



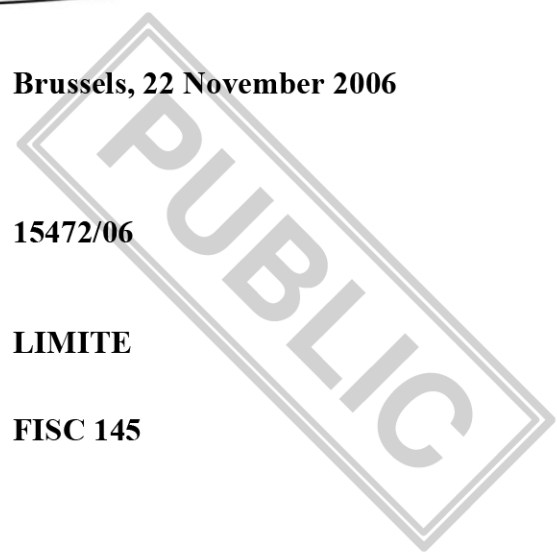
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**REPORT**

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from :	Code of Conduct Group (Business Taxation)
to :	ECOFIN Council
on :	28 November 2006
Subject :	Code of Conduct (Business Taxation)
	Report to the ECOFIN Council

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**INTRODUCTION**

1. The Council and the Representatives of the Governments of Member States, meeting within the Council, adopted on 1 December 1997 a Resolution on a Code of Conduct for business taxation which provides for the establishment of a Group within the framework of the Council to assess tax measures that may fall within the Code. In its report to the Feira European Council on 19 and 20 June 2000, the ECOFIN Council agreed that work should be pursued with a view to reaching agreement on the tax package as a whole, according to a parallel timetable for the key parts of the tax package (Taxation of savings, Code of Conduct (Business Taxation) and Interest and Royalties).
2. On 9 March 1998, the Council confirmed the establishment of the Code of Conduct Group. The Group reported regularly on the measures assessed and these reports have been forwarded to the Council for deliberation.

3. Two interim reports of the Code of Conduct Group were presented to the ECOFIN Council on 1 December 1998 and 25 May 1999 respectively (12530/98 FISC 164 and 8231/99 FISC 119). Subsequently, the Group reported to ECOFIN on 25 November 1999 setting out the results of the Group's work (SN 4901/99) on the assessment of 271 tax measures under the Code where 66 measures were considered harmful by the Group.
4. On 13 October 2003, the Council welcomed a report by the Working Party on Enlargement (Tax Experts) (13213/03 ELARG 94 FISC 138) establishing a list of 30 measures in the acceding states found harmful under the Code. The Council also agreed on the adequacy of the rollback measures envisaged or already undertaken for 27 of these measures.
5. This report from the Code Group encompasses the work of the Code Group in 2006 under the Finnish Presidency.
6. As required by the ECOFIN Conclusions of 9 March 1998, the Group's report to the 29 November 1999 ECOFIN Council reflected either the unanimous opinion of the members of the Group or the various opinions expressed in the course of discussion. References to 'the Group' in that report reflected the broad consensus where unanimity was not achieved and alternative views were shown in the notes as appropriate. Consistent with the Group's report to the 29 November 1999 ECOFIN, references to 'the Group' in this and other reports should be construed in the same way.

### **PROGRESS OF WORK**

7. The Code of Conduct Group met on 11 October 2006 and 8 November 2006 under the Finnish Presidency.
8. At the meeting on 11 October, Mr Lasse Arvela, Director General of Taxation in the Ministry of Finance in Finland, and Mr Florian Scheurle, Director General of the Tax Directorate at the German Federal Ministry of Finance, were confirmed as the first and second Vice-Chairs respectively for the period up to the end of the Finnish Presidency. The Group also confirmed a programme of work under the Finnish Presidency, agreeing to take forward work in the following areas:

- (a) implementation of rollback;
- (b) standstill;
- (c) further discussion on the future of the Code of Conduct, focused on extending the work of the Code of Conduct Group within the existing mandate<sup>1</sup>.

