

**EXPLANATION OF PROPOSED INCOME TAX TREATY  
BETWEEN THE UNITED STATES AND MALTA**

Scheduled for a Hearing  
Before the  
COMMITTEE ON FOREIGN RELATIONS  
UNITED STATES SENATE

On November 10, 2009

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Prepared by the Staff  
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## INTRODUCTION

This pamphlet,<sup>1</sup> prepared by the staff of the Joint Committee on Taxation, describes the proposed income tax treaty between the United States and Malta (the “proposed treaty”). The proposed treaty was signed on August 8, 2008 and is accompanied by official understandings implemented by an exchange of diplomatic notes (collectively, the “diplomatic notes” or “notes”) carried out on that same day. The Senate Committee on Foreign Relations has scheduled a public hearing on the proposed treaty for November 10, 2009.<sup>2</sup>

Part I of the pamphlet provides a summary of the proposed treaty. Part II provides a brief overview of U.S. tax laws relating to international trade and investment and of U.S. income tax treaties in general. Part III contains a brief overview of Malta’s tax laws. Part IV provides a discussion of investment and trade flows between the United States and Malta. Part V contains an article-by-article explanation of the proposed treaty. Part VI contains a discussion of issues relating to the proposed treaty.

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<sup>1</sup> This pamphlet may be cited as follows: Joint Committee on Taxation, *Explanation of Proposed Income Tax Treaty Between the United States and Malta* (JCX-50-09), November 6, 2009. References to the “Code” are to the U.S. Internal Revenue Code of 1986, as amended. This document is available on the internet at <http://www.jct.gov/>.

<sup>2</sup> For a copy of the proposed treaty, see Senate Treaty Doc. 111-1.

## I. SUMMARY

The principal purposes of the proposed treaty are to reduce or eliminate double taxation of income earned by residents of either country from sources within the other country and to prevent avoidance or evasion of the taxes of the two countries. The proposed treaty also is intended to promote close economic cooperation between the two countries and to eliminate possible barriers to trade and investment caused by overlapping taxing jurisdictions of the two countries. As in other U.S. tax treaties, these objectives principally are achieved through each country's agreement to limit, in certain specified situations, its right to tax income derived from its territory by residents of the other country.

For example, the proposed treaty contains provisions under which each country generally agrees not to tax business income derived from sources within that country by residents of the other country unless the business activities in the taxing country are substantial enough to constitute a permanent establishment (Article 7). Similarly, the proposed treaty contains certain exemptions under which residents of one country performing personal services in the other country will not be required to pay tax in the other country unless their contact with the other country exceeds specified minimums (Articles 14 and 16). The proposed treaty also provides that pensions and other similar remuneration paid to a resident of one country may be taxed only by that country and only at the time and to the extent that a pension distribution is made (Articles 17 and 18).

The proposed treaty provides that dividends and certain gains derived by a resident of either country from sources within the other country generally may be taxed by both countries (Articles 10 and 13); however, the proposed treaty limits the rate of tax that the source country may impose on certain dividends paid to a resident of the other country. These rules are consistent with the corresponding provisions of the United States Model Income Tax Convention of November 15, 2006 ("U.S. Model treaty"), but they represent a departure from the exemption from source-country withholding tax provided by several recent U.S. treaties and protocols for dividends paid by subsidiaries to parent corporations resident in the other treaty countries.

The proposed treaty's rule for Maltese taxation of Malta-source dividends paid to residents of the United States takes into account the Maltese imputation system of corporate tax (described in more detail below). The rule provides that the tax that may be charged by Malta on dividends paid by a Maltese company to a U.S. resident is limited to the Maltese tax chargeable on the profits out of which the dividends are paid.

The proposed treaty generally limits the rate of source-country tax that may be imposed on interest arising in one treaty country (the source country) and beneficially owned by a resident of the other treaty so that it may not exceed 10 percent of the gross amount of the interest (Article 11). Similarly, the proposed treaty provides that a royalty payment arising in a treaty country and beneficially owned by a resident of the other treaty country may be subject to a source country tax of up to 10 percent of the gross amount of the royalty (Article 12). These provisions differ from the corresponding rules of the U.S. Model treaty. The U.S. Model treaty provides an exemption from source-country tax for most interest and royalty payments beneficially owned by a resident of the other country.

Unlike the U.S. Model treaty, the proposed treaty permits limited source-country taxation of income not dealt with in other articles of the treaty. That income may be taxed by the source country at a rate not greater than 10 percent (Article 21). The U.S. Model treaty, by contrast, exempts this income from source-country taxation.

