INTRODUCTION TO TAXATION

Lecture 3 - International Tax Law

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Diploma in Law (Malta)

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Overview

1. Eliminating Double Taxation
2. Malta's double tax treaty network
3. The OECD Model Convention
4. The OECD Multilateral Instrument
5. Introduction to Transfer Pricing
6. Introduction to Pillar II

The Elimination of International Double Taxation

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Types of Double Taxation (1)

Juridical Double Taxation

Taxation of the SAME INCOME *twice* in the hands of the SAME TAXPAYER in two or more jurisdictions

e.g. interest on a foreign bank account derived by an individual which has been taxed in the Source State, and is taxed again in the Residence State

vs.

Economic Double Taxation

Taxation of the SAME INCOME *twice* in the hands of the TWO DIFFERENT TAXPAYERS

e.g. business profits which are taxed at the level of the company, and again at the level of the shareholders when such profits are distributed thereto as dividends

Types of Double Taxation (2)

How does juridical double taxation arise?

Source Jurisdiction

The income is subject to tax in the country where the **source of such income exists** *(i.e. jurisdiction has right to tax on the basis of the source of the income).*

Residence Jurisdiction

The income earner is **taxed on the basis of his/her residential status in that country** *(i.e. jurisdiction has right to tax on the basis of the residence of the taxpayer).*

Types of Double Taxation (3)

- When residents (be they individuals, corporations or enterprises) of any two given countries trade or transact commercially with each other, it gives rise to international trade, or cross-border transactions.

EXAMPLE

- A typical scenario is when A, a person based in Country A, transacts business with a person resident in the other country, Country B. The profits or gains thus accruing to A is, say, $100. This $100 is likely to be subject to tax in Country A (because he is resident or based in Country A), as well as in Country B (because the gains are derived or sourced from Country B).
- Thus, the same income item of $100 is subject to territorial double taxation, once in Country A, then again in Country B.
- Assuming Country A has a tax rate of 30%, while Country B taxes the income at 25%, A will potentially suffer a global tax of $55 [(30% of $100)+(25% of $100)], leaving him with a measly after-tax income of only $45.

General Principles (1)

- Like other jurisdictions, the Maltese tax system contemplates for **certain mechanisms** which may serve as important tools in avoiding any incidence of double taxation in Malta.

- The mechanisms provide for relief from double taxation, typically in the form of a **TAX CREDIT** (a reduction from the tax charge). The applicable relief mechanisms are listed under article 74 ITA and comprise the following:

Relief mechanism	Order
▪ **Treaty Relief**	1
▪ **Unilateral Relief**	2
▪ **Relief in respect of Commonwealth income tax**	3
▪ **A flat-rate foreign tax credit (FRFTC)**	4

In order of hierarchy

General Principles (2)

Unilateral Relief only applies where ***Treaty Relief*** is not available

FRFTC is applicable only where ***Treaty Relief*** and ***Unilateral Relief*** are not available

Unilateral Relief and **Treaty Relief** are only available where it has been proved to satisfaction of CfTC that **tax has been borne**

Treaty Relief

- Double tax treaty relief refers to double tax relief that is provided for in terms of a **DOUBLE TAX TREATY** that Malta has concluded with another jurisdiction.

What is a Tax Treaty?

- Definition in terms of the Vienna Convention:

  A "treaty" is an "***international agreement concluded between States in written form and governed by international law, whether embodied in a single instrument or in two or more related instruments***..."

- Confers rights and imposes obligations on the Contracting States in relation to their relations between each other.

Relationship between Tax Treaties and Domestic Law

- The basic principle is that the treaty should **PREVAIL** in the event of a conflict between provisions of domestic law and a treaty.

Treaty Relief

- The elimination of double taxation relief is applied through what is referred to as the '**credit method'**, in terms of which a **tax credit is granted for the amount of foreign tax paid on income received from a country with which Malta has signed a double taxation agreement.**
- The income received in Malta is **grossed up by foreign tax**, is **subject to tax at the Maltese taxpayer's tax rate** and a credit is granted against the tax charged.

Limitation on Credit

- The credit being granted is however **LIMITED** to the **LOWER** of the:
  i. **Malta tax attributable to chargeable income**; and
  ii. the **foreign tax on same income**.

Treaty Relief – Practical Example (1)

ABC Limited, which is registered in Malta, received foreign interest of €1000, on which foreign tax of €100 was incurred.

	€
Foreign Interest (gross of €100 foreign tax)	1,000
Malta Tax Rate @ 35%	350
Double Tax Relief	(100)
Malta Tax Payable	250

Treaty Relief – Practical Example (2)

ABC Limited, which is registered in Malta, received foreign interest of €1,000, on which foreign tax of €400 was suffered.

	€
Foreign Interest (gross of €400 foreign tax)	1,000
Corporate Tax Rate @ 35%	350
Double Tax Relief	(350)
Malta Tax Payable	-

Malta tax is lower than foreign tax

Treaty Relief

- A company which, for tax purposes, would be deemed resident in Malta in terms of domestic law, would have **access to Malta's tax treaty network**, and will have a right to benefit from double tax treaty relief provided that the following conditions are satisfied:

  i. **double taxation arrangements** must be in force by Ministerial order between Malta and the relevant jurisdiction;

  ii. the Maltese company must be in possession of **evidence of tax paid abroad**;

  iii. the tax paid abroad is either **income tax** or any **tax of a similar character** under the ITA under the laws of a territory outside Malta; and

  iv. the claim for allowance of relief by way of credit must be made not later than **TWO YEARS** after the end of the year assessment to which the claim refers.

Unilateral Relief

*Applicable **ONLY** where there is **NO TREATY in place** with the jurisdiction in which the income was subject to tax, and thus, **no treaty relief is available**.*

- A company which is tax resident in Malta will have a right to benefit from unilateral relief provided that the following conditions are satisfied:

  i. the income is has borne **tax of a similar character** to that imposed under the ITA;

  ii. the Maltese company must be in possession of **evidence of tax paid abroad**;

  iii. the claim for allowance of relief by way of credit must be made not later than **TWO YEARS** after the end of the year assessment to which the claim refers.

- A tax shall not be prevented from being of a similar character by reason only that it is payable under the law of a province, state or other part of a country, or is levied by or on behalf of a municipality or other local body.

Commonwealth Relief

- Applies to foreign tax paid in **Commonwealth countries** provided that the country provides for similar relief on Malta source income.
- **Ceases** to have effect **once a treaty is signed**.
- Tax credit available **up to 50% of Malta tax**.
- **Rarely applied in practice.**

Flat Rate Foreign Tax Credit (FRFTC)

The FRFTC is a credit for foreign tax **DEEMED** to have been suffered at a **fixed rate of 25%,** rather than for foreign tax actually suffered.

