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REPORT

From:	General Secretariat of the Council
To:	Permanent Representatives Committee/Council
Subject:	Code of Conduct Group (Business Taxation) – Report to the Council = Endorsement

Malta's patent box regime (MT015)

I/ AGREED DESCRIPTION

The following description was agreed by the Code of Conduct Group on 13 September 2019:

REGIME SELF-REVIEW TEMPLATE

Jurisdiction: **Malta**
Regime: **Patent Box Deduction Rules**
Description of regime: The regime provides for a deduction equal to a percentage of income or gains from Qualifying IP after applying the nexus ratio as required by the Action 5 Report on "Countering Harmful Tax Practices More Effectively, Taking into Account Transparency and Substance". The nexus ratio is calculated by dividing Qualifying IP Expenditure by Total IP Expenditure.

Part A: Preliminary factors	
A1: The regime has been previously reviewed and there have been no subsequent changes to the regime.	*No*
Comments: A previous IP regime was reviewed and abolished with effect from 1 July 2016 and no further benefits may be claimed in respect of that regime with effect from 1 July 2021.	
A2: The regime has been abolished. *(Where a regime has been abolished and replaced by a new regime, the new regime should be considered on a separate Template.)*	*No*
Comments: Please refer to reply to A1.	
A3: The regime falls outside the scope of the work of the Forum on Harmful Tax Practices. *(The scope of this work focuses on geographically mobile activities, such as financial and service activities, including the provision of intangibles. It excludes regimes designed to attract investment in plant, building and equipment.)*	*No*
***Where a regime falls outside the scope of the work of the Forum, please provide a full and detailed explanation as to why this is the case**:* N/A	
If the response to any of A1-A3 is 'Yes', there is no requirement to complete Parts B-D	
Part B: Key factors in identifying harmful preferential tax regimes	
B1: No or low effective tax rates *(this factor is the gateway criterion to further assessment)* [See 1998 Report, paragraph 61]	*Yes*
Comments: The regime provides for a deduction of 95% of net income or gains from Qualifying IP after application of the nexus ratio. Where 100% of the qualifying expenditures are carried out by the beneficiary, i.e. when the nexus ratio is equal to 1, the rate of tax may be reduced to a minimum of 1.75%.	
B2: Ring-fencing of regime from the domestic economy [See 1998 Report, paragraph 62; and Consolidated Application Note, chapter III]	*No*
Comments: The regime is available to all taxpayers who develop qualifying IP assets (incur expenditures) and are liable to tax in Malta.	

B3: Lack of transparency of the regime *(for example, the details of the regime or its application are not apparent, or there is inadequate regulatory supervision or financial disclosure)* [See 1998 Report, paragraph 63; and 2015 Action 5 Report, chapter 5]	*No*
Comments: The legislation will be published in the official government gazette and available on the Ministry of Justice website. Malta Enterprise Corporation has been tasked with the approval and monitoring of IP projects that benefit under the regime. Malta Enterprise Corporation is Malta's economic development agency and is independent from the Tax Administration.	
B4: Lack of effective exchange of information with respect to the regime [See 1998 Report, paragraphs 64-67]	*No*
Comments: Malta adheres to international exchange of information standards. Malta is bound by the relevant EU Directives and its tax treaties, and is party to the Joint OECD/Council of Europe Multilateral Convention for Assistance in tax Matters. There is no exception for this regime.	
B5: The regime encourages purely tax-driven operations or arrangements that involve no substantial activities [See 1998 Report, paragraph 79; 2015 Action 5 Report, chapter 4; and 2017 Progress Report, annex D]	*No*
Comments: The regime applies the nexus approach as a proxy for substantial activities.	
Part C: Other factors in identifying harmful preferential tax regimes	
C1: An artificial definition of the tax base [See 1998 Report, paragraphs 69-70]	*No*
Comments: Other than the deduction contemplated by the regime that is tied to the nexus ratio, the computation of the tax base is governed by the principles that are generally applied throughout the Income Tax Acts.	
C2: Failure to adhere to international transfer pricing principles [See 1998 Report, paragraphs 71-72]	*No*
Comments: The determination of profits for Maltese general income tax purposes is governed by the arm's length principle and subject to the general and specific anti-tax avoidance provisions of the Income Tax Acts. Furthermore, the regime includes a specific provision that requires the determination of the income or gains derived from qualifying IP to be made in accordance with the OECD's Transfer Pricing Guidelines.	
C3: Foreign source income is exempt from residence country taxation [See 1998 Report, paragraph 73]	*No*
Comments: The regime does not make any special rules or exceptions for foreign source income.	