In situations in which the country of source retains the right under the proposed treaty to tax income derived by residents of the other country, the proposed treaty generally provides for relief from the potential double taxation through the allowance by the country of residence of a tax credit for certain foreign taxes paid to the other country (Article 22).

The proposed treaty contains the standard provision (the “saving clause”) included in U.S. tax treaties pursuant to which each country retains the right to tax its residents and citizens as if the treaty had not come into effect (Article 1). In addition, the proposed treaty contains the standard provision providing that the treaty may not be applied to deny any taxpayer any benefits to which the taxpayer would be entitled under the domestic law of a country or under any other agreement between the two countries (Article 1).

The proposed treaty (Article 20) generally provides that students and business trainees who are residents of one treaty country and who visit the other treaty country (the host country) are exempt from host-country taxation on certain types of payments received from sources in their home country for their maintenance, education, or training.

The proposed treaty provides authority for the two countries to resolve disputes (Article 25) and exchange information (Article 26) in order to carry out the provisions of the proposed treaty.

The proposed treaty also contains a detailed limitation-on-benefits provision to prevent the inappropriate use of the treaty by third-country residents (Article 22). This provision generally reflects the anti-treaty-shopping provisions included in the U.S. Model treaty and more recent U.S. income tax treaties, but is more stringent in a number of respects.

The diplomatic notes include six understandings of the governments of the United States and Malta. Four of those understandings are described in the explanation of the proposed treaty in Part V of this pamphlet. The fifth understanding is that the United States has agreed to renew discussions with Malta regarding the application of the proposed treaty to Maltese mutual funds after the conclusion of the Organisation for Economic Co-operation and Development (“OECD”) project concerning collective investment vehicles. The sixth understanding is that the United States has agreed to renew discussions with Malta within one year of the date of the signing of the proposed treaty regarding waiver of the U.S. excise tax imposed on insurance premiums paid to foreign persons.

The provisions of the proposed treaty generally take effect on or after the first day of January following the date that the proposed treaty enters into force. With respect to withholding taxes (principally on dividends, interest, and royalties), the provisions of the proposed treaty take effect for amounts paid or credited on or after the first day of the second month following the date on which the proposed treaty enters into force.

The proposed treaty replaces an income tax between the United States and Malta that was signed in 1980 and that the United States terminated with effect in 1997. The rules of the proposed treaty generally are similar to rules of recent U.S. income tax treaties, the U.S. Model treaty,<sup>3</sup> and the 2005 Model Convention on Income and on Capital of the Organisation for Economic Cooperation and Development (“OECD Model treaty”). However, the proposed treaty contains certain substantive deviations from these treaties and models. Some deviations have been noted above, and those and other deviations are described throughout the explanation of the proposed treaty in Part V of this pamphlet.

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<sup>3</sup> For a comparison of the U.S. Model treaty with its 1996 predecessor, *see* Joint Committee on Taxation, *Comparison of the United States Model Income Tax Convention of September 20, 1996 with the United States Model Income Tax Convention of November 15, 2006* (JCX-27-07), May 8, 2007.

## **II. OVERVIEW OF U.S. TAXATION OF INTERNATIONAL TRADE AND INVESTMENT AND U.S. TAX TREATIES**

This overview briefly describes certain U.S. tax rules relating to foreign income and foreign persons that apply in the absence of a U.S. tax treaty. This overview also discusses the general objectives of U.S. tax treaties and describes some of the modifications to U.S. tax rules made by treaties.

### **A. U.S. Tax Rules**

The United States taxes U.S. citizens, residents, and corporations on their worldwide income, whether derived in the United States or abroad. The United States generally taxes nonresident alien individuals and foreign corporations on all their income that is effectively connected with the conduct of a trade or business in the United States (sometimes referred to as “effectively connected income”). The United States also taxes nonresident alien individuals and foreign corporations on certain U.S.-source income that is not effectively connected with a U.S. trade or business.

Income of a nonresident alien individual or foreign corporation that is effectively connected with the conduct of a trade or business in the United States generally is subject to U.S. tax in the same manner and at the same rates as income of a U.S. person. Deductions are allowed to the extent that they are related to effectively connected income. A foreign corporation also is subject to a flat 30-percent branch profits tax on its “dividend equivalent amount,” which is a measure of the effectively connected earnings and profits of the corporation that are removed in any year from the conduct of its U.S. trade or business. In addition, a foreign corporation is subject to a flat 30-percent branch-level excess interest tax on the excess of the amount of interest that is deducted by the foreign corporation in computing its effectively connected income over the amount of interest that is paid by its U.S. trade or business.