Thus, **UNLIKE** Double Tax Treaty Relief & Unilateral Relief, the credit is **NOT** granted on tax ***actually*** paid abroad.

- FRFTC is given in respect of income or gains received by a **company registered in Malta**;
- Applicable to profits which are allocated to the foreign income account, HOWEVER, the company must be **SPECIFICALLY EMPOWERED** to apply FRFTC.
- Therefore, there has to be a specific **objects clause** in the **Memorandum and Articles of Association** of the company catering for the application of FRFTC.
- **Documentary evidence** must be available – an auditor's certificate confirming that income was derived from foreign sources, is satisfactory documentary evidence in this respect.
- Any claim for a credit must be made within **TWO YEARS.**

Flat Rate Foreign Tax Credit (FRFTC)

Method of Calculation

1. **Gross up Income**: Credit as calculated is added to the income or gains;
2. **Deduction of expenses** against grossed up income or gains;
3. **Taxed at 35%;**
4. FRFTC amount is granted as a **credit** against tax due on chargeable income;
5. Credit is limited to **LOWER** of:

    i. FRFTC; and
    ii. 85% of the tax payable on profits allocated to the FIA less double tax relief credits claimed under the other methods

FRFTC – Practical Example

ABC Limited, which is registered in Malta, receives foreign income of €800 and incurs €250 of allowable expenses

	€
Foreign Income (net of any foreign tax)	800
FRFTC gross-up (25%)	200
Total Income	1,000
Expenses	(250)
Chargeable Income	750
Malta Tax @ 35%	263
FRFTC (subject to 85% limitation)	(200)
Malta Tax Payable	63

The OECD Model Tax Convention

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What is the OECD?

The Organisation for Economic Co-operation and Development (OECD) is an intergovernmental economic organization.

- Founded in **1961** to stimulate **economic progress and world trade;**
- **38** Member Countries - Malta **NOT** currently an OECD Member;
- **The** OECD publishes and updates a **MODEL TAX CONVENTION.**
- This model is accompanied by a **Commentary** which provides guidance in relation to the interpretation of the model convention provisions.

Relationship between Malta & the OECD

- Despite attempts to join the organisation after its accession to the EU, Malta is **NOT** a member of the OECD.

- That being said, Malta still **ACTIVELY PARTICPATES** in all of the **EU's and international tax transparency initiatives;**

  - As a matter of fact, Malta **follows the OECD Model Convention** and the **OECD Commentaries.**

The OECD Model Tax Convention

- The *OECD Model Tax Convention* serves as a **model** for *the* ***negotiation****,* ***interpretation*** *and* ***application*** **concluding double tax treaties**, *playing a crucial role in* ***removing tax-related barriers to cross border trade*** *and investment, helping to* ***prevent tax evasion and avoidance.***

- The OECD Model also provides a means for settling **on a uniform basis** the most common **problems that arise in the field of international double taxation**.

- The OECD Model Convention is the **most commonly used model**, although other models do exist (**UN Model, US Model**).

- The OECD Model Convention is **NON-BINDING** and is **NOT enforceable** through any *ad hoc* tribunal or court.

SUMMARY OF THE CONVENTION

Title and Preamble

Chapter I

SCOPE OF THE CONVENTION

Article 1 Persons covered
Article 2 Taxes covered

Chapter II

DEFINITIONS

Article 3 General definitions
Article 4 Resident
Article 5 Permanent establishment

Chapter III

TAXATION OF INCOME

Article 6 Income from immovable property
Article 7 Business profits
Article 8 International shipping and air transport
Article 9 Associated enterprises
Article 10 Dividends
Article 11 Interest
Article 12 Royalties
Article 13 Capital gains
Article 14 [Deleted]
Article 15 Income from employment
Article 16 Directors' fees
Article 17 Entertainers and sportspersons
Article 18 Pensions
Article 19 Government service
Article 20 Students
Article 21 Other income

Chapter IV

TAXATION OF CAPITAL

Article 22 Capital

Chapter V

METHODS FOR ELIMINATION OF DOUBLE TAXATION

Article 23 A Exemption method
Article 23 B Credit method

Chapter VI

SPECIAL PROVISIONS

Article 24 Non-discrimination
Article 25 Mutual agreement procedure
Article 26 Exchange of information
Article 27 Assistance in the collection of taxes
Article 28 Members of diplomatic missions and consular posts
Article 29 Entitlement to benefits
Article 30 Territorial extension

Chapter VII

FINAL PROVISIONS

Article 31 Entry into force
Article 32 Termination

Model Tax Convention – Structure

Personal Scope	Substantive Scope
Distributive Rules	Methods to avoid double taxation

Personal Scope – Article 1

- The first thing to ensure when applying a tax treaty is that it covers the interested taxpayer.
- The personal scope of treaties is typically enshrined within Article 1:

> This Convention shall apply to **persons** who are **residents** of **ONE** or **BOTH** of the Contracting States.

- Definition of "persons" under Article 3 - Includes an ***individual***, a ***company*** and any ***other body of persons***.
- Definition of "resident" under Article 4.

Substantive Scope – Article 2

This Convention shall apply to **taxes on income** and **on capital** imposed on behalf of a Contracting State or of its political subdivisions or local authorities, ***irrespective of the manner in which they are levied***.

- Taxes on income and on capital. The term 'tax' does not include social security contributions and fees imposed by the government for services rendered.
- Contracting States may also **list the taxes applicable** to which the Convention is to apply.
- Convention shall also apply to any ***identical*** or ***substantially*** *similar* taxes imposed after the date of signature. Therefore, the Convention renders a treaty still applicable even if existing taxes have been **abolished** and **new taxes have been introduced.**

Article 4 – Treaty Residence

- In order to benefit from a double taxation treaty a taxpayer must be **RESIDENT** in **one of the jurisdictions which has signed the treaty**.

- **Article 4** of the Model Tax Convention contains a **non-exhaustive definition** of who is deemed to be resident for treaty purposes.