C4: Negotiable tax rate or tax base [See 1998 Report, paragraph 74]	*No*
Comments: The tax rates and computation of the tax base are fully regulated by law.	
C5: Existence of secrecy provisions [See 1998 Report, paragraph 75]	*No*
Comments: There are no secrecy provisions provided for in the regime.	
Part D: Conclusion of self-review	
D1: In light of the above and other factors, does your jurisdiction believe the tax regime may be potentially harmful?	*No*
Comments: The rules that regulate the regime are in line with the recommendations in the OECD/G20 Action 5 Report applicable to IP regimes.	
D2: What measures are proposed to remove any features considered harmful?	
Comments: N/A	
D3: Further observations or comments	
Comments: Not required.	

<table>
<tr><th colspan="3">Country</th><th>Country name</th></tr>
<tr><td rowspan="6">1. Please provide below the basic information about your regime</td><td colspan="2">a. Name of the regime</td><td>Patent Box Deduction Rules</td></tr>
<tr><td rowspan="2">b. Year of introduction/relevant legislation</td><td>Year</td><td>2019</td></tr>
<tr><td>Please attach to this template (or provide a link to) the legislation which introduces your new IP regime (if in a language other than English or French, please provide a translation).)</td><td></td></tr>
<tr><td colspan="2">c. Benefits under your regime (e.g. a reduced rate or a deduction, an exception, or some other reduction in the taxable base)</td><td>The IP regime provides for a deduction of 95% of net income or gains from Qualifying IP after application of the nexus ratio</td></tr>
<tr><td colspan="2">d. Effective tax rate under your regime</td><td>Where 100% of the qualifying expenditures are carried out by the beneficiary, i.e. when the nexus ratio is equal to 1, the rate of tax may be reduced to a minimum of 1.75%.</td></tr>
<tr><td colspan="2">e. Statutory rate in your jurisdiction that would apply in the absence of the regime</td><td>35%</td></tr>
</table>

Country			Country name
	f. Stated purpose of your regime		Due to a lack of natural resources and other inherent hurdles, Malta's economic development hinges on its ability to foster and promote the expansion of human capital in order to sustain economic growth and employment. In this respect, Malta believes that the introduction of a patent box regime will boost the domestic R&D sector, which is slowly becoming an important contributor towards economic growth. Incentivising R&D activities will undoubtedly lead to a more innovative and diversified economy which could enable Malta to continue to overcome its challenges and support growth and development.
2. Please describe the scope of qualifying taxpayers under your regime.			The IP regime is available to all those taxpayers who develop qualifying IP assets (incur expenditures) and are liable to tax in Malta.
3. What types of IP assets can qualify for benefits under your regime?			• a patent or patents, whether issued or applied for, or where the issue of the patent is still pending and extensions of patent protection; • assets in respect of which protection rights are granted in terms of national, European or international legislation, including those relating to plants and genetic material and plant or crop protection products and orphan drug designations; • utility models; • software protected by copyright under national or international legislation; • other intellectual property assets as are non-obvious, useful and novel and having features similar to those of patents. Marketing-related intellectual property assets, including brands, trademarks and tradenames are explicitly excluded from qualifying IP.
4. Third	a. Are you	Yes/no	Yes