U.S.-source fixed or determinable annual or periodical income of a nonresident alien individual or foreign corporation (including, for example, interest, dividends, rents, royalties, salaries, and annuities) that is not effectively connected with the conduct of a U.S. trade or business is subject to U.S. tax at a rate of 30 percent of the gross amount paid. Certain insurance premiums earned by a nonresident alien individual or foreign corporation are subject to U.S. tax at a rate of one or four percent of the premiums. These taxes generally are collected by means of withholding.

Specific statutory exemptions from the 30-percent withholding tax are provided. For example, certain original issue discount and certain interest on deposits with banks or savings institutions are exempt from the 30-percent withholding tax. An exemption also is provided for certain interest paid on portfolio debt obligations. In addition, income of a foreign government or international organization from investments in U.S. securities is exempt from U.S. tax.

U.S.-source capital gains of a nonresident alien individual or a foreign corporation that are not effectively connected with a U.S. trade or business generally are exempt from U.S. tax, with two exceptions: (1) gains realized by a nonresident alien individual who is present in the

United States for at least 183 days during the taxable year, and (2) certain gains from the disposition of interests in U.S. real property.

Rules are provided for the determination of the source of income. For example, interest and dividends paid by a U.S. citizen or resident or by a U.S. corporation generally are considered U.S.-source income. Conversely, dividends and interest paid by a foreign corporation generally are treated as foreign-source income. Special rules apply to treat as foreign-source income (in whole or in part) interest paid by certain U.S. corporations with foreign businesses and to treat as U.S.-source income (in whole or in part) dividends paid by certain foreign corporations with U.S. businesses. Rents and royalties paid for the use of property in the United States are considered U.S.-source income.

Because the United States taxes U.S. citizens, residents, and corporations on their worldwide income, double taxation of income can arise when income earned abroad by a U.S. person is taxed by the country in which the income is earned and also by the United States. The United States seeks to mitigate this double taxation generally by allowing U.S. persons to credit foreign income taxes paid against the U.S. tax imposed on their foreign-source income. A fundamental premise of the foreign tax credit is that it may not offset the U.S. tax liability on U.S.-source income. Therefore, the foreign tax credit provisions contain a limitation that ensures that the foreign tax credit offsets only the U.S. tax on foreign-source income. The foreign tax credit limitation generally is computed on a worldwide basis (as opposed to a “per-country” basis). The limitation is applied separately for certain classifications of income. In addition, special limitations apply to credits for foreign taxes imposed on foreign oil and gas extraction income and foreign oil related income.

For foreign tax credit purposes, a U.S. corporation that owns 10 percent or more of the voting stock of a foreign corporation and receives a dividend from the foreign corporation (or is otherwise required to include in its income earnings of the foreign corporation) is deemed to have paid a portion of the foreign income taxes paid by the foreign corporation on its accumulated earnings. The taxes deemed paid by the U.S. corporation are included in its total foreign taxes paid and its foreign tax credit limitation calculations for the year in which the dividend is received.

## **B. U.S. Tax Treaties**

The traditional objectives of U.S. tax treaties have been the avoidance of international double taxation and the prevention of tax avoidance and evasion. Another related objective of U.S. tax treaties is the removal of the barriers to trade, capital flows, and commercial travel that may be caused by overlapping tax jurisdictions and by the burdens of complying with the tax laws of a jurisdiction when a person's contacts with, and income derived from, that jurisdiction are minimal. To a large extent, the treaty provisions designed to carry out these objectives supplement U.S. tax law provisions having the same objectives; treaty provisions modify the generally applicable statutory rules with provisions that take into account the particular tax system of the treaty partner.

The objective of limiting double taxation generally is accomplished in treaties through the agreement of each country to limit, in specified situations, its right to tax income earned within its territory by residents of the other country. For the most part, the various rate reductions and exemptions agreed to by the country in which income is derived (the "source country") in treaties are premised on the assumption that the country of residence of the taxpayer deriving the income (the "residence country") may tax the income at levels comparable to those imposed by the source country on its residents. Treaties also provide for the elimination of double taxation by requiring the residence country to allow a credit for taxes that the source country retains the right to impose under the treaty. In addition, in the case of certain types of income, treaties may provide for exemption by the residence country of income taxed by the source country.

