double taxation relief</u>** – provided in articles 76-78 ITA, both inclusive.
ii. **<u>Unilateral relief</u>** – provided in articles 79-88 ITA, both inclusive. This is where relief is granted unilaterally – a person can claim relief for tax paid abroad on a unilateral basis simply because the Maltese tax system offers unilateral relief. So, **even if there isn't a Treaty and therefore, no element of reciprocity**, Malta offers unilateral relief provided the person meets certain conditions;
iii. **<u>Commonwealth relief</u>** – provided in art. 89 ITA. Tax suffered in the CW is offered as a relief against Maltese tax;
iv. **<u>Flat Rate Foreign Tax Credit</u>** – provided in articles 92-95 ITA, both inclusive. This is a notional relief which is a credit given to companies which derive profits from abroad, regardless of the rate of tax suffered abroad, if any at all.

Interaction of the reliefs

<u>Article 75</u>

75. In respect of any claim for relief of double taxation:

(*a*) the provisions concerning unilateral relief shall be applied in calculating a person's tax liability in those cases where double taxation relief and relief in respect of Commonwealth income tax are not available to the person making the claim; and

(*b*) the provisions concerning the flat-rate foreign tax credit shall be applied in calculating a person's tax liability only in those cases where double taxation relief, relief in respect of Commonwealth income tax and unilateral relief, as governed by articles 79 to 88, are not available to the person making the claim.

The wording of Art. 75 ITA, the articles which regulates the interaction between the 4 reliefs suggests a hierarchical system of reliefs. Thus, art. 75(a) ITA prescribes that unilateral relief is applied in calculating a person's tax liability in those cases where double taxation relief and relief in respect of Commonwealth income tax are not available to the person making the claim.

Furthermore, the provisions concerning the flat-rate foreign tax credit are applied in calculating a person's tax liability only in those cases were double taxation relief, relief in respect of Commonwealth income tax and unilateral relief are not available to the person making the claim.

However, it would appear that **the hierarchy suggested in art. 75 ITA has been superseded** by a consistent Revenue practice which allows taxpayers a certain amount of latitude in applying reliefs.

Double Tax Treaty Relief
Domestic law provisions relating to double tax relief are contained in articles 76-78 ITA which refer to tax relief obtained by reference to bilateral double tax treaties.

Double tax treaties are, *qua* international treaties, governed by the Vienna Convention and **override the Income Tax Acts, in case of conflict**. Double tax treaties are subject to the legal maxim of *pacta sund servanda* (agreements must be honoured) and are enforceable by the contracting states.

Given that Malta applies the principle of Parliamentary Supremacy, treaties become enforceable by taxpayers after such treaties are either transposed or incorporated into Maltese law. Treaties are ratified by Legal Notice passed by the Minister of Finance pursuant to a power vested in him by art. 76 ITA.

In other words, art. 76 ITA gives the Minister of Finance the power to enter into **double tax Treaties** which are Treaties for **the elimination of double taxation**. In Malta, for these tax Treaties to become enforceable, **the treaty must be transposed in local law by Legal Notice** (subsidiary legislation).

If one had to look at subsidiary legislation published under the ITA, one will find that around 70 double tax Treaties have been transposed into Maltese law, all of which are now subsidiary laws on the ITA. Most of the double tax treaties Malta has entered into are based on the OECD Model Convention. One of the most notable exceptions is the Treaty which Malta has signed with the US which is based on the 1996/2006 US Model Convention.

Articles 76-78 ITA lay down the conditions which must be satisfied to a taxpayer for the purposes of claiming double tax treaty relief.

<u>Double taxation relief can be applied provided that the following conditions are satisfied –</u>

i. The person entitled to the income must be **a resident in Malta fir the year immediately preceding the year if assessment;** and
ii. The taxpayer must be in possession of **evidence of tax paid abroad**.
iii. Tax paid abroad is either income tax or any tax of a similar character imposed by the laws of that territory. In other words, it must be of a comparable or similar nature to income tax and there must be a double tax agreement.
iv. Double taxation arrangements must be in force by Ministerial order between Malta and the relevant foreign territory.

If you had to look at all of Malta's 70 double tax Treaties, one will see that the contents of these treaties are almost identical. Indeed, at first glance, they appear to be the same since they are all based on the same template/model. The model of the Organisation for Economic Cooperation and Development.