Country			Country name
category of IP assets	planning on allowing the third category of IP assets described in paragraph 37 of the Action 5 Report to qualify for benefits?	(i) Please describe how you will limit the taxpayers benefiting from the third category.	The benefit in respect of the third category of assets will be granted only to small entities. “Small entity” means a beneficiary which: (i) has a total turnover on a group basis amounting to not more than Euro 50 million (or equivalent); and (ii) does not itself earn more than seven million and five hundred thousand Euro (Euro 7,500,000) or equivalent from all its intellectual property assets; which thresholds shall be calculated in respect of each beneficiary on the basis of the applicable figures over an average five year period. The benefit will be granted only if to the satisfaction of Malta Enterprise, who shall determine this through a transparent certification process in terms of guidelines that it issues for this purpose.
		(ii) Please describe what IP assets will qualify under this category, and the reason why they will fit with the specific requirements in paragraph 37 of the Action 5 Report.	The IP assets that qualify under the third category must be derived from confirmed R&D activities ‘projects’ leading to: · Technological solutions · The development of new (or new parts of) physical products, physical processes or new technical software.

Country			Country name
		(iii) Please describe the transparent certification process (undertaken by a competent government agency that is independent from the tax administration) under your regime.	Malta Enterprise (the Corporation) is Malta's economic development agency and is independent from the Tax Administration. The Corporation already reviews the eligibility of R&D projects for support in various (State Aid) measures. The Corporation's methodology is based on the definitions of R&D established by the EU but uses the OECD Frascati Manual for guidance in determining whether a project constitutes R&D. In determining eligibility for the Patent Box Regime, the Corporation will require a small enterprise to produce the results of a patent search, conducted by an independent undertaking (3rd party) competent for carrying out such searches, that confirms the novelty of the IP. In addition, the Corporation will require documentation demonstrating the R&D activity that led to the IP on the basis of which it will conduct an internal review to confirm the process undertaken by the company to create the IP asset. If required, the Corporation will engage with the University of Malta (and other academia) to conduct a peer review to confirm the novelty and the possibility to patent the IP.
		(iv) Please describe the procedures you have implemented to ensure annual reporting to the FHTP and spontaneous exchange of information.	One of the conditions of entitlement to the deduction is that the beneficiary must request the Patent Box deduction in its income tax return [Rule 3(f)]. Such income tax return will include an ad hoc attachment that must be completed in order to claim the deduction. The said attachment will be designed to capture the data that Malta will require for its reporting and exchange of information obligations.

Country			Country name
5. What income will qualify for benefits? Please describe how you are ensuring that the amount of income is not equal to the gross income from IP assets.			The income or gains which shall be taken into account for the purpose of determining the income or gains derived from qualifying IP shall include: • chargeable income which is derived from the use, enjoyment and employment of the qualifying IP • royalty or similar income whether this is embedded in the consideration for the sale of goods and/or services or otherwise, • advances and similar income derived from the qualifying IP, • any sum paid for the grant of a licence or similar empowerment to exercise rights under qualifying IP, • compensation for infringements in respect of qualifying IP whether such compensation is granted through judicial means or otherwise, • gains on disposal of qualifying IP, and • other similar or related income as is derived from the qualifying IP Rule 4(2) of the Patent Box Deduction Rules clearly states that such income or gains are calculated after deducting such expenditure, whether of a capital nature or otherwise, as is deductible from income derived from the qualifying IP.
6. Embedded IP income	a. Does your regime allow embedded IP income to qualify for benefits?	Yes/No	Yes
	b. If yes, please describe how you are ensuring that non-IP income (e.g. marketing and manufacturing returns) does not also qualify for benefits.		The determination of the above-mentioned income or gains shall be made on the basis of a Transfer Pricing method which is appropriate for this purpose in terms of the OECD's Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations.