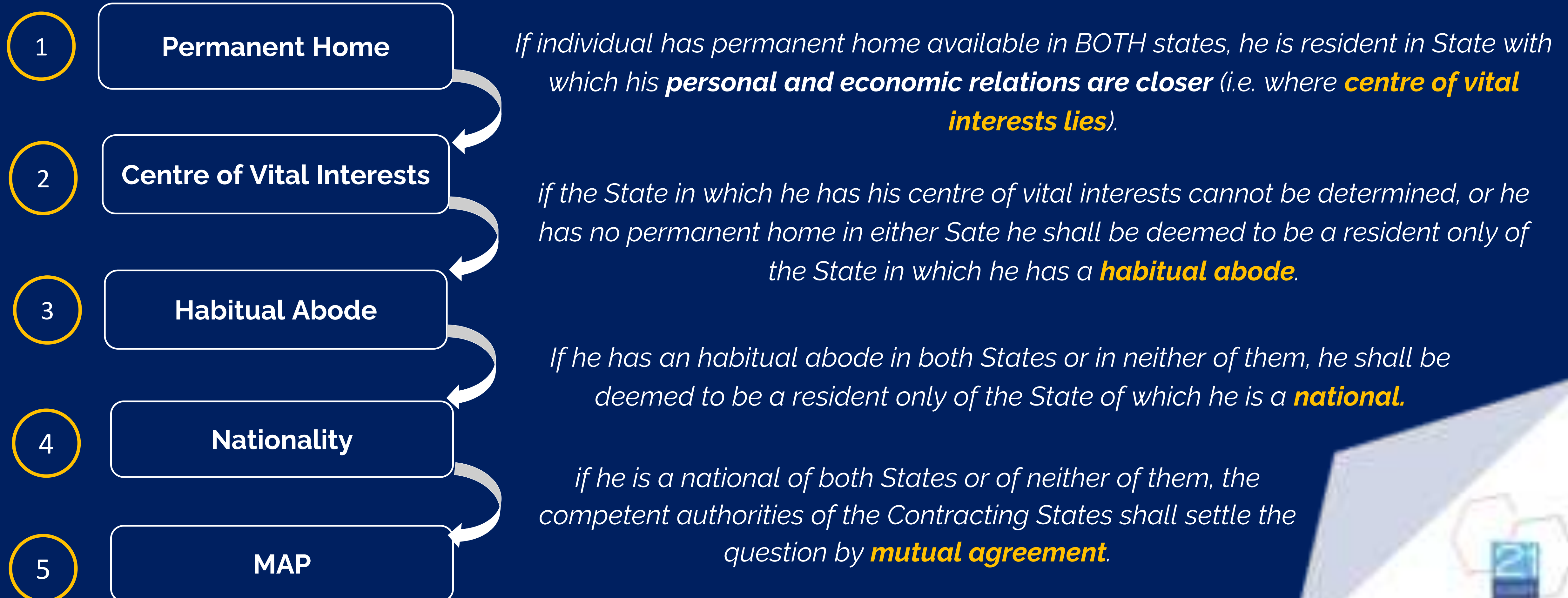
> *"For the purposes of this Convention, the term "resident of a Contracting State" means any person who, **under the laws of that State**, is liable to tax therein by reason of his **domicile, residence, place of management or any other criterion of a similar nature**, and also includes that State and any political subdivision or local authority thereof as well as a recognised pension fund of that State. This term, however, does not include any person who is liable to tax in that State in respect only of income from sources in that State or capital situated therein."*

- Treaty residence is determined in conjunction with the **domestic law of the Contracting State.**

Article 4 – Treaty Residence

What happens if an individual is resident in BOTH Contracting States?

TIE –BREAKER RULE



Article 4 – Permanent Home (1)

Permanent Home – Concept of 'Home'

- **ANY** form of home may be taken into account (***house or apartment belonging to or rented by the individual, rented furnished room***).

Permanent Home – Concept of 'Permanence'

- For a home to be considered permanent, "*the individual must have **arranged and retained it for his permanent use** as opposed to staying at a particular place under such conditions that it is evident that the **stay is intended to be of short duration***".

- Therefore, in order for a home to be permanent, it must **NOT** be of a short duration – it must be intended to last for some time.

- EXAMPLE: If I own a home in Country A but I am temporarily renting an apartment in Country B, my permanent home is in Country A.

Article 4 – Permanent Home (2)

Permanent Home – Concept of 'Available for Use '

- Ties in with the element of permanence – the individual has arranged to have the dwelling available to him at **ALL times, CONTINUOSLY**, and ***not occasionally***.

- Does not necessarily mean that the house is owned or rented by the taxpayer – so long as it is available to be used by the taxpayer.

EXAMPLE

A house owned by an individual cannot be considered to be available to that individual during a period when the house has been rented out and effectively handed over to an unrelated party so that the individual no longer has the possession of the house and the possibility to stay there.

Article 4 – Centre of Vital Interests

> *"if an individual has a permanent home available to him in both States, he shall be deemed to be a resident only of the State with which his* ***personal*** *and* ***economic relations are closer*** *(****centre of vital interests****)"*

While article 4(2) fails to mention what constitutes 'personal relations' or 'economic relations', regard is typically had to the individual's whole life, including:

- Family ties– e.g. spouse or partner, children and other dependants;
- Personal property;
- Social ties – membership in societal or other organisations
- His occupations,
- His political, cultural or other activities;
- His place of business;
- The place from which he administers his property

Article 4 – Centre of Vital Interests (2)

- In determining his centre of vital interests, it is **not enough simply to weigh or count the number of factors or connectors on each side**. The ***depth of the roots*** on one's centre of vital interests is more important than their number.

- If a person who has a home in ***one State*** sets up a **second in the other State while retaining the first,** the fact that he retains the first in the environment where he has always lived, where he has worked, and where he has his family and possessions, can, together with other elements, **go to demonstrate that he has retained his centre of vital interests in the first State.**

Article 4 – Centre of Vital Interests (3)

Example: (facts are based on *Hertel v Minister of National Revenue)*

- Mr. X was born in Germany in 1942 and emigrated to Canada in 1959, but returned to live in Germany in 1970. He started a business selling Canadian silver dollars to German banks and visited Canada as much as 15 times per year.
- From 1970 he purchased several properties in Canada, one of which was used by him and his family for holidays and another where he intended to take up residence at a later date.
- He thus had a permanent home in both countries and his centre of vital interests had to be determined. All his family and friends were resident in Germany; the only relative living in Canada was a brother.
- His **centre of vital interests was held to be in Germany** because of the **depth of those roots** there, despite the fact that he visited Canada regularly, had a number of properties in Canada and intended to return to live in Canada at some future time.

Article 4 – Habitual Abode (1)

> *"if the State in which he has his centre of vital interests cannot be determined, or if he has no a permanent home available to him in either State, he shall be deemed to be a resident only of the State in which he has a **habitual abode**.*

- Requires a determination of whether the individual lived **habitually**, in the sense of being **customarily or usually present,** in one of the two States but not in the other during a given period.
- The test will **NOT** be satisfied by simply determining in which of the two Contracting States the individual has spent more days during that period.

Article 4 – Habitual Abode (2)

- It is possible for an individual to have a habitual abode in the **TWO** States, which would be the case if the individual was **customarily or usually present in each State during the relevant period**, ***regardless*** of the fact that he spent **MORE** days in one State than in the other.