This is an important identification since there is this very powerful international organisation which is the **OECD** and it wanted states to enter into double tax treaties, so it created a model/template double tax treaty to encourage the execution of double tax treaties. It wasn't the only organisation to take such an initiative. As a matter of fact, even the UN created its own model convention. Nonetheless, t**he model created by the OECD turned out to be more successful**.

The OECD model is important because as yet, there is **no tax harmonisation** so, states use their own concepts to assert taxing rights, to assert fiscal jurisdiction. The model creates 'common denominators' which are **relatable tools to assert jurisdiction to tax**. Although the laws of all states are different, there are some commonalities and some recognised generalised principles of law, and **the model convention uses these common denominators as a way to achieve an element of consensus**.

Double tax treaties are governed by the rules of *pacta sunt servanda* meaning that they override domestic law and in double tax agreements, **states signatories abdicate/forgo their taxing rights, their fiscal jurisdiction**.

N.B. The Treaty overrides Maltese law with Malta accepting to forgo its fiscal jurisdiction and to apply it in terms of the treaty.

Malta has entered into around 70 treaties which look the same but are not identical. By way of illustration, we will refer to our Treaty with **Belgium** entered into in the 70s and the Treaty entered into with **Saudi**. Over the years, the model convention has changed whereby every other year, it is updated and so, some of our treaties reflect the old contents of the model while some others reflect the contents of more recent versions.

<u>Subsidiary Legislation 123.05 – Double Taxation Relief on Taxes on Income with the Kingdom of Belgium Order</u>

Art. 2

The structure is common to all treaties. First of all, you have an article relating to taxes covered. For example, Malta is Income Tax and Belgium's equivalent of Income Tax.

Art. 3

Then you have an article on definitions which vary from one treaty to another treaty and then we begin with the articles allocating taxing rights. In the Treaty, **taxing rights are allocated on the basis of (1) source, on the basis of (2) residence, and on the basis of (3) permanent establishment**. So, taxing rights are going to be allocated by reference to these tools.

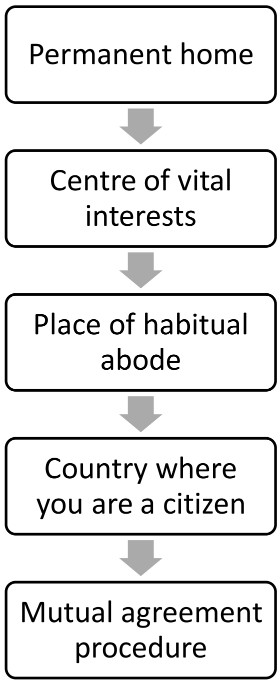
Art. 4

In all treaties, we have articles on Treaty residence. The question that arises is that when we have a cross boarder such as this Belgium-Malta, does 'residence' refer to the Maltese concept of residence or the Belgian concept? In Malta we use a facts and circumstances test whereby having a home in Malta makes you a resident while in Belgium you must spend 183 days to be a resident. This problem is resolved by the fact that within the Treaty itself, a definition of 'residence' is defined. It is the treaty concept of residence.

<u>The concept of residence and the tie breaker rules</u>

First of all, the treaty tells you that a person is resident where such person is treated as being resident. So, if you are only treated as a resident by one of the states, then you are only a resident in that state. But there could be overlapping claims to tax residence with both states treating you as their own resident. So, for example, both Belgium and Malta can treat you as their resident. In that situation, the Treaty lays down a methodology knows as the **tie-breaker rules** which held you identify where you are resident for the purposes of the Treaty. If you have a permanent home in both jurisdictions, then you are treated as a resident where you have your centre of vital interests, in other words, where your personal and economic relations are closers. The OECD model is accompanied by the OECD commentary which is a book which explains the contents of terms used in the model, such as centre of vital interests which is where a person has his family, his principal bank accounts, affections and so on. At times, it is not easy to establish where a person has his centre of vital interests. If a person has vital interests in more than one jurisdiction, the residence is where such person has his habitual abode which is the home he spends most of his time in. If such person has a habitual abode in both countries, or in none, his residence is determined on the basis of citizenship. **Normally, the tie is broken through this rule of nationality because most people have one citizenship**. There are persons, however, who have dual citizenship. In that case, the issue is more complicated, and tax residence is established by **mutual agreement procedure**. So, if the tie breaker rules do not work, then the matter is solved by mutual agreement procedure which is a procedure wherein the States exchange letters issuing a ruling saying this person is resident of a particular country.