Country			Country name
7. Tracking and tracing	a. Have you designed tracking and tracing requirements to ensure that income that is not from qualifying IP assets or that is not qualifying IP income does not qualify for benefits?	Yes/No	Yes

Country		Country name
	b. If yes, please describe your regime's tracking and tracing requirements.	Rule 5(3) obliges the beneficiary to, *inter alia*, maintain appropriate records (including any relevant underlying documentation) to prove the total expenditure and the Qualifying IP expenditure incurred in respect of any qualifying IP, the years in which such expenditure is incurred, and income and gains derived from any qualifying IP. In addition, Rule 7 provides that when required by the Commissioner for Revenue, the beneficiary must, for every item of qualifying IP, submit: • a copy of a confirmation issued by Malta Enterprise describing the particular qualifying IP, confirming that the qualifying IP is actually in existence and confirming the amount of qualifying expenditure to which the Patent Box deduction is applicable and the Total IP Expenditure; • documentary evidence which demonstrates the amount of the Patent Box deduction and how it was calculated for the particular year of assessment as well as the income or gains derived from qualifying IP and the costs and expenditure constituting the Qualifying IP Expenditure and the Total IP Expenditure; and • evidence which demonstrates that profits or gains derived from transactions relevant in the context of these Rules and carried out between parties who are related in the sense set out in sub-rule (2) of rule 5 of these Rules are calculated as if the parties to the relevant transactions are independent enterprises operating in similar conditions and at arm's length. These are in addition to the obligations imposed by the Income Tax Acts which require legal entities to keep accounting records, including all statutory bookkeeping records which contain records on costs incurred to develop intangible assets. These records may be subject to a tax audit undertaken by the tax administration.

Country			Country name
8. Please explain how losses associated with the IP income will be treated under your regime. The explanation should include how your regime ensures that the requirement under footnote 14 to paragraph 47 of the Action 5 Report is met.			The regime provides for an option. The beneficiary may opt to deduct losses on the basis of the reduced value method, which means that IP losses may be used against ordinary income as long as they are used at the IP regime rate. Otherwise, the beneficiary may opt to utilise the losses at the corporate rate of tax on condition that the benefit in subsequent years, i.e. when there is eligible income, be reduced by decreasing the eligible income by the amount of tax losses so utilised [Rule 6].
9. If you are not a Member State of the European Union, have you designed your regime to be consistent with footnotes 16 and 19 on page 42 of the Action 5 Report?			Malta is a Member State of the European Union
10. Related-party outsourcing	a. Does your regime limit benefits based on outsourcing to related parties?	Yes/No	Yes

Country			Country name
	b. If yes, please explain how your regime limits benefits based on outsourcing to related parties.		The IP regime provides for a deduction of a percentage of income or gains from Qualifying IP subject to the nexus ratio [Rule 4(1)]. The nexus ratio is calculated by dividing Qualifying IP Expenditure by Total IP Expenditure. Expenditure for outsourcing activities made to related parties is included in Total IP Expenditure (the denominator) as outlined in Rule 4(3) but is not included in Qualifying IP Expenditure (the numerator) as outlined in Rule 5(1). The definition of Qualifying Expenditure includes a further 30% uplift as permitted by the Action 5 Report. Related parties are defined in Rule 5(2) as the following: • an individual is deemed to be related to a body of persons if that body of persons is directly or indirectly controlled or beneficially owned as to more than 25% by such individual; • an individual is deemed to be related to another individual if the relationship between them is one of the following: spouse, descendants and ascendants in the direct line and their relative spouses, or in the absence of descendants to brothers or sisters and their descendants; • two bodies of persons are deemed to be related if they are, directly or indirectly, controlled or beneficially owned as to more than 25% by the same individuals.
11. Acquisitions of an IP asset	a. Does your regime limit benefits based on acquisitions?	Yes/No	Yes