EXAMPLE

- Over a period of five years, an individual owns a house in both States A and B but the facts do not allow the determination of the State in which the individual's centre of vital interests is situated.

- The individual works in State A where he habitually lives but returns to State B two days a month and once a year for a three-week holiday.

- Habitual abode is in **State A**.

Article 4 – Treaty Residence

What happens if a legal person is a resident of BOTH Contracting States?

TIE –BREAKER RULE

*"where by reason of the provisions of paragraph 1 a person other than an individual is resident of both Contracting States, the competent authorities of the Contracting States shall endeavour to determine by mutual agreement the Contracting State of which such person shall be deemed to be a resident for the purposes of the Convention, having regard to **its place of effective management**, the **place where it is incorporated** or **otherwise constituted** and any other relevant factors…."*

Article 4 – Treaty Residence

Example – Tie-Breaker rule for companies

- A company is incorporated in Malta but its board of directors take all the decisions outside Malta (e.g. in Poland).
- In this case, the company is deemed to be tax resident in Malta (by virtue of its incorporation) and potentially also in Poland (where the board takes the decisions).
- Applying the provisions of the tie-breaker rule, the Maltese company would be deemed to be tax resident in the country where its place of effective management is situated, i.e. Poland.
- Poland would therefore enjoy taxing rights under this scenario.

Article 5 – Permanent Establishment

What is a PE?

A tax notion indicating a **particular level of business & economic activity** in a State, **OTHER THAN** the **residence State**, thereby enabling a State to **tax business profits earned within its territory by a NON-RESIDENT enterprise.**

The term "permanent establishment" means a

FIXED PLACE OF BUSINESS

through which the **business of an enterprise is wholly or partly carried on**.

Article 5 – Permanent Establishment

Why is the concept of PE relevant?

Under Article 7, profits of an enterprise of a Contracting State shall be taxable **ONLY** in that State **UNLESS *the enterprise carries on business in the other Contracting State through a permanent establishment*** situated therein.

If the enterprise carries on business as aforesaid, the **profits that are attributable to the permanent establishment** may be taxed in that other State.

Article 5 – Permanent Establishment

What is a PE?

- The definition of PE contains the following conditions:

- The existence of a "**place of business**", a facility such as premises, or, in certain instances, machinery or equipment,
- This place of business must be "**fixed**", i.e. it must be established at a distinct place with a certain degree of permanence;
- The **carrying on of business through this fixed place of business**. This means usually that persons who, in one way or another, are dependent on the enterprise (personnel) conduct the business of the enterprise in the State in which the fixed place is situated.

COMMENTARY

Article 5 – Permanent Establishment

Types of Permanent Establishment

Physical PE	Project PE	Agency PE
Article 5 (1)	Article 5 (3)	Article 5 (5)

Article 5 – Permanent Establishment

Physical PE

Generally, includes the following, subject to meeting criteria as explained under the Commentary:

- **a place of management;**
- **a branch;**
- **an office;**
- **a factory;**
- **a workshop;**
- **a mine, an oil or gas well, a quarry or any other place of extraction of natural resources**

Article 5 – Permanent Establishment

Project PE

- A **building site** or **construction** or **installation project** constitutes a permanent establishment only if it lasts **MORE THAN <u>twelve months</u>.**
- 12-month threshold applies to each site or project **INDIVIDUALLY**. Time spent on unconnected projects should not be counted, unless project constitutes a coherent whole commercially and geographically.

EXAMPLE: A German company has secured a project to install 50 wind turbines in Malaysia within a five-month period. It is unlikely to establish a PE through this installation project alone because the Malaysia-Germany treaty stipulates a minimum period of twelve months.

Article 5 – Permanent Establishment

Agency PE

- A PE may exist even where **no fixed PE exists.**
- Person acts ***on behalf*** of an enterprise.
- In doing so, **habitually concludes contracts**, or **habitually plays the principal role leading to the conclusion of contracts** that are routinely concluded without material modification by the enterprise, and these contracts are:
  i. in the name of the enterprise, or
  ii. for the transfer of the ownership of, or for the granting of the right to use, property owned by that enterprise or that the enterprise has the right to use, or
  iii. for the provision of services by that enterprise,

Article 5 – Permanent Establishment

A PE of ABC Limited

Malta

Germany

ABC Limited

Supply of Garments
To Representative

Payment of Commission

Representative

Acts on behalf of
ABC Limited

Sale of Garments

Customers

- Agent is NOT independent – renders services exclusively;
- Takes instructions from ABC Limited - has limited choice on how business is conducted
- Enters into sales contracts on behalf of ABC Limited

Distributive Rules (1)

- Articles 6 – 22
- The function of distributive rules is to create an **exemption** or **limitation** to the right to tax so that there is at least a **limited overlap in the power to tax between the two states.**
- In principal, they are addressed in the source state and decide whether and how much it may tax.

Distributive Rules (2)

Exclusion of taxation rights in the source state

- An exclusion of the source state's taxation rights typically occurs through explicitly granting taxation to the **residence state.**
- Tax treaties aim at eliminating double taxation, and distributive rules operate so that the areas of overlapping jurisdiction of the contracting states are eliminated, or at least diminished. One of the possible ways with which this can be done is through the **exclusion of the source state's taxation rights.**

Limited taxation rights of the source state

- In addition to providing a total limitation of rights of the source state, there are also articles or parts of articles in the model conventions that **limit taxation rights**.
- Typically, such a limitation will be **expressed in a percentage of a base** that will constitute the grounds of justification of the use of tax sovereignty - they mainly **consist of a percentage up to which the source state may be able to tax.**

Allocation of Taxing Rights

"Shall only be taxable in….."

- *Exclusive right to tax given to **ONE** Contracting State*
- *Juridical double taxation solved immediately*

"May be taxable in….."

- *Right to tax given to the Contracting State where the taxpayer is not resident (i.e. shared taxing rights).*
- *Juridical double taxation problem **ONLY** solved when relief is given*

Article 6 – Immovable Property

- Income derived by a **resident of a Contracting State** from immovable property (including income from agriculture or forestry) **situated in the other Contracting State *MAY be taxed in that other State***.