Treaties define the term "resident" so that an individual or corporation generally is subject to tax as a resident by both of the countries. Treaties generally provide that neither country may tax business income derived by residents of the other country unless the business activities in the taxing jurisdiction are substantial enough to constitute a permanent establishment or fixed base in that jurisdiction. Treaties also contain commercial visitation exemptions under which individual residents of one country performing personal services in the other are not required to pay tax in that other country unless their contacts exceed certain specified minimums (for example, presence for a set number of days or earnings in excess of a specified amount). Treaties address passive income such as dividends, interest, and royalties from sources within one country derived by residents of the other country either by providing that the income is taxed only in the recipient's country of residence or by reducing the rate of the source country's withholding tax imposed on the income. In this regard, the United States agrees in its tax treaties to reduce its 30-percent withholding tax (or, in the case of some income, to eliminate it entirely) in return for reciprocal treatment by its treaty partner. In particular, under the U.S. Model treaty and many U.S. tax treaties, source-country taxation of most payments of interest and royalties is eliminated, and, although not provided for in the U.S. Model treaty, many recent U.S. treaties forbid the source country from imposing withholding tax on dividends paid by an 80-percent owned subsidiary to a parent corporation organized in the other treaty country.

In its treaties, the United States, as a matter of policy, generally retains the right to tax its citizens and residents on their worldwide income as if the treaty had not come into effect. The United States also provides in its treaties that it allows a credit against U.S. tax for income taxes paid to the treaty partners, subject to the various limitations of U.S. law.

The objective of preventing tax avoidance and evasion generally is accomplished in treaties by the agreement of each country to exchange tax-related information. Treaties generally provide for the exchange of information between the tax authorities of the two countries when the information is necessary for carrying out provisions of the treaty or of their domestic tax laws. The obligation to exchange information under the treaties typically does not require either country to carry out measures contrary to its laws or administrative practices or to supply information that is not obtainable under its laws or in the normal course of its administration or that would reveal trade secrets or other information the disclosure of which would be contrary to public policy. Several recent treaties and protocols provide that notwithstanding the general treaty principle that treaty countries are not required to take any actions at variance with their domestic laws, a treaty country may not refuse to provide information requested by the other treaty country simply because the requested information is maintained by a financial institution, nominee, or person acting in an agency or fiduciary capacity. This provision thus explicitly overrides bank secrecy rules of the requested treaty country. The Internal Revenue Service (the “IRS”), and the treaty partner’s tax authorities, also can request specific tax information from a treaty partner. These requests can include information to be used in criminal investigations or prosecutions.

Administrative cooperation between countries is enhanced further under treaties by the inclusion of a “competent authority” mechanism to resolve double taxation problems arising in individual cases and, more generally, to facilitate consultation between tax officials of the two governments. Several recent treaties also provide for mandatory arbitration of disputes that the competent authorities are unable to resolve by mutual agreement.

Treaties generally provide that neither country may subject nationals of the other country (or permanent establishments of enterprises of the other country) to taxation more burdensome than the tax it imposes on its own nationals (or on its own enterprises). Similarly, in general, neither treaty country may discriminate against enterprises owned by residents of the other country.

At times, residents of countries that do not have income tax treaties with the United States attempt to use a treaty between the United States and another country to avoid U.S. tax. To prevent third-country residents from obtaining treaty benefits intended for treaty country residents only, treaties generally contain “anti-treaty shopping” provisions designed to limit treaty benefits to bona fide residents of the two countries.

### III. OVERVIEW OF TAXATION IN MALTA<sup>4</sup>

#### A. National Income Taxes

##### Overview

Malta imposes tax on net income at the national level. The definition of income subject to tax is expansive and includes certain capital gains.<sup>5</sup> These gains may be taxed at lower rates than the rates applicable to ordinary income. Taxable income is computed on an annual basis<sup>6</sup> and is taxed either by assessment or by withholding tax. Withholding tax paid may be credited against income tax liability, and any excess may be refunded. The Maltese income tax system mitigates double taxation of dividend income through a full imputation system, which provides shareholders receiving dividends from Maltese corporations a credit for Maltese corporate tax imposed on earnings out of which dividends are paid by those companies.<sup>7</sup> The imputation credit is allowed for resident and non-resident shareholders.<sup>8</sup>