Country			Country name
	b. If yes, please explain how your regime limits benefits based on acquisitions. Following this question, please proceed to Question 13.		The IP regime provides for a deduction of a percentage of income or gains from Qualifying IP subject to the nexus ratio [Rule 4(1)]. The nexus ratio is calculated by dividing Qualifying IP Expenditure by Total IP Expenditure. Acquisition costs are included in Total IP Expenditure (the denominator) as outlined in Rule 4(3) and are only included in Qualifying IP Expenditure (the numerator) to the extent permitted by the 30% uplift in the Action 5 Report, as outlined in Rule 5(1).
12. Related-party outsourcing and acquisition of an IP asset in line with footnotes 16 and 19 on page 42 of the Action 5 report	a. Does your regime limit benefits based on the location of the R&D activities in the case of related-party outsourcing and acquisitions?	Yes/No	N/A
	b. If yes, please explain how your regime limits benefits based on the location of R&D activities.		N/A
13. Rebuttable presumption	a. Does your regime treat the nexus ratio as a rebuttable presumption?	Yes/No	No

Country			Country name
	b. If yes, please answer to the following questions (i) through (iii)	(i) Please describe how departures from the application of the nexus ratio will be limited to the exceptional circumstances described in paragraph 48 of the Action 5 Report.	N/A
		(ii) Please provide examples of situations where your jurisdiction expects taxpayers to rebut the presumption.	N/A
		(iii) Please describe the procedures you have implemented to ensure annual reporting to the FHTP and spontaneous exchange of information.	N/A

II / FINAL ASSESSMENT

The following draft assessment was agreed by the Code of Conduct Group on 24 October 2019:

	1a	1b	2a	2b	3	4	5	OA
MT 015 – Patent Box Regime (Deduction) Rules, 2019	X	?	X	?	X	?	X	X

V = harmful
X = not harmful

In accordance with the 24 November 2016 report of the Code of Conduct Group to the Council, the following assessment has been prepared with regard to paragraphs 1 to 5 of the Code of Conduct. This assessment is based on the responses to the OECD FHTP questionnaire (hereafter referred to as the "agreed description"), provided by Malta to the Commission services on 15 July 2019. This description was tabled and agreed at the COCG meeting of 13 September 2019[1]. This measure was assessed against all Code criteria and on the basis of the modified nexus approach.

Explanation

Significantly lower level of taxation:

“Within the scope specified in paragraph A, tax measures which provide for a significantly lower effective level of taxation, including zero taxation, than those levels which generally apply in the Member State in question are to be regarded as potentially harmful and therefore covered by this code”

The *Patent Box Regime (Deduction) Rules, 2019* (hereafter called the IP Regime) applies from 1 January 2019 onwards.

The IP regime allows for a deduction of 95% of net income, which with the current statutory headline corporate tax rate of **35%**, leads to an effective corporation tax rate of **1.75%.**

This rate is significantly lower than the rate generally applying. **It is therefore potentially harmful within the meaning of paragraph A of the Code.**

[1] See above.

Criterion 1: “whether advantages are accorded only to non-residents or in respect of transactions carried out with non-residents”
Criterion 1 contains two elements. The first element is whether the measure is exclusively available to non-residents or transactions with non-residents (criterion 1a). The second element is whether it is only or mainly used by non-residents or for transactions with non-residents (criterion 1b). 1a) Criterion 1a concerns the *de jure* application of the measure. Qualifying taxpayers are all taxpayers who develop qualifying IP assets and are liable to tax in Malta. There appear to be no provisions in the legislation restricting the benefits to non-residents or to transactions with non-residents. 1b) Criterion 1b is used to complement the assessment under criterion 1a which only looks at the literal interpretation of the measure. It takes account of the *de facto* effect of the measure. Where the majority of taxpayers (or counterparties to transactions) benefitting from the measure are in fact non-residents the measure will fall foul of criterion 1b. In light of the recent introduction of the IP regime, it is unlikely that statistical or impact data is either available at this stage, or representative enough to reflect the comprehensive effects of the newly IP regime. Moreover, the agreed description in the format used lacks such data. This is a horizontal issue for almost all assessments. To the extent that our draft assessment is based on currently available information on statistics, we suggest that the group reserves the possibility of reaching a potentially different outcome of a future assessment based on more complete information.

