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MEETING DOCUMENT

From:	Commission Services
To:	Code of Conduct Group (Business Taxation)
Subject:	MT – Notional Interest Deduction Rules - draft assessment

Delegations will find attached a document in view of the meeting of the Code of Conduct Group (Business Taxation) on 15 November 2018.

MT – NOTIONAL INTEREST DEDUCTION RULES

	1a	1b	2a	2b	3	4	5
MT – Notional interest deduction rules	X	?	X	?	X	X	X

In accordance with the agreement at the meeting of the Code of Conduct Group of 12 April 2018, the following draft assessment has been prepared with regard to paragraphs 1 to 5 under letter B of the Code, based on the replies to the agreed questionnaire (see WK 4005/2018, hereafter referred to as "agreed description"). The measure is assessed against all Code criteria and relevant agreed guidance.

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 Maltese Notional Interest Rules were published in October 2017. However, they were revised soon after and new superseding legislation was published in January 2018. The Rules are applicable as from the year of assessment 2018 (i.e. applicable for any tax period ending in 2017).

The general tax rate in Malta is 35%.

The Notional Interest Deductions Rules apply to:

- any company or partnership that is resident in Malta; and
- any company or partnership that is not resident in Malta that derives income that is effectively connected with a permanent establishment of the company or partnership situated in Malta.

The interest deduction on equity is calculated as a percentage of a company's "risk capital" (Rule 4 of L.N. 37 of 2018).

Risk capital is defined as follows:

In the case of a company or partnership resident in Malta the applicable equity is the share or partnership capital, any share premium, positive retained earnings, loans or other debt borrowed by the undertaking which do not bear interest, and any other reserves resulting from a contribution to the company or partnership, and any other positive balance which is shown as equity in the financial statements of the company or partnership;

In the case of a permanent establishment of a company or partnership that is not resident in Malta, the applicable equity is that part of the risk capital of that company or partnership that is attributable to the permanent establishment.

To compute the NID the reference rate is applied to the risk capital of the company or partnership less the "invested risk capital" to the extent that such invested risk capital either produces income exempt from tax, or produces no income, but if any income was produced, such income could have been exempt from tax. The invested risk capital is the risk capital that is directly employed in the form of securities, interest in a partnership, contributions and any other loans or debts that do not bear interest that the company or partnership holds in or provides to any other person whether resident in Malta or otherwise.

The deduction for the notional interest may not exceed 90% of the company's chargeable income for the relevant year before taking into account the notional interest deduction. Any excess amount may, at the option of the company or partnership, be carried forward for deduction in the following years.

The reference rate is the risk-free rate set by reference to the yield to maturity on Malta Government Stocks with a remaining term of approximately 20 years plus a premium of 5%. With a yield rate of 2,01%[1] the rate of interest deduction on equity is 7,01%.

This reduction of the tax base may lead to a significantly lower level of taxation. **The NID regime is therefore potentially harmful within the meaning of paragraph A of the Code.**

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. The NID applies and is available to all legal entities based in Malta without any restriction in terms of shareholding (resident or non-resident shareholders) or in terms of business sector.

We have therefore **proposed a cross ("X") for criterion 1a)**.

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). We do not have information to determine whether the NID is pre-dominantly used by non-residents and therefore **propose a question mark ("?") for criterion 1b)**.

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 / 2b We refer to what is mentioned above under criteria 1a) and b) and therefore **propose a cross ("X") for criterion 2a) and a question mark ("?") for criterion 2b).**

[1] 20 years, Yeild to maturity Q2 2018.

Criterion 3:
"whether advantages are granted even without any real economic activity and substantial economic presence within the Member State offering such tax advantages"

According to the standard practice for the evaluation of the potentially harmful measures against criterion 3, a measure is caught by this criterion if there are no express requirements with regard to real economic activities and notably any requirement with respect to employment obligations.

Such express requirement aims at ensuring that the activities generating the income are undertaken by the taxpayer benefiting from the preferential tax regime.