##### Individuals

Individuals who are both ordinarily resident and domiciled in Malta are subject to Maltese income tax on their worldwide income.<sup>9</sup> An individual's taxable income is the sum of all gain and profits from the following sources: trade or business; profession or vocation; employment or office; dividends, interests or discounts; pensions, annuities or annual payments; rents, royalties, premiums and any other profits arising from property; certain capital gains; and other gains or profits.<sup>10</sup> Trade losses may be offset against income of the same year and thereafter carried forward indefinitely and offset against the income for succeeding years. Losses due to depreciation, however, may only be carried forward indefinitely and set off against the profits of the same and continuing trade. No carry-back of losses is allowed. Losses arising

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<sup>4</sup> The information in this section relates to foreign law and is based on the Joint Committee staff's review of publicly available secondary sources, including in large part IBFD Regional Analysis, Malta, available at <http://checkpoint.riag.com> [hereinafter IBFD Malta Country Analysis]; Ernst & Young's 2009 Worldwide Corporate Tax Guide [hereinafter E&Y] as well as the Ministry for Justice and Home Affairs, the Laws of Malta, *available at* <http://www.gov.mt/frame.asp?l=2&url=http://www2.justice.gov.mt/lom/home.asp>. The information in this section was reviewed by foreign law specialists on the staff of the Law Library of Congress. The description is intended to serve as a general overview; many details have been omitted and simplifying generalizations made.

<sup>5</sup> Income Tax Act, c. 123, arts. 2, 4, available at [http://docs.justice.gov.mt/lom/legislation/english/leg/vol\\_4/chapt123.pdf](http://docs.justice.gov.mt/lom/legislation/english/leg/vol_4/chapt123.pdf) [hereinafter Income Tax Act]; IBFD Malta Country Analysis B.1.2.

<sup>6</sup> Income Tax Act, art. 4.

<sup>7</sup> Income Tax Act, art. 59.

<sup>8</sup> Income Tax Act; IBFD Malta Country Analysis B.1.1.3.

<sup>9</sup> Income Tax Act, art. 4.

<sup>10</sup> Income Tax Act, art. 4; IBFD Malta Country Analysis B.1.2.1.

outside Malta are allowed as a deduction if the losses, had they been profits, would have been taxable in Malta. Capital losses may be set off only against capital gains. The set-off is allowed against capital gains of the current and following years.<sup>11</sup>

The Maltese tax system distinguishes between “taxed income” and “untaxed income.”<sup>12</sup> The difference between a company’s distributable profits, as shown in its financial statements, and the total amounts of the taxed income, is referred to as untaxed income.<sup>13</sup> As a result of the operation of the full imputation system, there is generally no withholding tax on dividends paid out of profits subject to Maltese corporate tax. However, a 15-percent withholding tax rate applies to dividends paid to resident individuals out of untaxed profits.<sup>14</sup> In general, there is no withholding tax on interest paid to resident individuals. However, a 15-percent final withholding tax may apply in the case of interest paid by Maltese banks, the government of Malta and public corporations and authorities. There are no withholding taxes on royalties paid to resident individuals.<sup>15</sup>

Income tax is imposed on capital gains derived from the transfer of ownership of certain assets by individuals.<sup>16</sup> Tax on capital gains does not apply to immovable property that has been owned and occupied for at least three years as the transferor’s own residence immediately preceding the transfer and provided that the property is disposed of within 12 months of vacating the premises.<sup>17</sup> Exempt capital gains also include those from the sale of securities listed on the Malta Stock Exchange, other than securities in a collective investment scheme held in a fund investing less than 85 percent of its total investments in Malta-based securities.<sup>18</sup>

For both resident and non-resident individuals, Maltese tax law generally does not allow the deduction of expenses related to income from capital or employment. Only deductions for expenses for the production of business income and income from self-employment are permitted. Other deductible expenses for individuals include: alimony payments, expenses for a child’s special education needs, a child’s school fees, child day care expenses and payments on behalf of elderly family members.<sup>19</sup> The rate structure is progressive and differs between married couples, resident individuals, and non-resident individuals. For married couples, rates range from zero

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<sup>11</sup> Income Tax Act, art. 14(1)(g); IBFD Malta Country Analysis B.1.9.

<sup>12</sup> Income Tax Act, art. 2.

<sup>13</sup> Income Tax Act, art. 2.

<sup>14</sup> Income Tax Act, arts. 33, 62(1).

<sup>15</sup> Income Tax Act, art. 12(1); IBFD Malta Country Analysis B.1.10.3.