Criterion 2: “whether advantages are ring-fenced from the domestic market, so they do not affect the national tax base”
As regards criterion 2 the division between criteria 2a and 2b is done in the same way as in the case of criterion 1 (i.e. *de jure* interpretation and *de facto* analysis). In general, a measure is caught by criterion 2 if the advantages are ring-fenced from the domestic market so that they do not affect the national tax base. In most cases, the evaluation against criterion 2 follows closely that of criterion 1. 2a) What has been written under criterion 1a also applies to criterion 2a. There are no rules preventing domestic taxpayers from benefiting from the IP regime, nor are there rules to exclude domestic transactions. 2b) On the basis of the explanations provided above and the marking under criterion 1b, the evaluation of criterion 2b follows the same reasoning. In light of the recent introduction of the IP regime, it is unlikely that statistical or impact data is either available at this stage, or representative enough to reflect the comprehensive effects of the new IP regime. Moreover, the agreed description in the format used lacks such data. This is a horizontal issue for almost all assessments. To the extent that our draft assessment is based on currently available information on statistics, we suggest that the group reserves the possibility of reaching a potentially different outcome of a future assessment based on more complete information.

Criterion 3: “whether advantages are granted even without any real economic activity and substantial economic presence within the Member State offering such tax advantages”
In November 2014 the Group agreed, in co-ordination with developments at the OECD, on the modified nexus approach as the appropriate method to ensure that patent boxes require sufficient substance. Under this agreed approach, criterion 3 for the Code is to be interpreted in line with the modified nexus approach. The key elements of the modified nexus approach are: Scope (qualifying IP assets), Nexus ratio, Tracking and tracing, Rebuttable presumption and Treatment of losses. **<u>1. Scope</u>**: *<u>Qualifying IP assets</u>: Income benefiting from an IP regime has to come from a qualifying asset, comprised in one of the three categories 1) patents and functionally equivalent assets including utility models, protection granted to plants and genetic material, orphan drug designations and extensions of patent protection; 2) copyrighted software, and 3) assets that share the features of patents and are substantially similar to the two previous categories and are certified as such by a competent government agency in the State*[2]. Rule 2 of the legislation provided sets out the qualifying IP assets. These are: patents (issued or applied for), and including extensions of patent protection, IP assets such as plants and genetic material, plant or crop protection, and orphan drug designations, utility models, and copyright software. The MT IP regime also includes the third category of IP assets for small and medium size enterprises[3]. The regime restricts this category to taxpayers with a group turnover of not more than €30 million, and taxpayers with their own turnover of not more than €7.5 million. In line with the nexus approach, these are both to be calculated on the basis of a five-year average. The certification process is carried out by Malta Enterprise, which is independent from the tax administration.

[2] Category limited to companies which are not part of a group with more than €50m turnover and gross revenues of €7.5m from all IP assets.

[3] Given that such inventions are substantially similar to the IP assets in the first two categories, they should be certified in a transparent certification process by a competent government agency that is independent from the tax administration.

In order to ensure reporting to the FHTP and spontaneous exchange of information on the third category of IP assets, the income tax return will require additional information that will be used by Malta for its reporting and information exchange obligations.

In summary, the scope of the Malta IP regime is in line with the Nexus approach.

2. Nexus ratio:

The tax advantage granted under the MT IP regime is a deduction of 95% of net income or gains from the qualifying IP.

This deduction applies after the application of the nexus ratio.

Rule 4(1) sets out the Nexus formula in line with the Nexus approach:

$$95\% \times \left(\frac{\text{Qualifying IP Expenditure}}{\text{Total IP Expenditure}} \text{ X Income or Gains from Qualifying IP} \right)$$

Qualifying Expenditure is defined in rule 5 as: expenditure incurred directly by the taxpayer for or in the creation, development, improvement or protection of, the qualifying IP, **and** expenditure incurred by the taxpayer in relation to the creation, development, improvement and protection of the qualifying IP subcontracted to persons not related to the beneficiary.