TIE-BREAKER RULES



The tie breaker rules work for individuals, it is thought of as a framework applicable to human beings. Not all taxpayers are human beings, some are legal persons.

How is the residence of a corporate established? When there is a conflict meaning that there are overlapping claims to residence, you look at the place of **effective management**

and control of the enterprise. Note the emphasis, the qualification. It is not just management and control but **effective**. The commentary tells us how to establish effective management and control. It is where the directors meet, where the senior staff are resident, where the books are kept, where the main bank account are held and so on.

Art. 5

The74 concept of residence and permanent establishment

The tie breaker rules are not the only **concept of residence** used by treaties to assert fiscal jurisdiction. There is also use of the concept of permanent establishment. Taxing rights are allocated even on the basis of the concept of permanent establishment. Permanent establishment is not residence but is a taxable presence in a country. So, a company is taxed in a country even though it is not a resident of that country, it is **taxed even if it only has a permanent establishment in a country**.

In this article we have a definition of permanent establishment, and this can be split up in 3 components –

i. A fixed placed of business (the Treaty gives us examples of the form of this **fixed place of business**);

ii. **The construction site or installation permanent establishment.** In some cases, a company is deemed to have a permanent establishment even if all it does in a country is build or install something, provided that the project endures for a period of time. In fact, we speak of project permanent establishment, installation permanent establishment, and construction permanent establishment.

   For example, a foreign company building a road in Malta which whether it has a permanent establishment or not will depend on it the duration of its works. By installation and construction, originally, we meant building but over the years, the concept has been extended to, for example, software installation. There is a feeling that this concept of a permanent establishment is antiquated for the digital economy and something else will be discussed;

iii. **The independent agent**. A human being can be the permanent establishment of someone else, if he is a dependant agent. When a person keeps in a country an agent who is dependant, a person who habitually exercises the power to contract on behalf of the principal. So, for example, there is a law firm abroad which doesn't have an office in Malta, but I am its dependant agent and I always sign on behalf of the foreign law firm, and I am its representative in Malta. The mere fact that the law firm keeps this representative in Malta implies that it has a permanent establishment in Malta.

<u>Under Treaties, the tools which are used to allocate taxing rights are (1) source, (2) residence, and (3) permanent establishment. How are these applied in practice?</u>

The technique used by the Treaty is **to identify income streams allocating taxing rights depending on the income stream itself** –

- **Art. 6** – **Income for immovable property** – taxed on the basis of source,
- **Property** – taxed on the basis of the *lex situs* principle which is where the asset is located.
- **Art. 7** – **Business profits** – taxed in the state of residence but if business profits are attributable to a permanent establishment in another contracting state, then the other contracting state has a right to tax the income which is attributable to the permanent establishment.
  For example, you have a Maltese company which has operations in Belgium. For sure, the company is going to be taxed in Malta because it is a resident of Malta. Will it be taxed in Belgium and on what will it be taxed in Belgium? Does the company have a permanent establishment in Belgium? If it doesn't then it is not taxed in Belgium but what if it has one? If the company has a permanent establishment in Belgium, it will be taxed in Belgium, but it will be taxed in Belgium on the profits attributable to its Belgian permanent establishment. So, **in Belgium the taxing rights will be confined to the profits attributable to Belgium**.

  Another example is a Maltese company having a supermarket in Belgium and in Malta. In Malta, the company makes a profit of €1M attributable to its Maltese supermarket. In Belgium it is going to derive profits from its operations there and these are going to be of €5M. Is it going to be taxed in Malta and Belgium and on what? The company is a resident in Malta, and so in its tax return the company will have to report the €6M and in Belgium, €5M. It is going to be taxed both in Malta and Belgium. **The tax paid in Belgium is going to be available as a credit against the tax paid in Malta**.

So the effect of the treaty is two-fold – (1) to limit Belgian tax to the profits attributable to Belgium and (2) to offer a credit in Malta for the tax paid in Belgium.

There are companies for whom the concept of permanent establishment is not suited.

- **Art. 8** – **Shipping and air transport** – The **concept of PE doesn't work well for certain companies including companies which are in the shipping and aviation industry**. Consequently, we find a special rule for shipping and aviation companies because these companies are very mobile and would have permanent establishment all over the world and applying the permanent establishment rule to companies in the aviation and shipping sector is not good. These companies are not subject to the permanent establishment rule. **Shipping and aviation companies pay tax only where they have their effective management and control**. So, they will only be taxed in one country.