Notional interest regimes such as the Maltese Notional interest deduction rules are different from other preferential tax regimes in that their tax benefits are not based on income generated or the activity performed but on the policy goal to tackle the debt bias, making it difficult to expect a correlation between income-generating activities and benefits.

Such a regime should nonetheless be properly contained by appropriate anti-abuse measures in order to tackle tax planning opportunities, especially when associated with the windfall effect of a regime based on the stock of equity (as compared to an incremental system that rewards only the increase in equity).

Paragraph L of the Code of Conduct states that: "anti-abuse provisions or countermeasures contained in tax laws and in double taxation conventions play a fundamental role in counteracting tax avoidance and evasion". In past assessments, the Code Group has taken into account, in the overall assessment of various regimes, the existence of appropriate anti-abuse provisions or countermeasures.

In order to avoid tax planning and abuse connected to notional interest regimes, the following limitations of the scope and anti-abuse measures have been identified in a previous assessment[2].

[2] Limitation of scope:

- Exclusion of own shares: this exclusion prevents the possibility for a company to increase its equity and simultaneously subscribe the new shares.

- Exclusion of shares held in other resident and non-resident legal persons: this exclusion tackles the possibility to cascade the ACE through chains of equity injection.

- The application of the allowance may not create nor increase tax losses. Consequently, a negative result due to this deduction does not generate a loss carry forward.

- Assets not necessary for conducting business: this is a classical exclusion in NID systems to avoid benefiting from NID on assets that do not generate taxable income (for instance, luxury goods, artwork, etc.).

- No deduction of NID with regard to capital which is allocated to a foreign permanent establishment. If the foreign PE was a legal person (a subsidiary), the parent company holding its capital would have to exclude those shares from the ACE base.

Anti-abuse rules targeting specifically transactions between related parties: The proposal for an EU Directive on a common consolidated tax base (CCCTB) contains an allowance for growth and investment (AGI). Art. 11(6) of the CCTB reads as follows:

"*The Commission shall be empowered to adopt delegated acts in accordance with Article 66 to lay down more detailed rules against tax avoidance, and more particularly in the following fields relevant to the AGI:*

(a) intra-group loans and loans involving associated enterprises;

(b) cash contributions and contributions in kind;

(c) transfers of participations;

(d) the re-categorisation of old capital as new capital through liquidations and the creation of start-ups;

The same structure and content will be used for the assessment of the Maltese Notional interest deduction rules.

Malta's Notional interest deduction rules include the following limitations of its scope:

To compute the notional interest deduction the reference rate is applied to the risk capital (see definition under the Gateway criterion) of the company or partnership less the "invested risk capital" (see definition under the Gateway criterion) to the extent that such invested risk capital either produces income exempt from tax, or produces no income, but if any income was produced, such income could have been exempt from tax. Excess amounts may, at the option of the company or partnership, be carried forward for deduction in the following years.

The provision on scope excludes

- own shares;
- shares held in other resident and non-resident legal persons;
- the application of the NID may not create not increase tax losses;
- assets not necessary for conducting business.

This is complemented by the fact that Malta's Notional interest deduction rules include a general anti-abuse provision (Rule 6). The provision is applied in cases where the taxpayer tries to obtain an "undue advantage which has the effect of reducing their liability to tax in a manner which is not reconcilable with the object and purpose of the Notional interest rules".

Concerning the fifth criterion on limitation of scope a NID deduction is allowed for capital allocated to a foreign PE (Rule 2(b)). However, if the income from the PE would be exempt from income tax under Maltese income tax law no deduction would be allowed.

Rule 2 of the Maltese notional interest regime intra-group loans that carry interest do not fall within the scope of the notional interest deduction. This avoids abuse involving intra-group loans (see (a) footnote 2).