Rule 5 (c) also allows for the 30% uplift, which is permitted in the Nexus approach.

Total IP expenditure is defined as expenditure directly incurred by the taxpayer in the acquisition, creation, development, improvement or protection of the qualifying IP. This is the sum of qualifying expenditure and includes acquisition costs and outsourcing.

Income or Gains from Qualifying IP is the total income from the IP, including embedded royalties, licence fees, compensation from infringements, and gains on the disposal of qualifying IP, <u>after deducting expenditure</u>. Therefore this refers to net income, as required by the nexus approach.

This formula accurately reflects the "nexus ratio" as depicted in the OECD's Report on BEPS Action 5:

[QE (+30% uplift) / OE x OI]:

- QE being qualifying expenditure excluding outsourcing to related parties and acquisition costs;

- OE being overall expenditure, including outsourcing to related parties and acquisition costs;

- OI being overall income calculated as a net income.

- <u>Embedded royalties:</u> *The separation of embedded royalties from other income must use a "consistent and coherent method" according to the nexus approach. If embedded royalties are allowed into patent boxes, there should be a clear method for identifying them. Transfer pricing principles are identified as one possibility.*

According to the agreed description, the eligible income from embedded royalties is calculated by applying transfer pricing principles as outlined in the OECD Transfer Pricing Guidelines. The IP regime specifically makes reference to the OECD's Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations. Article 5(6) of the Income Tax Management Act and Articles 2 and 12(1)(u)(2) of the Income Tax Act make reference to the Arm's Length Principle.

In summary, the nexus ratio of the MT IP regime appears to be in line with the nexus approach.

3. Tracking and tracing:

MS must require companies to track expenditure, IP assets and income. When such tracking would be unrealistic and require arbitrary judgements, MS may allow the application of the nexus approach so that the nexus may be between expenditure, products arising from IP assets and income (product-based approach). It requires tracking of all QE and OE at the level of the product.

The MT IP regime sets specific provisions regarding the tracking and tracing requirements. The entity is required to maintain appropriate records needed to determine income, total expenditure, and qualifying expenditure related to the IP assets involved. Rule 7 sets out in detail the tracking and tracing required, and this is in addition to the normal obligations imposed by the Income Tax Acts to maintain records.

4. Rebuttable presumption[4]:

Under the MT IP regime, the nexus ratio is not treated as a rebuttable presumption.

5. Treatment of losses[5]:

Two options are provided for taxpayers to deal with losses in this regime. Rule 6 sets out that the taxpayer can choose either the *reduced value method* or the *benefit recovery method*. The reduced value method allows the taxpayer to use losses from inside the regime on ordinary income, provided that they are used at the rate of the IP regime. This IP regime also allows taxpayers to choose to use the losses at their full value; however the benefit in subsequent years is reduced by decreasing the eligible income by the tax losses that have been used. Both of these methods are in line with the Nexus approach, however the benefit recovery method must have safeguards. It should not allow taxpayers to move assets in and out of a regime to benefit from asymmetrical treatment. The MT regime requires that whatever method is chosen by the taxpayer is irrevocable and ensures that if the benefit recovery method is chosen, the benefit in subsequent years is reduced.

[4] Jurisdictions could treat the nexus ratio as a rebuttable presumption but would need to limit to exceptional situations where the ratio could be rebutted to those that meet at minimum the following requirements: the taxpayer should first use the nexus ratio to establish the presumed amount of income that could qualify for benefits; the nexus ratio (excluding the up-lift) should equal or exceed 25%; the taxpayer should demonstrate that because of exceptional circumstances, the application of the nexus ratio would result in an outcome inconsistent with the nexus approach (burden of proof on the taxpayer).