9. The Commission Services also provided the Code Group with an oral report on their work on rollback with Bulgaria and Romania. As from 1 January 2007, these countries are full Member States and full members of the Code Group, and subsequent work on rollback and on monitoring standstill falls to the Code of Conduct Group.

#### **IMPLEMENTATION OF ROLLBACK**

10. Malta (Rollback of measures ML4 and ML5): The Code Group continued its work on the rollback of Malta's measures (International Trading Companies (ML4) and Dividends from (other) Maltese companies with Foreign Income (ML5)).
11. At the Code meeting on 11 October, the Group considered new information from Malta relating to the rollback proposals for ML4 and ML5. The Group was also presented with updated draft descriptions of the rollback proposals provided by Malta in respect of the measures International Trading Companies (ML4) and Dividends from (other) Maltese Companies with Foreign Income (ML5), each of which had been prepared by the Commission Services in consultation and agreement with Malta.
12. The Group recalled that, in its work under the Austrian Presidency, the Group had already agreed on the basis of the information available at the time that work on the evaluation of Malta's proposed rollback of ML4 and ML5 should be moved on to the next stage and that the Commission Services should provide an agreed description as well as an initial assessment against the criteria in paragraph B of the Code for consideration by the Group at its next meeting.

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<sup>1</sup> The Belgian delegation was of the opinion that further discussion on the future of the Code, including discussion on extending the Code Group's work within the existing mandate, should not be included in the Code Group's programme of work.

13. However, in view of the new information available, in particular the revised draft descriptions of Malta's rollback proposals, the Group concluded that work on the evaluation of rollback should be taken forward on the basis of the new descriptions provided. With the assistance of the Maltese delegation and the Commission Services, the Group agreed that the updated descriptions provided an acceptable basis for its work.
14. The Group carried out its work on the evaluation of rollback by taking the rollback proposal for each of the harmful measures in turn.
15. The Group noted that Malta's International Trading Companies measure (ML4) was to be abolished with effect from 1 January 2007 and, as from that date, would no longer be open to new entrants.
16. The Group's consideration of Malta's proposed rollback of Dividends from (other) Maltese Companies with Foreign Income (ML5) was informed by an initial assessment which had been prepared by the Commission Services against criteria 1 to 5 of paragraph B of the Code.
17. In view of the points raised in discussion, it was agreed that members of the Group should be invited to submit any remaining questions or points of clarification to the Chair to allow the Maltese delegation sufficient time to fulfil its undertaking to reply in good time before the next Code meeting.
18. Further clarification from Malta on the proposed rollback of ML5 was made available to members of the Group for the Code meeting on 8 November 2006.
19. The Maltese delegation also presented the Group with new information relating to Malta's rollback proposal for ML5 focussing, in particular, on the enhancements of Malta's proposed anti-abuse provisions.

20. The Group evaluated the rollback proposal for ML5 on the basis that it will be introduced as now proposed (see agreed description in annex). The Group completed its work on the evaluation of rollback concluding that the rollback proposal was adequate.<sup>2</sup>
21. The Group also noted reports concerning the outstanding requests for an extension of benefits for ML4 and ML5 and agreed that these matters should be referred to the Council. Specifically, the requests concerned extension of benefits until 31 December 2010 for those beneficiaries existing on 31 December 2006, in respect of:
- ML4 (Malta's International Trading Companies);
  - ML5 (Dividends from (other) Maltese Companies with Foreign Income).
22. UK: Isle of Man, Jersey and Guernsey - supplementary information on progress of rollback:  
The Group also considered supplementary information from the UK on the progress of rollback in the Isle of Man, Jersey and Guernsey.
23. The UK delegation, recalling the Code Group report dated 26 November 2002 (14812/02), explained that with the introduction of a standard rate of tax for all Isle of Man companies of 0% and a higher rate of 10% on two closely defined types of business income (income of licensed banks deriving from banking business and investment of minimum regulatory capital, and income from land and property situated in the Isle of Man), the Isle of Man's six harmful measures were all repealed or revoked. This was accepted as constituting the rollback of the harmful regimes. Specifically, F065 and F067 had been revoked with effect from 1 January 2006 and 6 April 2006, and the tax legislation relating to the other four harmful measures (F061, F062, F063 and F066) had been repealed with the introduction of the Isle of Man's new Income Tax (Corporate Taxpayers) Act 2006. The repeals of F061, F062, F063 and F066 were effective from 6 April 2007 with no new entrants permitted from 6 April 2006.