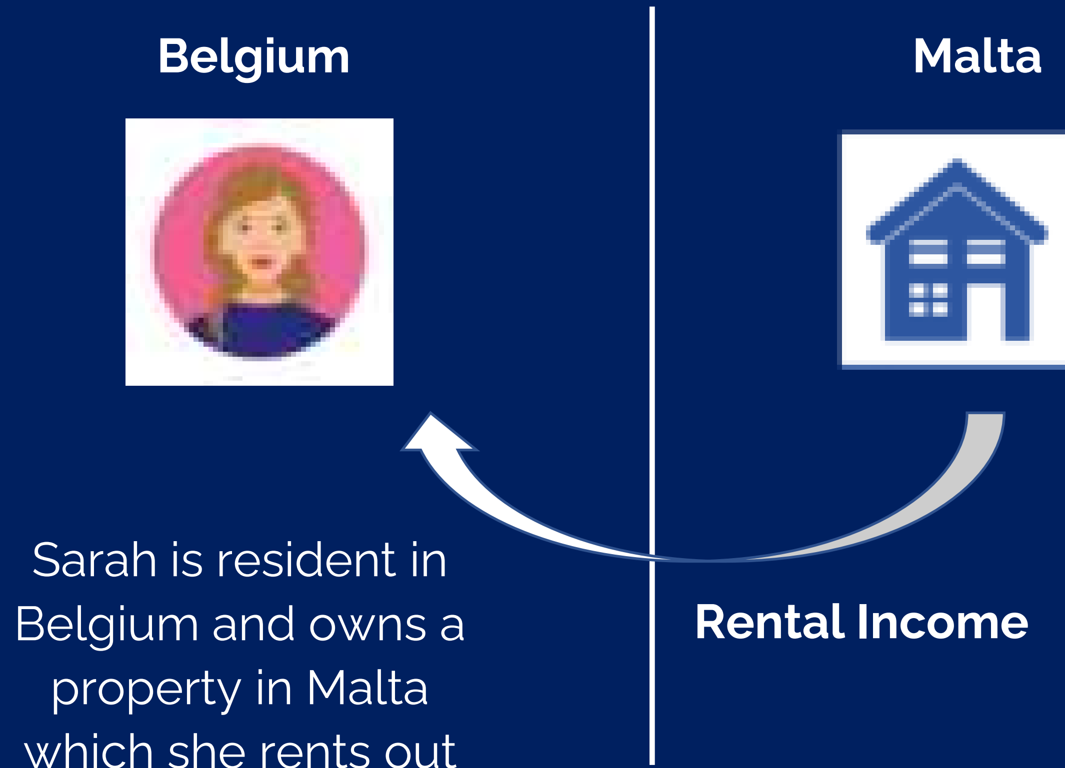
Only applies if a resident of a CS **derives income from immovable property in the other CS**

Primary taxing right afforded to Situs State **se economic connection** between the source of this income and the State of source.

Shared taxing right: State where immovable property is located (Situs State) may tax. Though, not explicit, residence State may also tax.

- 'Immovable Property' is defined as **per the law of the Contracting State in which the property is situated**, and this will help to avoid difficulties of interpretation over the question whether an asset or a right is to be regarded as immovable property or not.

Article 6 – Immovable Property



- Income is being income derived by **a resident of a Contracting State (Belgium)** from **immovable property situated in the other CS *(Malta)***.
- Article 6 therefore applies.
- As a result, income received by Sarah from the immovable property situated in Malta, **may be taxed in Malta.**
- Despite not explicitly stated, Belgium may also tax the income received by Sarah.

Article 7 – Business Profits

- The Profits of an enterprise of a Contracting State shall be taxable **ONLY** in that State **UNLESS** the enterprise carries on business in the other Contracting State through a ***permanent establishment*** situated therein.

- If the enterprise carries on business as aforesaid, **the profits that are attributable to the permanent establishment may be taxed in that other State**.

Therefore, SOURCE STATE can ONLY tax profits that are attributable to the PE.
There is no force of attraction on all profits derived by general enterprise in the Source State.

Article 7 – Supremacy of Other Distributive Rules

Article 7(4)

- Where profits include items of income which are dealt with separately in other Articles of this Convention, then the provisions of those Articles **SHALL NOT be affected** by the provisions of Article 7.

- Given wide scope of Article 7 (Business Profits), if Article 7 overlaps with **more specific rule**, the **other article takes precedence** (*lex specialis derogat lex generalis*).

Article 10 – Dividends (1)

- Article 10 of the OECD Model Convention deals with **dividends** paid by a company resident in State A (*the **source state of the dividends***) to a company or individual resident in State B.

- Dividends paid by a company which is a resident of a Contracting State to a Resident of the other Contracting State **MAY be taxed in that other State, i.e. SHARED jurisdiction to tax.**

- The article applies to dividends paid between residents of **TWO DIFFERENT** Contracting States: *it does not apply to dividends paid between residents of the same State or to dividends paid or paid by residents of a third State*.

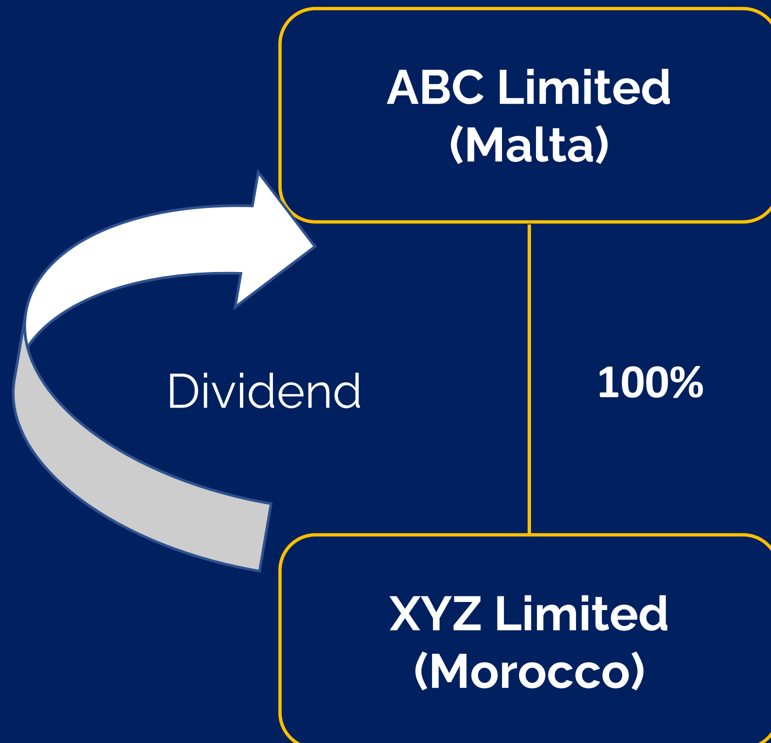
Article 10 – Dividends (2)

Limited Source State Taxing Rights

- The DTT also reserves **a limited right to tax to the State of Source of dividends**, that is, the State of which the **company paying the dividends is a resident**.

