

Executive Summary

Study concerning measures relating to inbound and outbound dividend, interest, and royalty payments

This Report has been drawn up in accordance with Malta's commitment in terms of the Recovery and Resilience Plan (submitted as part of the NextGenerationEU Initiative) to conduct a study concerning measures relating to inbound and outbound dividend, interest and royalty payments (the 'Payment Flows'). The overall objective of the study is to provide the Government of Malta with guidance for the formulation of recommendations to mitigate aggressive tax planning risks, particularly situations resulting in double non-taxation of income, in the area of inbound and outbound dividend, interest and royalty payments.

The specific objectives of the study are to analyse the state of play with respect to the Payment Flows and provide recommendations for different legal measures that could be introduced with respect to outbound and inbound dividend, interest, and royalty payments, between companies established in Malta and related companies established in jurisdictions that either form part of the EU list of non-cooperative jurisdictions ('NCJs') or that are zero-tax or low-tax jurisdictions (the 'Covered Jurisdictions'). It is understood that the study, coupled with further consultations as may be deemed necessary, shall form the basis for the Government of Malta to propose legislation intended to mitigate the risks so identified.

We understand that any legislative measures are intended to enter into force by 1 October 2024. We have outlined a sequence of events and milestones intended to enable the Competent Authority (the 'CA') to study the outcomes of this Report, engage with key stakeholders and develop appropriate legislative responses to the defensive tax measures proposed. Our recommendation is that the policy measures selected are integrated into Malta's existing international tax framework through amendments to primary law, as opposed to legislative action via secondary legislation. We recommend public consultation prior to the selected policy measures being finalised.

An overview of the existing tax treatment of Payment Flows in terms of the Income Tax Act (Chapter 123 of the Laws of Malta) identified certain vulnerabilities inherent to Malta's international tax framework that may enable the Payment Flows to be used for base erosion and profit shifting ('BEPS') and may occasion double non-taxation outcomes, particularly in the context of transactions with counterparties located in Covered Jurisdictions.

The quantitative and qualitative analysis performed for the purposes of the Report, revealed that while the volume of foreign capital flows are indeed significant relative to the size of the country's economy, the majority of Payment Flows are not in fact connected to Covered Jurisdictions. Furthermore, it is recognised that, Payment Flows that are connected to Covered Jurisdictions, may in a number of situations arise as a result of (a) the key economic sectors driving Malta's economy, and (b) the economic ties of those sectors with certain Covered Jurisdictions.

It was recognised that there are limitations on the data sources available, as well as the suitability of the data for an exercise of this nature. The balance of payments (the 'BoP') represents the principal source of data underpinning the analysis. While the BoP data represents the most complete dataset concerning international transaction flows that is available at present, the data does have limitations. In particular:

- a. BoP data does not include information concerning individual transactions and is instead estimated on the basis of extrapolation of survey data and other estimation methods,
- b. The use of various assumptions in the compilation and estimation of BoP data renders detailed analysis difficult, and best practice requires one to avoid detailed interpretation at a highly segregated level, and
- c. Seasonal patterns cannot be evaluated as, while the data is presented on a monthly basis, in most instances, such monthly data is arrived at through an even distribution of the annual estimate across months.

Consequently, BoP data lacks sufficient transaction level data to enable accurate review of the underlying risks associated with the Payment Flows that have been evaluated in this Report. For example, there is no information concerning the proportion of transaction flows that originate or flow to related parties, or whether such transaction flows impact the effective tax rate of individual entities to an extent which is not justified relative to the different value-added activities across different jurisdictions involved within a business operation's corporate structure.

The analysis further established the existence of certain assumptions underpinning the dataset that could, if not appropriately scrutinized and understood, distort any conclusions reached, such that those conclusions would not be reflective of the state of play in actual terms. This is especially so insofar as concerns the statistical definition of a special purpose entity and the consequent allocation of Payment Flows to a 'financial services' category for BoP purposes. This suggests that the estimated relative size of the financial sector as a proportion to the overall economy may be misaligned to its size in real terms.

Concerns around the BoP data set were corroborated by material discrepancies identified between transactions reported to the Commissioner for Revenue (the 'Commissioner') via the relevant schedule within the Malta corporate income tax return relating to the nexus of the taxpayer with NCJs as compared to BoP estimates.

Notwithstanding the weaknesses in the data set, the quantitative analysis, together with the system vulnerabilities identified within Malta's international tax framework, support the view that a degree of intervention is warranted so as to mitigate the risk of BEPS, including double non-taxation, tax fraud and evasion.

Policy decisions taken pursuant to the recommendations made, must recognise that legitimate financial links between Malta and any Covered Jurisdictions may in fact subsist and therefore, the measures ultimately introduced must be proportionate and appropriately targeted.

The Terms of Reference of the Tender requested the design of defensive tax measures concerning dealings with associated enterprises located in NCJs¹ (these have been defined as Category 1 territories in the Report), as well as so-called zero and low tax² jurisdictions (these have been defined as Category 2 territories in the Report and consist of territories which are not Category 1 territories, and are not Union Member States, or Member States of the European Economic Area). As the different categories present different risks and challenges, different measures have been proposed. The category to which a territory is allocated impacts the severity of the defensive tax measure, and the degree of administrative and compliance effort required.