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<sup>2</sup> The Spanish delegation considers that the anti-abuse clauses concerning the Rollback of measure ML5 do not prevent the eventual harmful effects of the above mentioned scheme. It is the Spanish opinion that the Rollback measures adopted must not constitute a precedent for future assessments.

24. There were also concerns raised by the Group, including in relation to the Isle of Man's new anti-deferral measure (a Distributable Profits Charge (DPC)) which was also effective from 6 April 2006. The UK agreed to reflect further on the points raised by members of the Group. The UK also undertook to communicate these points to the Isle of Man and to keep the Group informed of developments in advance of the next round of the Group's work on rollback and standstill.

#### **STANDSTILL**

25. Member States are committed not to introduce new tax measures which are harmful within the meaning of the Code.
26. As part of its work on monitoring fulfilment of this ongoing commitment, at the Code meeting on 11 October, the Code Group considered the four new measures which potentially fell within the scope of the Code and which had been enacted in the twelve months to end-January 2006, as notified to the Group as part of its work under the Austrian Presidency:
- Poland: Changes to regulations on Special Economic Zones
  - Slovenia: Enlargement of the period for a loss carry-over
  - Slovenia: Relief for investment in research and development
  - Slovenia: Harmonisation with the amendments to the Mergers Directive.
27. As previously requested by the Group, the Commission Services had prepared descriptions of each of the above measures in consultation with the Member State concerned. On the basis of its consideration of the information provided, the Group concluded that none of these new measures required assessment under the Code.

#### **FUTURE OF THE CODE OF CONDUCT**

28. An initial debate on the issue of whether and, if so, how the Code of Conduct Group's work might be extended within its existing mandate was held at the meeting of the Code Group on 11 October. Various views were expressed in the course of the discussion.
29. Discussion on the issue of whether and, if so, how to extend the work within the existing mandate of the Code will continue under the German Presidency.

**Malta: Rollback proposal - ML4 (International Trading Companies) and ML5 (Dividends from (other) Maltese Companies with Foreign Income)**

**ML4 – International Trading Companies**

Malta will abolish measure ML4 with effect from 1 January 2007 – as from this date no new international trading companies will be created.

**ML5 – Dividends from (other) Maltese Companies with Foreign Income**

Currently a shareholding in a non-resident company will qualify as a 'participating holding' of a Maltese company if the latter holds equity shares in a non-resident company and it:

- has at least 10% of the equity shares in the non-resident company or
- is an equity shareholder in the non-resident company and is entitled to purchase the balance of the equity shares of the non-resident company, or it has the right of first refusal to purchase such shares; or
- is an equity shareholder in the non-resident company and is entitled to either sit on the Board or appoint a person on the Board of that subsidiary as a director; or
- is an equity shareholder which invests a minimum in the non-resident company of Lm 500,000 (or the equivalent sum in a foreign currency); or
- holds the shares in the non-resident company for the furtherance of its own business.

Provided that a holding of shares whether equity shares or not, in a company not resident in Malta, held as trading stock for the purpose of a trade shall not constitute a participating holding.

These rules will remain applicable for participating holdings existing at 31 December 2006 until the end of 2010.

