Considerations for multinationals with US and Maltese operations

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Malta has long been viewed as a favorable jurisdiction in which to conduct international business operations. The island nation located off the coast of Sicily is an EU member. In addition, the Maltese tax system offers a tax refund mechanism that can result in an effective corporate income tax rate of between 0% and 10% for certain Maltese corporations owned by nonresidents.

Because of these and other features, such as the fact that Malta does not impose withholding tax on dividends, interest, or royalties under its domestic law and the island country's extensive tax treaty network, many multinationals, including those with U.S. operations, may be tempted to incorporate a Maltese entity into their group structure. Multinational businesses, however, should carefully assess the interaction of Malta's tax refund mechanism with the ability to claim benefits under the United States–Malta tax treaty, as well as the potential interaction with proposed U.S. anti-conduit regulations. This discussion explores certain issues that multinationals should consider when deciding whether to use Malta as part of their worldwide operations.

Malta imputation system

Under the Maltese Income Tax Act, corporations that are incorporated and tax resident in Malta are generally subject to a 35% corporate income tax on their worldwide income, but in certain circumstances a substantial refund is available. More specifically, a corporation's distributable profits are allocated to a number of "accounts," depending on the source and nature of the profits. Under the Maltese imputation system, provided certain conditions are fulfilled, dividend distributions made from these accounts may entitle the shareholder to a partial refund of the taxes paid on the distributed income, with the most common tax refund being six-sevenths of the Maltese tax paid on active trading income. This results in an effective Maltese tax rate of 5% (i.e., one-seventh of 35%).

Given the mechanics of the imputation system, a business may benefit from choosing to set up two Maltese corporations that are in a parent-subsidiary relationship, with the subsidiary (OpCo) acting as the operating company and the parent company (TopCo) acting as a holding company. To give a simplified numeric example, if OpCo generated $100 of active trading income, it should be subject to the 35% Maltese corporate income tax. OpCo could then pay out the remaining $65 to TopCo as a dividend. TopCo should not be subject to tax

on the $65 of income and can also claim a refund of six-sevenths (i.e., $30) of the $35 of tax previously paid by OpCo on the distributed income (which generally would also not be taxable to TopCo). Between TopCo and OpCo, therefore, $5 of tax is paid on $100 of active trading income, without the income being distributed to TopCo's shareholders.

As set out below, however, this beneficial regime could create issues when seeking to claim benefits under the U.S.–Malta income tax treaty and must also be carefully analyzed in the context of proposed U.S. anti-conduit regulations under Prop. Regs. Sec. 1.881-3.

Limitation-on-benefits articles

Looking first at the U.S.–Malta income tax treaty, some businesses may be presented with a conflict between taking advantage of the Maltese imputation system and claiming benefits under the tax treaty. The reason involves a base-erosion test in the treaty.

To be eligible for benefits under the U.S.–Malta treaty, a Maltese person must be considered a tax resident under Article 4 and must meet at least one of the tests set out in Article 22, the limitation-on-benefits (LOB) article.

At first glance, the LOB tests in the U.S.–Malta treaty are generally in line with the 2016 U.S. Model Income Tax Convention, as well as U.S. tax treaties with other European jurisdictions. Importantly, however, a number of the tests, including the "active trade or business" test (Paragraph 4), the "publicly traded company" test (Paragraph 2c), and the "ownership/base erosion" test (Paragraph 2f), each require Clause ii of Paragraph 2f to be met.

Clause ii, often referred to as the "base-erosion test," is generally aimed at preventing taxpayers from stripping earnings out from an entity that is eligible for treaty benefits to an entity that is not eligible. In the U.S.–Malta treaty, the base-erosion test is passed if "less than 25 percent of the person's gross income for the taxable year, as determined in the person's State of residence, is paid or accrued, directly or indirectly, to persons who are not residents of either Contracting State [i.e., of the United States or Malta] entitled to the benefits of this Convention under [certain subparagraphs] (other than in the form of arm's length payments in the ordinary course of business for services or tangible property)."

Notably absent from the treaty provision is language stating that the payments taken into account for purposes of the base-erosion test include only those that are deductible for income tax purposes in the person's country of residence. By comparison, language setting out such a restriction is included in many other U.S. income tax treaties (see, for example, Paragraph (2)(f)(ii) of Article 23 of the United States–United Kingdom treaty; Paragraph (2)(f)(ii) of Article 26 of the United States– Netherlands treaty; and Paragraph (2) (f)(bb) of Article 28 of the United States–Germany treaty) but not in the U.S.–Malta treaty.

This difference in wording is quite significant because dividends (e.g., paid by OpCo) are generally not deductible for income tax purposes. If the U.S.– Malta treaty had limited the scope of its base-erosion test to deductible payments, dividends would generally not be taken into account when determining whether the base-erosion test was passed. But because the language in the U.S.–Malta treaty is not limited to "tax deductible payments,"

the position may be taken that dividends paid by a Maltese corporation should be taken into account in applying the base-erosion test.