- However, if the **beneficial owner of the dividend** is a resident of the other Contracting State, the **tax charged will NOT exceed 5% of the gross amount of the dividends,** also provided that the **BO is a company which holds directly at least 25% of the capital of the company paying the dividends**.

Article 10 – Dividends



- Where Participation exemption does NOT apply, **one would refer to the treaty in place between Malta and Morocco**.
- Article 10(1) of the DTT states that dividends paid by a company which is a resident of a Contracting State to a resident of the other Contracting State **may be taxed in that other State.**

- On this basis therefore, the dividend income derived by the ABC Limited from its subsidiary in Morocco, would, in the event that the participation exemption does not apply, **be subject to tax in Malta, at the rate of 35%.**
- State of source of dividends (i.e. **Morocco) has a limited right to tax (subject to the 5% limitation). If Morocco also taxes that dividend**, ABC Limited would be entitled **to a credit of the foreign tax suffered under the treaty relief mechanism**.

Article 11 – Interest

- Interest arising in a Contracting State (the **source state of the interest**) and paid to a resident of the other Contracting State **may be taxed in that other State.**

- Interest shall be deemed to arise in a Contracting State **when the payer of the interest is a resident of that State UNLESS the** interest has an obvious economic link with a PE, in which case the source state is the State of PE.

Shared Taxing Rights

However, interest arising in a Contracting State **MAY ALSO** be taxed in **that State** according to the laws of that State.

BUT

if the ***beneficial owner of the interest*** is a **resident of the other Contracting State**, the tax so charged shall not exceed **10% of the gross amount of the interest**.

(therefore, source state is only granted a LIMITED taxing right)

Article 15 – Employment Income

Subject to the provisions of Articles 16, 18 and 19, **salaries, wages and other similar remuneration derived by a resident of a Contracting State in respect of an employment shall be taxable ONLY in that State,**

UNLESS

the employment is exercised in the other Contracting State.

If the employment is so exercised, such remuneration as is derived therefrom may be taxed in that other State.

Therefore, employment is exercised in the place where the employee is **PHYSICALLY present** when performing the activities for which the employment income is paid.

Article 15 – Employment Income

The **residence state** of the employee has the **ECLUSIVE right to tax** the remuneration derived from employment, ***UNLESS*** *the* ***employment is exercised*** in a state other than the residence state.

In the latter case, *subject to the conditions laid down in Art. 15 (2)*, a right to tax is granted to the **work state**.

Article 15 – Employment Income

- Article 15(2) of the OECD Modell Convention decides under what circumstances **the work state** is **PREVENTED** from taxing the remuneration received **in respect of services rendered there by an employee who is a resident of the other contracting state**.

- The work state should refrain from taxing and the **right to tax reverts exclusively to the resident state of** the employee if **EACH** of the three following conditions are fulfilled:

  - the recipient is **present in the other State** for a period or periods **not exceeding** in the aggregate **183 days** in any twelve month period commencing or ending in the fiscal year concerned, **and**
  - the remuneration is paid **by, or on behalf of, an employer** who is **not a resident** of the other State, **and**
  - the remuneration is **not borne by a permanent establishment** which the employer has in the other State.

Article 16 – Directors Fees

- Directors' fees and other similar payments derived by a resident of a Contracting State in his capacity as a member of the board of directors of a company which is a resident of the other Contracting State **may be taxed in that other State.**

- Article 16 **ONLY** applies to director fees (also benefits in kind), and **not to any other functions performed by the person.**

Article 23 – Methods for Eliminating Double Taxation

Exemption Method

- In the Article it is laid down that the **State of residence** shall **EXEMPT** from tax income and capital which in accordance with the Convention "***may be taxed***" in the other State.

- The State of residence must accordingly exempt income and capital which may be taxed by the other State in accordance with the Convention ***whether or not the right to tax is in effect exercised by that other State.***

- This method is regarded as the most practical one since it **relieves the State of residence from undertaking investigations of the actual taxation position in the other State**.

Article 23 – Methods for Eliminating Double Taxation

Credit Method

- Article 23 B - Residence State **includes the income earned in the Source State** for the **purposes of computing total tax liability in the Residence State.**
- A **CREDIT** is then given for taxes paid in the Source State.
- **Malta is a credit country**

Article 25 – Mutual Agreement Procedure

Where a taxpayer believes that the actions of one of both Contracting States results / will result in taxation against the Treaty, *irrespective of whether domestic law remedies have been exhausted*, the taxpayer may present his case to the Competent authority of either State **WITHIN 3 YEARS** from first notification.

Article 25 – Mutual Agreement Procedure

- This Article institutes a mutual agreement procedure for resolving difficulties arising out of the application of the Convention.

- In this sense, the **competent authorities shall endeavour** by mutual agreement **to resolve the situation of taxpayers** subjected to taxation not in accordance with the provisions of the Convention.

- It also invites and authorises the competent authorities of the two States **to resolve by mutual agreement problems relating to the interpretation or application of the Convention** and, furthermore, to **consult together for the elimination of double taxation in cases not provided for in the Convention.**

Article 26 – Exchange of Information

- Contracting States to exchange information for application of Treaty or administration / enforcement of domestic laws.

- Information received is treated as secret.

- If information is requested by a Contracting State, this should be obtained even if not needed by other Contracting State

- Extends beyond bank secrecy or fiduciary / nominee relationships

Multilateral Convention to implement tax treaty related measures to prevent Base Erosion and Profit Shifting (MLI)

Diploma in Law (Malta)

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Overview

What is Base Erosion and Profit Shifting?

Base erosion and profit shifting (BEPS) refers to tax **planning strategies** that **exploit gaps and mismatches in tax rules** to artificially **shift profits to low or no-tax locations** where there is little or no economic activity, resulting in **LITTLE** or **NO overall corporate tax being paid**.

Overview

OECD/G20 BEPS Project

jurisdictions jointly developed

15 ACTIONS

to tackle ***tax avoidance***, ***improve the coherence of international tax rules,*** ensure a ***more transparent tax*** environment, and ***minimize the losses suffered*** by countries as a result of base erosion and profit shifting (BEPS).

The 15 BEPS Actions (1)

- The 15 Actions comprising the OECD's BEPS package **equip governments with domestic and international rules and instruments to address tax avoidance**, ensuring that **profits are taxed <u>where economic activities generating the profits are performed</u>** and where **<u>value is created</u>**.