Art. 9

Art. 9 deals with associated enterprises with the concept of transfer pricing and the concept of international tax avoidance. Article 9 provides that if associated companies put into place arrangements to minimise tax through intragroup charges, the effect of which is the minimisation of tax, then that arrangement is disregarded. So, invoicing lacking substance will be disregarded for tax reasons. This is known as **transfer pricing**. This year, what are known as transfer pricing rules are being written. In the Treaty we will find that it classifies income telling us where such income is taxable, for example dividend income is taxable both in the source state as well as the resident state with the latter offering a credit for the tax paid in the source state. there are rules prescribing max amounts which apply in the source state. there are also rules on interest income and interest income is taxable both where it arises as well as in the state of residence. Credit for tax paid abroad would be granted. Conversely, royalties are taxable only in the state of residence. Capital gains are taxed where the asset being transferred is situated.

Art. 15
Dependant personal services are income from employment. You have a situation where say a Maltese resident goes to work in Belgium. The tax Treaty says that for a taxpayer to be taxable only in his state of residence, such a person must satisfy 3 criteria in Belgium –
1) That person must not spend more than 183 days in Belgium,
2) He must not work for a Belgian resident and
3) His salary must not be borne by a Belgian PE.

Art. 23
In treaties, you will find an article explaining how double taxation is to be eliminated. In certain cases, tax is only to be levelled in one jurisdiction, in other cases, both states will tax but the state of residence must give a credit for the tax paid abroad.

Double tax treaties are not only created to eliminate double taxation but also to create the framework for there to be exchange of information between tax authorities providing for cooperation in the context of joint investigations and the like.

Double tax treaties are not the only mechanism which exists to eliminate double taxation. There are others, some of which are unilateral, some of which are multilateral.

Unilateral relief
The rules relating to Unilateral Relief are prescribed in articles 79-88 ITA. Unilateral relief provides relief for double taxation in a manner which is very similar to double taxation treaty relief.

However, **it applies outside of a restricted tax treaty context**. Unilateral relief is granted unilaterally, **in the absence of a double tax treaty**. In addition, unilateral relief incorporates a mechanism for the relief for underlying tax under art. 82, by allowing, in defined cases, relief for foreign tax when such foreign tax includes tax paid in respect of a dividend indirectly. Unilateral relief and relied for underlying taxation can be used to provide relief for corporate tax paid by the company which disturbs the dividend.
In simple terms, there are solutions, some of which are unilateral, others are bilateral, and others are multilateral. **Unilateral solutions** are systems contained in domestic laws, in the laws of individual states, which unilaterally either exempt income derived by foreigners or unilaterally give a credit against tax suffered abroad.

Within the context of Maltese exemptions, there are a number which unilaterally exclude double taxation such as –

- **Article 12(1)(c) exempts from tax non-residents on certain income streams**. That eliminates double taxation since Malta forgoes its taxation rights.
- **The Participation exemption** which **excludes taxation on foreign dividends** which can be viewed as a form of unliteral relief.

Commonwealth relief
Art. 76 refers to Commonwealth relief where Malta grants relief for tax paid in another commonwealth state.

The Flat Rate Foreign Tax Credit ('FRFTC')
Art. 92 ITA notional relief which is known as the Flat Rate Foreign Tax Credit (FRFTC). These provide **for a credit for tax actually paid abroad** but **<u>the FRFTC provides for a flat tax credit on income received from abroad</u>**. So, with FRFTC, you get a credit for tax regardless of any tax paid abroad, if any at all. And relief is granted at a flat rate of 25% irrespective of whether tax paid abroad is more or less than 25%. So, you need to think of the flat rate foreign tax credit as being a tax incentive of sorts, but it is not applicable to everyone. It has particular eligibility criteria. To begin with, only companies can claim the Flat Rate Foreign Tax Credit and it is available only with respect to foreign source income and in addition, it is available only to companies which have a particular type of memorandum and articles of association (which incorporates an empowerment clause which stipulates that these companies are entitled to apply the FRFTC). The FRFTC is granted at a flat rate of 25% and is granted unliterally in the absence of a treaty regime.

Last week, we discussed the elimination of double taxation. given that there isn't an element of harmonisation in international tax law, what are known as **conflicts of laws** could arise.

