Amendments to the EU Parent Subsidiary Directive and Malta's Participation Exemption

Introduction

Council Directive 2014/86/EU was issued on the 8th July 2014 which amended Directive 2011/96/EU on the common system of taxation applicable in the case of parent companies and subsidiaries of different Member States (hereinafter referred to as the 'Parent Subsidiary Directive'.

The EU Parent Subsidiary Directive

The 1990 EU Directive was designed to eliminate tax obstacles in the area of profit distributions between groups of companies in the EU by:

1. Abolishing withholding taxes on payments of dividends between associated companies of different Member States and
2. Preventing double taxation of parent companies on the profits of their subsidiaries.

Changes to the EU Parent Subsidiary Directive

The new Council Directive issued on the 8th July 2014 amended Article 4 of the Parent Subsidiary Directive so that the benefits of the directive would not lead to situations of double non-taxation and therefore generate unintended tax benefits for groups of parent companies and subsidiaries of different Member States when compared to groups of companies of the same Member State.

The amendment is a result of the fact that the benefits of the Directive are abused by companies to avoid paying taxes in any Member State. The EC therefore amended the Directive in order to close loopholes and to introduce a general anti-abuse rule. The Directive provides that situations of double non-taxation derived from mismatches in the tax treatment of profit distributions between Member States should be avoided.

For example in the case of hybrid instruments, (i.e. instruments that have characteristics of both debt and equity) if the Member State of the paying company considers such payment to be interest, while the Member State of the recipient company considers such a receipt to be a dividend, double non taxation would result. The company effecting the payment will claim a deduction for tax purposes in the Member State in which it is resident, while the recipient company will benefit from an exemption from tax in its own Member State.

The Council Directive thus provides that Member States should not allow companies to benefit from the tax exemption applied to received distributed profits, to the extent that such profits are deductible by the subsidiary in its Member State.

Thus the new Article 4(1)(a) of the Directive reads as follows:

'Refrain from taxing such profits to the extent that such profits are not deductible by the subsidiary, and tax such profits to the extent that such profits are deductible by the subsidiary'

Member States must bring the required changes into their legislation by not later than 31st December 2015.

The Participation Exemption in Malta

Malta's income tax legislation provides the same benefits of the Parent Subsidiary Directive by applying a participation exemption regime in respect of income and gains derived from a participating holding.

A participating holding must consist of:

(i) a holding of the share capital in a company which is not a property company, or

(ii) a holding in a Maltese partnership *en commandite* whose capital is not divided into shares (or a holding in foreign partnership that is similar in nature to such a Maltese partnership) which is not a property partnership, or

(iii) a holding in a collective investment vehicle (CIV) which is constituted outside of Malta and which is not resident in Malta, where the liability of investors in the vehicle is limited to the amount invested.

The said holding must in turn entitle the company that holds it to at least any two of the following rights (referred to as 'equity holding rights') in the company, partnership or CIV:

(i) a right to vote;

(ii) a right to profits available for distribution;

(iii) a right to assets available for distribution on a winding up of that company, partnership or CIV.

Once it has been established that a holding is an "equity holding", the said holding can qualify as a "participating holding" if any **one** of the following conditions are satisfied:

(a) the holding constitutes at least 10% of the equity shares AND confers an entitlement to the company holding the said equity holding of at least 10% of two of the three equity holding rights (i.e. votes, profits available for distribution and assets available for distribution on a winding up);

(b) the company that owns the equity holding also holds an option to acquire the remaining equity holding that it does not own to the extent permitted by the law of the country of the company, partnership or CIV;

(c) the company that owns the equity holding has pre-emption rights over the remaining equity holding that it does not own (i.e. where the other holders of the equity holding wish to dispose, redeem or cancel their equity holding, they must first offer their equity holding to the company);

(d) the company that owns the equity holding is entitled to either sit or appoint a person to sit on the Board (or equivalent body) of the company, partnership or CIV;

(e) the equity holding represents a total value, as on the date or dates on which it was acquired, of €1,164,000 (or the equivalent sum in a foreign currency) and that holding in the company, partnership or CIV is held for an uninterrupted period of not less than 183 days;

(f) the company that owns the equity holding has acquired such holding for the furtherance of its own business and the holding is not held as trading stock for the purpose of a trade.

Claiming the participation exemption on a gain arising from the transfer of a participating holding

Once a holding in a company, limited partnership or CIV qualifies as a participating holding, then a company registered in Malta that derives a gain from the transfer of the said holding should be entitled to claim the participation exemption on the gain that it derives. Accordingly, if the company elects for the participation exemption, no income tax will be payable by the company on the said gain.

Claiming the participation exemption on dividends derived from the participating holding

In order for a company registered in Malta to be entitled to claim the participation exemption on income it derives from a participating holding (e.g. dividends if the holding consists of shares in a company), it is necessary for certain additional conditions to be satisfied by the company, limited partnership or CIV in which the participating holding is held.

The participation exemption cannot be claimed in respect of income derived from participating holdings in companies or limited partnerships that are resident in Malta. Accordingly, the participation exemption in respect of such holdings can only be claimed in respect of gains arising from the transfer of such holdings.

In order to claim the participation exemption in respect of income from a participating holding, the company, limited partnership or CIV must meet **one** of the following three conditions:

(i) it is resident or incorporated in a country or territory which forms part of the European Union; **or**

(ii) it is subject to any foreign tax of at least fifteen per cent (15%); **or**

(iii) it does not have more than fifty per cent (50%) of its income derived from passive interest or royalties.

Where none of these three conditions are met, Maltese income tax legislation provides an alternative condition that may be satisfied in order for income from a participating holding to qualify for the participation exemption. This condition is considered to be satisfied if **both** the following tests are met:

(i) the participating holding held by the company registered in Malta is not part of a portfolio investment; **and**

(ii) the company, limited partnership or CIV in which the participating holding is held or the said entity's passive interest or royalties has been subject to any foreign tax at a rate which is not less than five per cent (5%).

Changes to the Participation Exemption in Malta to bring it in line with the amended Parent Subsidiary Directive

The Maltese Inland Revenue Department has issued guidelines, which clarify the taxation treatment of interest including interest from loans that have characteristics of both debt and equity.

The guidelines clarify that interest is chargeable to tax under the provisions of Article 4(1)(c) of the Income Tax Act. Interest received from sources situated outside Malta is taxable in Malta and does not benefit from an exemption related to income from participating holdings as described above. Thus interest is not considered to be income from share capital or from an equity holding for the purposes of the Income Tax Act.

This means that in terms of these guidelines issued by the Maltese Inland Revenue Department, any interest received by a Maltese company will be subject to tax in Malta at the rate of 35% and cannot benefit from the participation exemption described above.

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