Action	Title
Action 1	Tax Challenges Arising from Digitalisation
Action 2	Neutralising the Effects of Hybrid Mismatch Arrangements
Action 3	Controlled Foreign Company
Action 4	Limitation on Interest Deductions
Action 5	Harmful Tax Practices
Action 6	Prevention of Tax Treaty Abuse

The 15 BEPS Actions (2)

Action 7	Permanent Establishment Status
Action 8	Transfer Pricing: Intangibles
Action 9	Transfer Pricing: Risk & Capital
Action 10	Transfer Pricing: Other High Risk Transactions
Action 11	BEPS Data Collection and Analysis
Action 12	Mandatory Disclosure Rules
Action 13	Country-by-Country Reporting
Action 14	Mutual Agreement Procedure
Action 15	Develop a Multilateral Instrument

Implementation of the MLI

As a product of the BEPS project, the MLI helps the fight against BEPS by **implementing the tax treaty-related measures developed through the BEPS Project in existing tax treaties** in a synchronised and efficient manner. This results in an innovative cooperation between states, whereby the MLI operates alongside the existing bilateral tax treaties **without the requirement of renegotiating each bilateral tax treaty.**

The measures implemented **put an end to treaty abuse** and "**treaty shopping**" by transposing in existing tax treaties jurisdictions' commitment to minimally include in their tax treaties **tools to ensure these treaties are used in accordance with their intended object and purpose**.

The MLI further **enhances treaty-related dispute resolution mechanisms**. In addition, certain jurisdictions have decided to introduce, via the MLI, **an arbitration procedure in their tax treaties**, which further improves tax certainty.

Key Figures

More than 100 Jurisdictions have signed the Multilateral Instrument from all continents

The Multinational Instrument covers over 2800 **bilateral tax treaties worldwide**

It entered into force on the **1st of July 2018,** and its provisions effective as from the **1st of January 2019**

Impact on Malta

Jurisdiction	Date of Signature	Date of Entry into Force	Convention
Albania ‡	02-May-00	23-Nov-00	LN 123 of 2001
	28-May-19	01-Jan-21	Synthesised text
Andorra ‡	20-Sep-16	27-Sep-17	LN 138 of 2018
	07-Jun-17	01-Jan-22	
Armenia	24-Sep-19	25-Nov-21	LN 28 of 2022
Australia ‡	09-May-84	20-May-85	LN 47 of 1985
	07-Jun-17	01-Apr-19	Synthesised text
Austria ‡	29-May-78	13-Jul-79	LN 120 of 1981
	07-Jun-17	01-Apr-19	Synthesised text
Azerbaijan	29-Apr-16	27-Dec-16	LN 241 of 2018
Bahrain ‡	12-Apr-10	28-Feb-12	LN 82 of 2013
	27-Nov-20	01-Jun-22	
Barbados* ‡	03-Dec-01	19-Jun-02	LN 248 of 2002
	23-Sep-13	30-Apr-14	LN 447 of 2013
	24-Jan-19	01-Apr-21	
Belgium ‡	28-Jun-74	03-Jan-75	LN 108 of 1975
	23-Jun-93	17-Oct-02	LN 83 of 2003
	19-Jan-10	21-Jul-17	LN 58 of 2020
	07-Jun-17	01-Oct-19	

* Includes amending Protocol

† Convention signed but not in force

‡ modified by the MLI

The MLI has resulted into **MODIFICATIONS** of some of the **double tax treaties** that Malta has entered into over the years.

As a result of Malta's implementation of the MLI, double taxation treaties **must now be interpreted in light of the MLI provisions**.

In this regard, the Commissioner for Tax and Customs indicates which of the Double tax Treaties have so far been modified as a result of the MLI.

Impact on Malta

Minimum Standard MLI Provisions

Jurisdictions that sign the MLI are required to **adopt MLI provisions** forming part of the **agreed minimum standards.**

- **Treaty Abuse**:
  - Article 6 - Purpose of a tax treaty, Changes to Preamble;
  - Article 7 - Prevention of treaty Abuse – Introduction of Principle Purpose Test & Limitation on benefits clause
- **Improving Dispute Resolution:**
  - Article 16 - Mutual Agreement Procedure

Impact on Malta

Optional MLI Provisions

The MLI allows countries to **opt into additional provisions** in the MLI.

Optional changes to tax treaties in the MLI include changes to modify tax treaties in respect of:

- Permanent establishments (PEs)
- Transparent entities
- Residency tiebreakers
- Minimum shareholding periods
- Capital gains derived from immovable property and
- Mandatory binding arbitration.

Malta introduced provisions in connection with capital gains from alienation of shares or interests of entities deriving their value principally from immovable property.

Introduction to Transfer Pricing

Diploma in Law (Malta)

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What is Transfer Pricing?

- Transfer pricing deals with **determination of the prices charged in transactions performed between related companies**.
- Transfer pricing techniques could (inter alia) significantly influence the **overall tax due of multinational group.**

OECD Arm's Length Principle

- Where:

  a) *an enterprise of a Contracting State **participates directly or indirectly in the management, control or capital of an enterprise of the other Contracting State**, or*

  a) *the **same persons participate directly or indirectly in the management, control or capital of an enterprise of a Contracting State and an enterprise of the other Contracting** State,*

  *and in either case **conditions are made or imposed between the two enterprises in their commercial or financial relations** which **DIFFER** from those **which would be made between INDEPENDENT ENTERPRISES,** then any profits which would, but for those conditions, have accrued to one of the enterprises, but, by reason of those conditions, have not so accrued, may be included in the profits of that enterprise and taxed accordingly.*

- As such, **prices charged in related party transactions <u>should not differ</u>** from prices charged in **third party transactions under comparable circumstances** (market value).

OECD and Transfer Pricing

- Arm's Length Principle embodied in the **OECD & UN Model Tax Conventions Art. 9 and Art. 7.**
- Art. 9 equivalent can be found in **thousands of concluded Income & Capital Tax Treaties** (incl. Malta's).
- Many countries' tax authorities have transfer pricing regulations that follow the **OECD Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations**, these being regarded as global standards in TP (constantly updated).
- **BEPS project**:
  - ✓ Action 8-10: Aligning TP Outcomes with Values Creation
  - ✓ Action 13: Guidance on TP Documentation and CBCR

Practical Example (1)

Enterprise C (China)

100%

Enterprise A (Malaysia)

Manufactures pianos in Malaysia

Related Party Transaction

@Transfer Price

100%

Enterprise B (Hong Kong)

Distributes pianos from HK

Uncontrolled Transaction

@Market Price USD 5000

Clients

Practical Example (2)

- The price at which one piano is sold by A to B affects their individual financial results. If A charges a high price, A makes more profit. If A charges a low price, B makes more profit.
- From a commercial perspective, the price doesn't matter. The financial results of A and B are consolidated. For shareholder C, it doesn't matter which of the two companies makes the profit.
- However, from a tax perspective it *does* matter:
  - A is taxed in Malaysia and B is taxed in Hong Kong. The corporate tax rate in Hong Kong is 16.5%. In Malaysia, it is 25%. C wants to see as much profit after tax as possible. C can use its influence as a shareholder to set the prices in such a way that the profits are highest where taxes are lowest.