[5] Note 14 to Action 5 Report: Jurisdictions should also use any tax losses associated with the IP income in a manner that is consistent with domestic legislation and that does not allow the diversion of those losses against income that is taxed at the ordinary rate.

Criterion 4:

"whether the rules for profit determination in respect of activities within a multinational group of companies departs from internationally accepted principles, notably the rules agreed upon within the OECD"

<u>- General transfer pricing rules:</u>

Maltese tax legislation makes reference to the arm's length principle, and the IP regime legislation makes reference to the OECD's Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations.

The arm's length principle is relevant to the following features of a patent box: the reduction of the tax base by a fixed percentage, if any; the calculation of royalty profits; the application of safe harbour rules; the asymmetrical treatment of losses (if any).

-<u> Reduction of the tax base by a fixed percentage:</u> *in principle, reducing a company's arm's length profits by a fixed amount means that the final result does not reflect the arm's length principle. This is a question about the circumstances in which fixed reductions of the tax are acceptable and is therefore part of the overall assessment that the Group need to make.*

The IP regime provides a deduction to the tax base equal to 95% of qualifying profits. This feature of the tax regime could be understood as a technical measure aimed to achieve the tax benefit, which is at the end an effective tax rate significantly lower than the rate generally applying.

<u>- Calculation of royalty profit (embedded royalties):</u> *where transfer pricing rules exist, the profits that go into a patent box will reflect the arm's length principle because they are just a part of the company's total profit. In principle this applies both to royalties and embedded royalties. If the IP regime covers also the latter category, its identification within the sale price of a product should rely on transfer pricing principles.*

What has been written above under criterion 3 on the same topic also applies to criterion 4.

<u>- Safe harbour rules:</u> *adoption of safe harbours is not in accordance with internationally agreed principles; safe harbours are not recommended in the Transfer Pricing Guidelines.*[6]

The Malta IP Regime does not appear to provide for such safe harbour rules.

<u>- Asymmetrical treatment of losses:</u> *where the profits from particular IP assets are taxed at a lower rate in a patent box then the losses should be treated in the same way and not deducted outside the box at a higher rate.*

What has been written under criterion 3 above on losses also applies to criterion 4.

The reduction of the tax base by a fixed percentage is a horizontal issue that the Group has not yet adopted a position on in the context of the assessment of patent boxes[7], hence the question mark ("?") for criterion 4.

[6] *Transfer Pricing Guidelines*, p167.

[7] In December 2017, the Group agreed on Guidance on the interpretation of the fourth criterion, which deals with the reduction of the tax base by a specific percentage (Doc. 15447/17, FISC 348, ECOFIN 1094). In the Commissions' services view the Maltese regime is also consistent with the new guidance.

Criterion 5: “whether the tax measures lack transparency, including where legal provisions are relaxed at administrative level in a non-transparent way”
All preconditions necessary for the granting of a tax benefit should be clearly laid down in publicly available laws, decrees, regulations *etc*. before a measure can be considered transparent. The nexus approach contains commitments to additional transparency in three areas. These concern the third category of qualifying assets, new entrants to existing IP regimes after 6 February 2015 and the rebuttable presumption rule. *Third category of qualifying assets* The third category of IP assets is included in the Maltese IP regime. What has been written under criterion 3 above on the same topic also applies to criterion 5 and the appropriate transparency obligations for this category appear to be complied with. *New entrants* The rollback of the previous, non-Nexus compliant IP regime was accepted by Ecofin in December 2016. *Rebuttable presumption rule* Not applicable, as nexus ratio is not treated as a rebuttable presumption.

Overall assessment (OA):

In light of the assessment made under all Code criteria, the Maltese IP regime is considered as **not harmful** from a Code of Conduct point of view.

Overall the MT IP regime is in line with the modified nexus approach. Similar to other recently introduced or amended measures, question marks remain in the grids in relation to criteria 1b and 2b, and 4.

In summary, our overall assessment is that this measure is **not harmful**.