Subject to the foregoing, with regard to acquisitions of participating holdings made on or after 1 January 2007, where the non resident company, having mainly passive income, is not resident or incorporated in an EU Member State or is subject to tax at a rate which is less than 15%, the following additional conditions must be satisfied:

- the shares in the non-resident company must not be held as a portfolio investment. In any event the Maltese company's holding in the foreign company will be deemed to be a portfolio investment if more than 50% of the foreign company's income is derived from portfolio investment. For the avoidance of any doubt it should be noted that a portfolio investment is regarded as that held as part of a portfolio of investments usually with a view to risk spreading and for mere investment purposes. In such cases the investment is not that of a parent-subsidiary/associated company relationship; there is no interest and/or influence in the management of the foreign company; it is not a strategic investment; the only involvement is to follow the share prices and dividend policy to maximise investment returns and to sell as soon as it appears that the shares may lose value, and
- the non-resident company or its passive income must have been subject to tax at a rate which is not less than 5%.

When dividends received from a participating holding are distributed by a Maltese company to its shareholders such shareholders are entitled to claim a refund of 100% of the ACIT paid on the distributed profits. Resident individual shareholders will be subject to Malta tax on the dividend and tax refund while non-resident shareholders and resident corporate shareholders in receipt of the dividend and tax refund will not be subject to tax thereon.

If the conditions to qualify as a participating holding are not met the normal general tax system including the normal tax refunds will be applicable. Since the tax refund applicable upon the distribution of passive interest and royalties shall be 5/7<sup>ths</sup> the tax refund upon the distribution of dividends received from participating holdings which are caught by the anti-abuse provision shall also be 5/7<sup>ths</sup> since it is likely that such dividends would mainly be derived from passive interest and royalties.

Under the new tax system upon the distribution of all profits derived from all sources (other than income derived from immovable property situated in Malta) all shareholders (resident or non resident in Malta) are entitled to claim the same tax refund. Since foreign income will be afforded the same tax treatment as local income, this constitutes the proposed roll-back for ML5 as regards other income (i.e. all other income not being dividends from participating holdings).



## **Transitional arrangements**

Malta proposes the following transitional arrangements:

New entrants under the existing regimes 'International Trading Companies (ML4) and 'Dividends from (other) Maltese companies with foreign income' (ML5) will be allowed until 31 December 2006; for ML4 the number of possible new entrants from 22 April 2006<sup>3</sup> to 31 December 2006 will be limited to 435, being the yearly average number of ITC companies having been created in the last five years;

Existing beneficiaries benefiting from these regimes ML4 and ML5, existing on 31 December 2006, will be allowed to benefit from the respective regimes until 31 December 2010.

## **Description of Malta's new tax system**

### General income tax

All companies resident in Malta are subject to income tax at a rate of 35%. There is no separate system of corporation tax, and a company is subject to tax in much the same way as an individual. A full imputation system is applicable which means that dividends paid by a company resident in Malta carry a tax credit equivalent to the tax paid by the company on its profits out of which the dividends are distributed. This system applies to both resident and non-resident shareholders. Resident shareholders are taxed on the gross dividend at the applicable tax rates, but are entitled to deduct the tax credit attached to the dividend against their total income tax liability. Individual shareholders of companies will be entitled to tax refunds when their marginal tax on the dividend is less than the tax paid by the distributing company.

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<sup>3</sup> The date of the MT acceptance of the appropriate measures for State aid relating to ML4 and ML5.

Under this general system an Advance Company Income Tax (ACIT) will be introduced as described below:

- ACIT will be payable upon distributions, by all companies, of all profits which are not derived from immovable property situated in Malta. The ACIT paid may be set-off by the distributing company against its company income tax. Once ACIT has been paid by the distributing company, all shareholders, whether resident in Malta or not, may claim tax refunds as described below.
- The ACIT will be levied at the level of the distributing company at the rate of 35% and upon distribution all shareholders (whether resident or non resident) will be entitled to a refund of a part or whole of that ACIT. This refund will be reduced where the distributing company would have claimed double taxation relief. The actual level of the refund of the ACIT paid has not yet been decided upon by Malta but will in any case not be set higher than  $\frac{6}{7}$ <sup>ths</sup> of the ACIT. For completing the examples in the table in this description the refund is set at  $\frac{6}{7}$ <sup>ths</sup> of the ACIT paid.
- Passive income of interest and royalties: The general tax refund that will be applicable upon the distribution of dividends arising from passive income consisting of interest and royalties (whether locally sourced or foreign sourced) shall be  $\frac{5}{7}$ <sup>ths</sup> instead of  $\frac{6}{7}$ <sup>ths</sup>.
- Resident individual shareholders will be subject to Malta tax on the dividend and tax refund while non-resident shareholders and resident corporate shareholders in receipt of the dividend and tax refund will not be subject to tax thereon (see table below).
- On the question of substance, Malta wishes to state that it is Government policy that as the economy of the country shifts towards a service type economy, that companies establishing themselves in Malta must create employment. Naturally certain types of companies such as investment funds by their nature will not create employment. However, in terms of where substance applies, companies must have a place of business, create employment and exercise management and control from Malta. Malta will be issuing guidance notes to companies as part of its tax legislation. It is important to note that licensed companies are required by the financial services regulator to manage and control their business activities in Malta and that they employ persons who are competent in their line of business.
- Malta further states that as a result of the ECJ Cadbury Schweppes decision Member States can apply their CFC legislation where they have no evidence of substance being provided by companies establishing subsidiaries in other jurisdictions. Furthermore information may be obtained through Double Tax Treaties or through information exchange instruments.

## Participating holdings

As an exception to the general tax refund system as described above, the refund in the case of profits emanating from a participating holding will in any case be a full refund. In view of the fact that this 100% refund deviates from the tax system and the normal tax refunds as described above, anti-abuse measures will be introduced as described above. The definition of a participating holding and the related anti-abuse provisions are set out in the Roll-back description for ML5 above. Since for participating holdings the ACIT paid by the distributing company is wholly refunded to the shareholder, the system, in principle, results in an effective 0% tax rate and thus in practice leads to a similar result as a participation exemption (holding regime).

### Conditions and tax consequences at the level of the shareholder

All beneficial shareholders (resident and non-resident) in a Maltese company will be entitled to an ACIT-refund.

The result of the new system is reflected in the following table assuming a normal refund of the ACIT paid of 6/7ths, a refund of 5/7ths in the case of passive income and a 100% tax refund in the case of participating holdings.

Tax treatment at company level						
	Maltese company					
Total company profits	1,000					
Income tax payable (rate 35%) normal tax or ACIT	(350)					
Profits available for distribution	650					
Tax treatment at shareholder level						
Source	Dividends from participating holdings			Other Income		
Shareholder of Maltese company	Resident Individual	Resident Company	Non-resident Person	Resident Individual	Resident Company	Non-resident Person
Net dividend received	650	650	650	650	650	650
ACIT Refund (100% or 6/7; or 5/7 for passive income) of the ACIT paid by the company on the profits	350	350	350	300	300	300
	250**	250**	250**	250*	250*	250*
Taxable income in Malta for shareholder (at rate of maximum 35%)	1000	0	0	950	0	0
	900**			900*		
Imputation credit to shareholder						
Tax payable by shareholder	350	0	0	332.5	0	0
	315**			315*		
Total tax on profits payable in Malta (on company and shareholder level)	350	0	0	382.5	50	50
	415**	100**	100**	415*	*100	100*
Effective combined level of taxation of corporate profits in Malta	35%	0%	0%	38.25%	5%	5%
	41.5%**	10%**	10%**	41.5%*	10%*	10%*

\* - In the case of passive income (interest and royalties) the refund becomes 5/7, instead of 6/7.

\*\* - In the case the anti-abuse provision for participating shareholdings applies, a 5/7 tax refund will be applied upon the distribution of dividends.