Notional interest deducted at the level of a subsidiary is characterised as deemed interest income for the parent company (Rule 3(1)). An increase of the equity of the subsidiary resulting in a notional interest deduction would lead to taxable income for the parent company. This counters abuse concerning cash contributions and contributions in kind (see (b) footnote 2) when the parent company is resident in Malta but would not address the situation when the parent is a foreign entity as the income would not be taxable in Malta for the foreign parent company. However, this is a general feature of the Maltese tax system which does not fall within the scope of this assessment. This also addresses situations re-categorisation of old capital as new capital through liquidations and the creation of start-ups to the extent that it is relevant in the case of a stock-based regime such as the Maltese (see (d) footnote 2).

Rule 4(1) of the Maltese notional interest regime provides that the risk capital on which the notional interest deduction is calculated be reduced by an amount of invested risk capital where such risk capital produces exempt income. It also provides for such reduction when the

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(e) the creation of subsidiaries;

(f) acquisitions of businesses held by associated enterprises;

(g) double-dipping structures combining interest deductibility and deductions under the AGI;

(h) increases in the amount of loan financing receivables towards associated enterprises as compared to the amount of such receivables at the reference date."

invested risk capital produces no income but, if any income was produced, such income could have been exempted from tax. This measure targets multiple deductions on cascading risk capital in structures involving a mix of resident and non-resident undertakings (see (c) footnote 2).

Rule 2 provides that “invested risk capital” is not included in the “risk capital” which forms the basis for the notional interest deduction. Invested risk capital is defined as securities, interest in a partnership, contributions and any other loans or debts that do not bear interest that is held in or provided to any other person. This eliminates the risk of abuse through the creation of subsidiaries (see (e) footnote 2) as well as the issue relating to acquisitions of businesses held by associated enterprises (see (f) footnote 2).

Rule 5(1) of the regime deems the interest that is deducted under its provisions to be income (i.e. notional interest income) in the hands of the relevant shareholders/partners. The tax treatment of notional interest income arising from financing through equity is intended to be identical to the tax treatment of interest income arising from debt financing. This prevents double dipping combining interest deductibility and notional interest (see (g) footnote 2).

If income derived from a foreign PE of a resident undertaking is exempt from tax under the provisions of the Income Tax Act, no notional interest deduction is available against such exempt income. Deductions are only allowable to the extent that they are wholly and exclusively incurred in the production of income that is chargeable to tax. Contributions and loans that do not bear interest are not included in the equity which is the basis for the NID. Also a NID which has been deducted will be considered as income in the hands of the shareholder. This covers the situation with increases in the amount of loan financing receivables towards associated enterprises as compared to the amount of such receivables at the reference date (see (h) footnote 2).

The burden of proof for the application of the specific anti-abuse provisions of the Rules (Rule 6) is for the taxpayer. In cases where it appears to the Maltese Commissioner for Revenue that the tax payable by a person has been determined at a lesser amount than that which ought to have been charged, including through artificial arrangements, the Commissioner may make an assessment of the chargeable income of that person and the tax chargeable thereon. When the taxpayer appeals against such an assessment The onus of proving that the assessment complained of is excessive shall be on the appellant (article 35(3) of the Income Tax Management Act).

Malta also has a general anti-abuse rule in the Maltese Income Tax Act targeting any scheme which reduces the amount of tax payable by any person is artificial or fictitious or is in fact not given effect to.

On the basis of the available information the applicable anti-abuse provisions meet the requirements of the Code of Conduct to avoid a measure being used for tax avoidance. **Therefore, we have proposed a cross ("X") for this criterion.**

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”

The measures do not contain such elements that would be relevant from the point of view of internationally accepted principles as referred to in criterion 4 of paragraph B of the Code, and we have therefore **proposed a cross (“X”) for this criterion**.

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. **Since this is the case with respect to this measure we propose a cross ("X") for criterion 5.**

Overall assessment:

With respect to the overall evaluation of the Maltese Notional interest reduction rules we have suggested a cross (“X”) indicating that the regime is overall not harmful.