The conflicts which could arise can take the form of (1) residence-residence conflicts, (2) residence-source conflicts, and (3) source-source conflicts. **The effects of these conflicts are that the same income could be taxable in one or more jurisdiction**. We discussed how this problem is eliminated. There exist various solutions to the problem of international double taxation.

(1) Unilateral
In truth, we had already seen solutions to the problem of double taxation which are unilateral (exemptions), and which are contemplated in the Maltese tax system. We said that **certain exemptions eliminate the problem of double taxation**. Examples of such Maltese exemptions which eliminate double taxation, include the exemptions in art. 12(1)(c)(1) ITA and art. 12(1)(c)(2) ITA **exempting non-residents from paying tax on interest royalties and capital gain**s. Indeed, these are a unilateral measure to eliminate double taxation. Also, the participation exemption which **exempts branch profits, foreign source capital gains attributable to a participating holding and income from a participating holding**.

(2) Bilateral
In certain cases, double taxation is eliminated unilaterally, just by one country through exemptions, but solutions to the problem of double taxation can be bilateral too**, taking the form of the double tax treaty**. Malta has entered into around 70 double tax treaties. Essentially, double tax treaties **eliminate double taxation by allocating taxing rights or allowing in the state of residence credit for tax paid in another jurisdiction.** We saw that most, if not all, Malta's double tax treaties are based on the OECD model.

The OECD Model
There is this international organisation known as the organisation for economic cooperation and development which developed a template as a standard form treaty. States can use it as **a basis for a first draft double tax treaty**. This model was enormously successful to the extent that most of our treaties are based on this model.

The contents of this model were discussed by reference to Malta's oldest double tax treaties, being that with Belgium.

We saw that the first article of the double tax treaty deals with **taxes covered** which in the case of Malta would be **income tax**. We then saw that **in order to allocate taxing rights**, treaties use as a basis, as tools, the concept of **source**, the concept of **residence** and the concept of **permanent establishment**.

But the issue is that, taking the case of Malta and Belgium, if the Treaty says, 'residence of a contracting state and taxable in a contracting state', when it is saying 'resident' was does it mean? Is it meaning that defined in Maltese law or as defined in Belgium law? The solution to this is that there is a common definition in the Treaty because **Treaties prevail**, they override over domestic law – '**treaty override'.**

In the Belgian Treaty, we find how 'residence' is **determined for treaty purposes**. We see that a person is treated as a resident of either Belgium or Malta depending on whether either Belgium or Malta treats him as resident. So, if a person is treated as a resident of only one jurisdiction, then there is no issue. **Problems arise when both Malta and Belgium treat the person as a resident of theirs**. So, if you have a person who is treated as a Belgian resident and a Maltese resident. We saw that the Treaty creates a concept of residence which breaks this tie which is known as a **'tie breaker rule'**, the effect of which is to reach a conclusion that a person is a resident either of Malta or Belgium, in the case of this Treaty.

Certain presumptions are used; presumptions which help you reach a conclusion. What is the conclusion? That **you are treated as a resident where you have your permanent home**. If you have a home available in two countries, you look at **the centre of vital interests** where your personal and economic relationships are closer. If this cannot be established, you consider where you have **a place of habitual abode**. If this cannot be established, then for tax treaty purposes you are **considered to be a resident where you are citizen**. If you have citizenship in both countries, the matter is resolved by **mutual agreement procedure** (the tax authorities of the two countries sit down and discuss a particular tax treatment).

The tie breaker rules help you **reach a solution and remove doubts**.

Residence is an important criterion used to establish jurisdiction to tax but is not the only one. There is the concept of permanent establishment which is defined in all Treaties.

<u>In Malta's traditional treaties, those based on the OECD model of the traditional type, these incorporate 3 types of Permanent establishment –</u>

1) Fixed place of business
2) Project/installation permanent establishment;
3) Dependant agency.

The concept of permanent establishment in these 3 forms is **a tool for the allocation of taxing rights**.

Then the Treaty proceeds to list items of income or capital gains determining how they are going to be taxed. For instance, **business profits are taxable in the state of residence**. But if a company happens to have a permanent establishment in another country, then profits attributable to the foreign permanent establishment may be taxed where the permanent establishment is situated. On this point, there was a good case involving a Maltese company having a presence both in Malta and in Belgium. In Malta, the company is going to be taxed on all its income worldwide but in Belgium, it will be taxed on the income attributable to its Belgian permanent establishment. **Any tax paid in Belgium would be available as a credit against the tax in Malta**.