A number of specific policy recommendations consisting of defensive tax measures intended to address the key risks emerging from the findings of the Report have been developed. The Report ultimately identified a total of seven defensive tax measures.

Measures concerning outbound payments

Measure 1: Application of a withholding tax on certain payments to bodies of persons located in Category 1 territories

It is proposed that a withholding tax would apply to certain payments (at the least, interest and royalties) made to any body of persons located in Category 1 territories, or to a person resident in Malta on behalf of such non-resident body of persons, by a body of persons resident in Malta, where the body of persons are associated enterprises and where the said payment represent a tax deduction.

¹ List as published by the Council of the European Union, updated periodically and available online at the following address: <<https://www.consilium.europa.eu/en/policies/eu-list-of-non-cooperative-jurisdictions/>>, accessed on 17 July 2023.

² For the purposes of this Report, a zero and low tax rate is a nominal tax rate below 1%.

It is proposed that the recipient of the payment should be entitled to furnish documentary evidence to the Commissioner that the payment has been taken into account for the purposes of calculating a controlled foreign company ('CFC') charge or a top-up tax under the OECD Global Minimum Tax ('GloBE') rules so as to recover the tax withheld.

Measure 2: Application of a withholding tax on specified dividend payments made to persons located in Category 1 territories

It is proposed that a withholding tax would apply where a person resident in Malta or, not being resident in Malta has a permanent establishment in Malta, pays a dividend out of profits allocated to its untaxed account to a related person resident in a Category 1 territory or, to a person resident in Malta on behalf of the latter.

It is proposed that the recipient of the dividend should be entitled to furnish documentary evidence to the Commissioner that the underlying profits out of which the dividend was distributed have been taken into account for the purposes of calculating a CFC charge or a top-up tax under the OECD GloBE rules so as to recover the tax withheld.

Measure 3: Application of a withholding tax on refundable imputation tax paid to persons located in Category 1 territories

It is proposed that a withholding tax would apply on any payment of any imputation tax refund pursuant to article 48(4) or article 48(4A) Income Tax Management Act (Chapter 372 of the Laws of Malta), paid to a person that is located in a Category 1 territory.

It is proposed that the claimant should be entitled to furnish documentary evidence to the Commissioner that the underlying profits by reference to which the refund claim has been made, have been taken into account for the purposes of calculating a CFC charge or a top-up tax under the OECD GloBE rules so as to recover the tax withheld.

Measure 4: Denial of tax deduction on certain payments to persons located in Category 2 territories

It is proposed that a deduction limitation would apply to any body of persons that pays to a related body of persons resident in a Category 2 territory, or to a person resident in Malta on behalf of such non-resident body of persons, on any non-arms' length interest or royalties.

It is proposed that the taxpayer should be entitled to furnish documentary evidence to the Commissioner that the payment has been taken into account for the purposes of calculating a CFC charge or a top-up tax under the OECD GloBE rules so as to reverse the effects of the deduction limitation.

Measures concerning inbound payments

Measure 5: Application of a deemed remittance rule (Category 1 territories)

It is proposed that where a certain payment is made by a payor located in a Category 1 territory to a company incorporated outside of Malta, that is tax resident in Malta, a defined portion of the payment that has not been received in, or remitted to, Malta by the recipient, shall be deemed to have been received in Malta by the taxpayer and shall become subject to Malta tax at a prescribed rate.

It is proposed that the taxpayer should be entitled to furnish documentary evidence to the Commissioner that the payment has been taken into account for the purposes of calculating a CFC charge or a top-up tax under the OECD GloBE rules so as to reverse the effects of the deeming rule.

Measure 6: Application of a deemed remittance rule (Category 2 territories)

It is proposed that where a certain payment is made by an associated enterprise located in a Category 2 territory to a company incorporated outside of Malta, that is tax resident in Malta, a defined portion of the payment that has not been received in, or remitted to, Malta by the recipient, shall be deemed to have been received in Malta by the taxpayer and shall become subject to Malta tax at a prescribed rate.

It is proposed that the taxpayer should be entitled to furnish documentary evidence to the Commissioner that the payment has been taken into account for the purposes of calculating a CFC charge or a top-up tax under the OECD GloBE rules so as to reverse the effects of the deeming rule.

Measure 7: Limitation on the participation exemption on dividend income paid by associated enterprises located in a Category 2 territory

It is proposed that where a dividend is paid by a participating holding located in a Category 2 territory (being an associated enterprise of the recipient) to a company registered in Malta, the ability to claim an exemption from tax in terms of the participation exemption should be limited to a defined percentage of the dividend paid.

It is proposed that the recipient of the dividend should be entitled to furnish documentary evidence to the Commissioner that the underlying profits out of which the dividend was distributed have been taken into account for the purposes of calculating a CFC charge or a top-up tax under the OECD GloBE rules so as to reverse the effects of the limitation.