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by Wolfgang Kessler and Rolf Eicke

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HIGHLIGHTS

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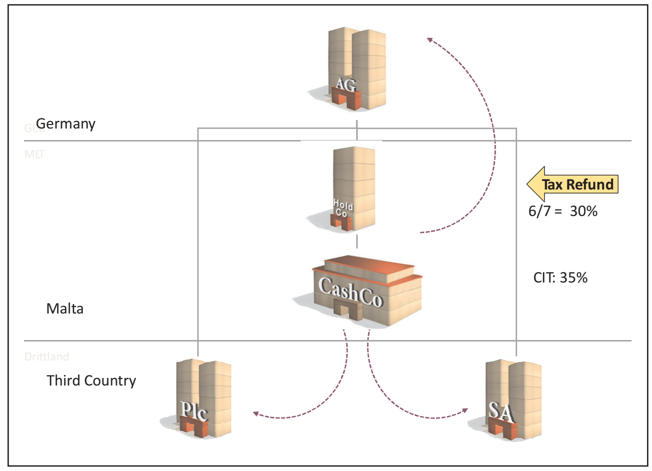
Many European companies are attracted to Malta because of its full imputation system, more commonly known as the international holding company regime. In fact, a vast majority of German blue chips run a Malta holding or finance company.

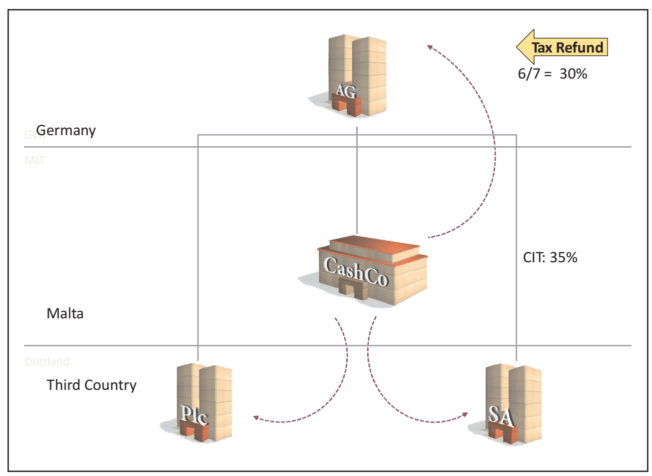
The current full imputation system has been in force since January 1, 2007, after being approved by the European Commission, which had targeted the previous imputation system as a harmful tax practice. (For prior coverage, see *Doc 2007-26985* or *2007 WTD 250-12*.)

Under the Malta model, a standard onshore Maltese company is taxable on its income at the standard rate of 35 percent. This is also true for profits derived by a Maltese company from passive sources situated outside of Malta and for profits allocated to a foreign permanent establishment of a Maltese company. However, the Maltese company's shareholder — either another Maltese company or a foreign company or individual — can claim a tax refund of either 6/7 or 5/7 of the corporate taxes paid by the Maltese company. That means that the shareholder receives a reimbursement of 25 percent or 30 percent of the taxes paid.

This sort of legal tax planning used to work both with a two-tier structure:



and even with a single-tier structure in which the German parent company claims the Maltese tax refund.



Germany's Response

On November 26 the German Bundesrat (upper house of parliament) passed the Annual Tax Act 2010, which includes a powerful amendment to the German controlled foreign corporation rules in the Foreign Tax Act that specifically targets Maltese companies taking advantage of the imputation system. This ''lex Malta'' takes effect on January 1.

Basically, the German CFC rules are triggered if a foreign intermediary company:

- is controlled by a German shareholder or shareholders (meaning a participation above 50 percent);
- yields passive income; and
- is located in a low-tax jurisdiction, which is the case if the passive income was subject to a tax rate of less than 25 percent.

As a consequence of triggering the CFC rules, a resident company or individual is deemed to have received a dividend paid by that foreign intermediary company. However, these deemed distributions are not granted the same relief that applies to genuine dividends.

Historically, the bone of contention regarding Maltese holding companies was whether Malta is a low-tax jurisdiction. There is some irony considering that Germany deems a country a low-tax jurisdiction if it has a tax rate of less than 25 percent while Germany proudly features a 15 percent corporate income tax rate (along with a 14 percent trade tax rate that is, in most cases, levied on top of the corporate income tax). However, Malta used to be safe in this regard because of the 35 percent tax rate levied at the level of the Maltese corporation.

Because Germany's new CFC rules not only take the tax burden of the Maltese intermediary company into account, but also the imputation credit of the shareholder of that company, the days of a passive-income Maltese company acting beyond the scope of the German CFC rules are numbered.

Using a consolidated perspective in the future, the tax refund of the shareholder will be combined with the 35 percent corporate tax rate of the Maltese intermediary company, leading to an overall tax rate of either 5 percent or 10 percent, depending on whether a 6/7 or 5/7 refund is granted.

In short, for purposes of calculating low taxation, the tax burdens of two separate entities or an entity and an individual are both taken into account, disregarding the principle of separation. Thus, the imputation credit receives much more attention for purposes of establishing ''low taxation'' under the new rule.

In essence, the lex Malta is a country-specific exception to the principle of avoidance of double taxation at the level of the corporation. Thus, it should have been added as an exception to the general rule in order to prevent misunderstandings and interpretation problems. The correct location would have been the participation exemption regime in section 8b of the Corporate Income Tax Act.

Besides the insertion of the new rule in the wrong law, some specific problems have not yet been addressed by the German legislature — particularly how loss carryforwards and minimum taxation rules are taken into consideration in the calculation of low taxation.

Enforcing unilateral measures to end a dissent between two tax jurisdictions is never the most appropriate solution in the international tax arena, especially when the tax regime of only one country is targeted. It remains highly questionable why Germany did not at least try to resolve the issue by means of an amendment to the Germany-Malta income tax treaty.

For companies affected by the new way of calculating low taxation, only two options are left: active or out — either the Maltese company receives active income as defined by the German CFC rules or it may have to leave Malta. ◆

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The views expressed here are entirely the authors' own.