We see even there are income streams which are special which are **income from aviation** and **shipping** which are taxable where the company is affectively managed and controlled.

For shipping and aviation companies, the concept of permanent establishment is not well suited and for shipping and aviation companies, they are taxed only where they are effectively managed and controlled.

We then proceeded to discuss other items of income such as income from interest, royalties, dividends and very often these would be taxed in both sourced country and country of residence, but the latter would be obliged to give a credit for tax paid at source.

We also saw income from dependant personal services and income from independent personal services (employment). In certain cases, employment income is taxable only in the state of residence this is if 3 criteria are met –

1) provided that the employer of the company is not resident in the source jurisdiction,
2) The employee doesn't spend 180 days or more in the source jurisdiction,
3) The salary of the employee is not borne by a permanent establishment which the employer has in this source jurisdiction.

In summary, we discussed that double tax treaties have a number of aims not only the elimination of double taxation. **They create the framework for exchange of information and mutual assistance between tax authorities**.

Art. 76 ITA lays down Malta's mechanisms for the elimination of double taxation. In this article, one finds 4 mechanisms for the elimination of double taxation, within which there is a reference to double taxation treaty relief. But there is also reference to unliteral relief where Malta will grant a credit for tax paid abroad regardless of whether there is a treaty.

So, in Malta we have a mechanism for unliteral relief and relief for underlying tax. We also saw that art. 76 refers to Commonwealth relief where Malta grants relief for tax paid in another commonwealth state.

Then we find in art. 92 ITA notional relief which is known as the Flat Rate Foreign Tax Credit (FRFTC). These provide **for a credit for tax actually paid abroad** but <u>**the FRFTC provides for a flat tax credit on income received from abroad**</u>. So, with FRFTC, you get a credit for tax regardless of any tax paid abroad, if any at all. And relief is granted at a flat rate of 25% irrespective of whether tax paid abroad is more or less than 25%. So, you need to think of the flat rate foreign tax credit as being a tax incentive of sorts, but it is not applicable to everyone. It has particular eligibility criteria. To begin with, only companies can claim the Flat Rate Foreign Tax Credit and it is available only with respect to foreign source income and in addition, it is available only to companies which have a particular type of memorandum and articles of association (which incorporates an empowerment clause which stipulates that these companies are entitled to apply the FRFTC). The FRFTC is granted at a flat rate of 25% and is granted unliterally in the absence of a treaty regime.

EU TAX LAW

(Not examinable)

Certain tools to eliminate DT arise from EU law. in EU Law, you will find directive which eliminate DT such as the merger directive, the interests and royalty's directive and the parent subsidiary directive which incorporate exemptions on interest, royalties and dividends in certain cases, provided certain conditions are met. Traditionally, the remit of the EU was not that of intruding into matters relating to direct taxation. One finds within EU law concepts of certain freedoms and concepts combatting market distortions which create tax rules, and which are being used to impose tax harmonisation. This is a very vast topic. Right now, Malta is in the middle of a war over tax harmonisation which has been going on for many years.

EU Law provides for a general prohibition on barriers to free movement of capital, persons and so on and prohibitions of market distortions. These prohibitions have been used to achieve or to build arguments to achieve tax harmonisation. Over the years, there have been renewed pressured by the OCED as well as the G20 to combat what they call based erosion and profit shifting. Base erosion and profit shifting is the diversion of profits from high tax jurisdiction to low tax jurisdictions. Eroding the legitimate tax based of a high tax jurisdiction by moving profits to a low tax jurisdiction. There have been a lot of efforts aimed at fighting this phenomenon. Some Member States of the EU were very keen to fight this phenomenon of base erosion of profit shifting. Treaty provisions and provisions of EU law aimed at protecting from market distortions and free movement have been used to justify measures leading to tax harmonisation. In this module, the topic is not examinable and is not discussed in detail but know that the EU has not only created directives aimed at eliminating international double taxation, but it has actually introduced laws intended to avoid base erosion and profit shifting and a few years ago, it created a Directive known as the Anti-Avoidance Directive which has been enhanced since then and there are a number of measures currently being discussed, such as the Pillar II Directive which is expected to become law in a few years' time.