In other words, Maltese corporations seeking to claim treaty benefits under the active trade or business test, the publicly traded company test, or the ownership/base-erosion test, but whose parent corporations do not meet one of the permissible LOB tests set out in the base-erosion test language, are presented with a conflict between claiming treaty benefits and taking advantage of the Maltese imputation system. On one hand, the Maltese corporation may wish to maximize its dividend distributions to allow its shareholder to claim the highest possible tax refund. On the other hand, paying out dividend distributions may result in the base-erosion test being failed and treaty benefits (which may be required, for example, to apply a reduced withholding tax rate) not being available.

Proposed anti-conduit regulations

Multinational business with U.S. and Maltese operations should also be aware of proposed U.S. anti-conduit rules (REG-106013-19). These proposed regulations arguably are targeted at tax regimes such as the Maltese imputation system.

Broadly, the current anti-conduit rules allow the IRS to disregard the participation of one or more intermediary entities in a financing arrangement where such entities are acting as "conduit entities" (Regs. Sec. 1.881-3(a)). If such a financing arrangement is found to exist, the IRS can recharacterize the arrangement as a transaction directly between the remaining parties.

While a discussion of the anti-conduit rules and definitions is outside the scope of this item, very generally, a "financing arrangement" means a series of transactions by which one person (the "financing entity") advances money or other property, or grants rights to use property, and another person (the "financed entity") receives money or other property, or rights to use property. The advance and receipt must be effected through one or more other persons (the "intermediate entities"), and there must be financing transactions linking the financing entity, each of the intermediate entities, and the financed entity. Certain conditions must be fulfilled for the intermediate entity to be considered a conduit entity, which include that its participation reduces the tax imposed under Sec. 881; its participation is pursuant to a tax-avoidance plan; and either it is related to the financing entity or the financed entity, or it would not have participated in the financing arrangement on substantially the same terms but for the fact that the financing entity engaged in the financing transaction with the intermediate entity.

Under the current regulations, nonredeemable equity in a corporation is generally not considered a "financing transaction" for purposes of the anti-conduit rules. Importantly, however, proposed regulations issued in April 2020 would expand the definition of a financing transaction to include:

■ Equity interests where the issuer is allowed a deduction or another tax benefit (including a credit or a notional deduction) for amounts paid, accrued, or distributed with respect to the stock or similar interest, either under the laws of the issuer's country of residence or a

country in which the issuer has a taxable presence, such as a permanent establishment (Prop. Regs. Sec. 1.881-3(a)(2)(ii)(B)(1) (iv)); and

■ Equity interests with respect to which a person related to the issuer is, under the tax laws of the issuer's country of residence, allowed a refund (including through a credit) or similar tax benefit for taxes paid by the issuer to its country of residence on amounts paid, accrued, or distributed (deemed or otherwise) with respect to the stock or similar interest, without regard to any related person's tax liability under the laws of the issuer's country of residence (Prop. Regs. Sec. 1.881-3(a)(2)(ii)(B) (1)(v)).

As noted above, tax regimes such as the Maltese imputation system are arguably the target of these proposed regulations. Notably, the proposed anti-conduit rules may also be perceived as being broader than other areas of the Internal Revenue Code that seek to target similar regimes. For example, final regulations under Sec. 267A may disallow deductions where the income attributable to the payment is offset by an offshore deduction (the imported-mismatch rules). However, additional requirements (such as a deduction/ no-inclusion outcome) must be met for the imported-mismatch rules to apply; such additional conditions are not required under the proposed anti-conduit regulations.

If the regulations are finalized as proposed, the Maltese imputation system could fall within the expanded definition of a financing transaction. If so, taxpayers with U.S. and Maltese operations would need to analyze whether their intergroup transactions could fall within the scope of the U.S. anti-conduit rules. The proposed regulations relating to such conduit transactions are proposed to apply to payments made on or after the date of publication of the final regulations in the *Federal Register.*

Conclusion

Maltese corporations may be able to mitigate the trade-off of claiming a tax refund and being eligible for tax treaty benefits by, for example, timing the payment of the dividends (or the claim of the shareholder's refund) to years in which treaty benefits may not be as important. However, this may prove difficult to predict and could become burdensome from an administrative and commercial perspective. Similarly, while equity interests of Maltese corporations that take advantage of the Maltese imputation system could fall within the definition of a financing transaction, the remaining criteria required to fall afoul of the anti-conduit rules may not always be met.

As is highlighted by these two potential issues, businesses should carefully assess the potential advantages and issues to manage before deciding whether to use Malta as part of their worldwide operations.

Editor Notes

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