Practical Example (3)

	A (Manufacturer)	B (Distributor)	Consolidated
Revenues	**4000**	5000	5000
Direct/Indirect Costs	1000	4000	1000
Profits before tax	3000	1000	4000
Tax @ Regular Rate	750	165	915
Profit after tax	**2250**	**835**	**3085**

Scenario 1: Transfer price (i.e. USD 4000) close to market price (i.e. USD 5000)

	A (Manufacturer)	B (Distributor)	Consolidated
Revenues	**2000**	5000	5000
Direct/Indirect Costs	1000	2000	1000
Profits before tax	1000	3000	4000
Tax @ Regular Rate	250	495	745
Profit after tax	**750**	**2505**	**3255**

Scenario 2: Transfer price (i.e. USD 2000) not close to market price (i.e. USD 5000). This results in there being lower profits being taxed in the higher tax jurisdiction (i.e. Malaysia). Lowering the transfer price charged to B was done with the aim of shifting the profits to the jurisdiction with the relatively lower tax rate, i.e. Hong Kong.

Transfer Pricing in Malta

In 2021, an **enabling provision** (Art. 51A) **empowering the Minister to make rules in relation to transfer pricing** & APAs was introduced in the ITA.

1

On 22 December 2021, the CfR launched a Public **Consultation on the Draft Transfer Pricing Rules**. The consultation period ended 28 February 2022.

2

Malta introduced **formal transfer pricing regulations** on 18 November 2022 by means of **Legal Notice 284 of 2022**

3

Transfer Pricing in Malta

Enterprises falling within the scope of the Rules

The rules apply to **cross border arrangements** between **associated enterprises**.

Associated Enterprises

- Bodies of persons will be considered associated enterprises when there is ***direct*** or ***indirect*** control through a holding of **more than 75%** of the **voting rights** or **ordinary share capital** or by virtue of any powers conferred by the articles of association or other document regulating the controlled body of persons.
- Bodies of persons **subject to common control** by virtue of the above-mentioned threshold (75%) will also fall within the scope of the Rules.

Transfer Pricing in Malta

Enterprises falling within the scope of the Rules

The rules apply to **cross border arrangements** between **associated enterprises**.

The Rules set out that the following instances constitute a cross-border arrangement:

Cross-Border Arrangements

- An arrangement between a **Maltese-resident company** and a **non-Maltese-resident party**;
- An arrangement between a **Maltese-resident company** and a **permanent establishment situated outside Malta** to which the arrangement is effectively connected;
- An arrangement between **a company that maintains a permanent establishment in Malta** to which the arrangement is effectively connected, or otherwise derives income or gains arising in Malta, **and a non-Maltese resident party.**

Transfer Pricing in Malta

Enterprises falling within the scope of the Rules

The Rules **SHALL NOT APPLY** to:

- ***micro***, ***small*** or ***medium-sized enterprises*** (as per definition in Annex I of Commission regulation (EU) 651/2014, being enterprises which **employ fewer than 250 persons** and which have **an annual turnover** not exceeding **EUR 50 million**, and/or an annual **balance sheet** total not exceeding **EUR 43 million**).

Transfer Pricing in Malta

- The rules will apply to basis years **commencing on or after 1 January 2024**, in relation to **arrangements entered into ON or AFTER 1 January 2024** and arrangements entered into **PRIOR TO 1 January 2024** that are ***materially altered*** on or after that date (no guidance yet).

- The introduction of transfer pricing rules means that entities having transactions falling within the scope will **have to substantiate adherence of their related party transactions** to the **arm's length principle** by demonstrating that **such transactions yield a return that unrelated parties would derive in comparable circumstances.**

- In relation to an arrangement to which the Rules apply, a company is to **prepare** on a timely basis and **retain such records** as may be reasonably be required.

Introduction to Pillar II

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Pillar II – In a Nutshell

- The Pillar Two Model Rules (also referred to as the "**Global Anti-Base Erosion**" or "**GloBE" Rules**), released on 20 December 2021, are part of the **Two-Pillar Solution** to address the **tax challenges of the digitalisation of the economy** that was agreed by 137 member jurisdictions of the OECD/G20 Inclusive Framework on BEPS and endorsed by the G20 Finance Ministers and Leaders in October 2021.

- The Pillar Two Model Rules are designed to ensure **large multinational enterprises (MNEs)** pay a **MINIMUM level of tax of 15% on the income arising in EACH jurisdiction where they operate**.

Pillar II

Where applicable, pay **TOP-UP TAX** for the difference between their ETR per jurisdiction and the **15% minimum rate**.

1 **In-Scope entities**

- *Multinational groups with consolidated revenue over €750 million*
- *Operating in two or more jurisdictions*
- *Members of a group are called constituent entities*
- *Consider excluded entities*

2 **Determine GLOBE Income**

Determine each constituent entity's GLOBE income (subject to certain adjustments)

3 **Calculate ETR**

Calculate their **effective tax rate** (ETR) for **EACH** jurisdiction where they operate

4 **Calculate Top Up Tax**

5 **Charge Top-Up Tax**

Primary mechanism is Income Inclusion rule

How does Pillar II impact Malta? (1)

- In his Budget 2024 speech, on 30 October 2023, the Minister of Finance, Clyde Caruana, confirmed that Malta will be exercising its right to apply the **DEROGATION** allowed by the EU Minimum Tax Directive, applicable for Member States in which no more than 12 ultimate parent entities of MNE groups within scope of this Directive are located.

- As a consequence, Malta will be deferring the introduction of the 15% minimum top-up tax under Pillar 2, **past 2024.**

- Accordingly, the three main components of the Pillar 2 rules, namely the Income Inclusion Rule (IIR), the Undertaxed Profits Rule (UTPR), and the Qualified Domestic Minimum Top-Up Tax (QDMTT), have **NOT been transposed into Maltese law in 2024.**

How does Pillar II impact Malta? (2)

- For the time being, despite prior indications from the Minister, there do not seem to be any concrete plans to alter Malta's current corporate tax system, and accordingly, the full imputation system of taxation and the tax refund system will continue to apply.

- As further announced during the budget speech of 2025, discussions with the European Commission regarding the incentives which Malta would intend to introduce under the Pillar II rules, primarily in the form of grants and/or credits such as the **Qualifying Refundable Tax Credits (QRTCs)** are firmly underway - this in order to ensure that Malta conforms with such rules whilst also remaining competitive as a jurisdiction.