New income tax rules impacting upon the allocation of company profits to tax accounts

New rules requiring changes to the analysis of companies' distributable reserves were enacted by means of amendments to the Income Tax Act on 16 March 2007 (Act II of 2007). These amendments are effective as from year of assessment 2008 (other than for Collective Investment Schemes in respect of which it will enter into force at a later stage) and therefore impact upon information to be disclosed in company income tax returns from the said year of assessment – detailed supplementary rules in this respect were issued in February 2008 by virtue of Legal Notice 79 of 2008.

New tax accounts

One important change requiring immediate attention is the allocation of taxed income to two new taxed accounts, i.e. the Final Tax Account (FTA) and the Immovable Property Account (IPA). These new tax accounts will now attract some of the profits that would have been allocated to the Foreign Income Account (FIA) and, the Maltese Taxed Account (MTA) prior to the aforementioned amendments. The principal reasons behind the introduction of these new accounts is:

- to create a distinction between those profits the tax on which is imputable in favour of the shareholders and profits which do not carry imputable tax when they are distributed to such shareholders; and
- to distinguish between those profits the tax on which is not available for refund and those profits the tax on which may be refunded on distribution.

Allocation of certain income to the new tax accounts – the “first tier” allocation

The new rules require that the amount of any income or profits that was subject to a final tax, was exempt from tax, or that was relieved by some form of tax credit, should be allocated to the FTA.

On the other hand, income and profits that are to be allocated to the IPA include, among others, income derived from immovable property in Malta of whatever nature, including that from transfers of immovable property (or shares in entities principally owning immovable property), rents, premiums, provision of accommodation (or related management services), work carried out on, or in relation to, such immovable property, and any other income that is otherwise related to immovable property situated in Malta (but transfers of property subject to the 12% final withholding tax are allocated to the FTA).

Companies in receipt of income specified above should notify this fact to their tax practitioners indicating also the amount of such income.
Further allocations to the new tax accounts – the “second tier” allocation

In addition to the allocations mentioned above, the new rules also require a second tier allocation. This involves the re-allocation of amounts from the MTA and (when applicable) from the FIA, to the IPA. In other words, in the second-tier allocation, an amount would need to be re-allocated to the IPA that is not based on profits which are derived from the particular activity.

These re-allocations are of amounts as described in the table below:

<table>
<thead>
<tr>
<th>Second tier allocations to the IPA</th>
<th>Amount to be reallocated</th>
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<tbody>
<tr>
<td>1 Interest, fees, and any other consideration directly or indirectly related to the granting of loans or derived from any form of credit to finance the acquisition, development, refurbishment, renovation, etc. of immovable property situated in Malta</td>
<td>Gross amount</td>
</tr>
<tr>
<td>2 Insurance premiums related to the insurance of immovable property situated in Malta</td>
<td>Gross amount</td>
</tr>
<tr>
<td>3 The amount of annual market rent of: Immovable property owned (including under title of emphyteusis) and used by the company for the purposes of its activities OR Immovable property used by the company but owned by a “related person” for no consideration or for a consideration which is less than the market rental value of the property</td>
<td>Aggregate surface area of all floors of such premises at €60 per square metre less any consideration paid for the use of such property (if not owned)</td>
</tr>
</tbody>
</table>

With respect to point 3 above, a person is deemed to be related to a company if:

- that person and the company are, directly or indirectly, controlled or beneficially owned to the extent of more than 25% by the same persons; or
- that person owns, directly or indirectly, more than 25% of the ordinary share capital or voting rights of the company; or
- that person, in any capacity whatsoever including that of a trustee, holds the said property or receives the said consideration for and on behalf of or for the benefit of a related person.

In the event that, in any year of assessment, a company does not have sufficient profits initially allocated to the MTA (and FIA when applicable) to be reallocated to the IPA in terms of the second tier allocation as per above, the shortfall is carried forward and added to the second tier allocations due for the following year.

Where the allocation of profits made in a tax return is materially incorrect in terms of the said legislation, the Commissioner is entitled to consider that tax return as not being correct in all material respects for the purposes of the Income Tax Management Act.

To this effect, every company must, as soon as possible so as to enable a timely and accurate preparation of its relative income tax return, provide its tax practitioner with the relative information set out in the above table. Please also note that this information is required on a yearly basis from now on.