<sup>16</sup> Income Tax Act, art. 5.

<sup>17</sup> Income Tax Act, art. 5(5)(b).

<sup>18</sup> IBFD Malta Country Analysis B.1.7.

<sup>19</sup> Income Tax Act, arts. 14A-C; IBFD Malta Country Analysis B.1.8.

percent for taxable income up to €1,900 (\$16,711) to 35 percent for taxable income exceeding €28,700 (\$40,303).<sup>20</sup> Unmarried resident individuals' rates range from zero percent for taxable income up to €8,500 (\$11,937) to 35 percent for taxable income exceeding €19,500 (\$27,384).<sup>21</sup> Under Maltese tax law no personal allowances or credits are granted.<sup>22</sup>

## **Corporations**

Corporations that are both ordinarily resident and domiciled in Malta are generally taxed in Malta on a worldwide basis at a 35-percent rate.<sup>23</sup> Maltese tax law does not specifically provide for taxation of corporations on the basis of accounting profit. However, in practice, the profit shown on the income statement, in accordance with International Financial Reporting Standards forms the basis on which income is computed and the basis on which tax is levied, subject to such specific adjustments as are required and imposed by the relevant tax rules. In general, a company's gains on the transfer of capital assets are aggregated with its other income, and the total income and capital gains are taxed at the general rate.<sup>24</sup> However, gains on the transfer of immovable property situated in Malta are separately subject to a flat rate property transfer tax.<sup>25</sup> Reduced income tax rates of five percent to 15 percent are applicable to companies qualifying for benefits under the Business Promotion Act.<sup>26</sup> Malta has neither thin capitalization rules with respect to deductibility of interest expense nor controlled foreign company rules or other similar specific anti-abuse legislation.<sup>27</sup>

Under the "participation exemption rules" Malta exempts from tax dividend income and capital gains derived by a company registered in Malta from a "participating holding" of a foreign subsidiary or from the disposal of such holding.<sup>28</sup> A holding in a foreign company is considered to be a participating holding if either a company holds directly at least 10 percent of the equity shares of a foreign company (that is, a company that is not resident in Malta) or a company is an equity shareholder that invests €1,164,000 (\$1,634,605) or more in a foreign

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<sup>20</sup> The quoted tax rates and local currency apply in 2009. U.S. dollar equivalents were calculated using the exchange rate for January 1, 2009 according to OANDA's FX Converter, available at [www.oanda.com](http://www.oanda.com).

<sup>21</sup> Income Tax Act, art. 56(1). *See* also Inland Revenue Malta, Non-Resident Tax Rates, 2009, [http://www.ird.gov.mt/services/taxrates\\_nr.aspx](http://www.ird.gov.mt/services/taxrates_nr.aspx); Inland Revenue Malta, Resident Tax Rates, 2009, <http://www.ird.gov.mt/services/taxrates.aspx>; IBFD Malta Country Analysis B.1.10.

<sup>22</sup> IBFD Malta Country Analysis B.1.8.

<sup>23</sup> Income Tax Act, art. 5.

<sup>24</sup> *Ibid.*

<sup>25</sup> Income Tax Act, art. 5(1)(a)(i); IBFD Malta Country Analysis A.2.5.

<sup>26</sup> IBFD Malta Country Analysis A.2.12.

<sup>27</sup> IBFD Malta Country Analysis A.13.

<sup>28</sup> Income Tax Act, art. 12(1)(u).

company and that investment is held for an uninterrupted period of at least 183 days.<sup>29</sup> Dividends derived from a participating holding of a foreign subsidiary acquired after January 1, 2007 qualify for the exemption if the company in which the participation is held satisfies any of the following conditions: (1) it is a European Union (“EU”) resident; (2) it is subject to tax in its country of residence of at least ten percent; or, (3) it does not derive more than 50 percent of its income from passive interest or royalties.<sup>30</sup> If none of the above conditions is satisfied, both of the following two conditions must be fulfilled: the investment in the non-Maltese resident company is not a portfolio investment in the hands of the Maltese company; and, the non-Maltese resident company or its passive interest or royalties income is subject to tax in its country of residence tax of at least five percent.<sup>31</sup>

There is generally no withholding tax on the payment of dividends, interest, or royalties by one Malta resident company to another Malta resident company.<sup>32</sup>

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<sup>29</sup> Income Tax Act, art. 2.

<sup>30</sup> Income Tax Act., art. 12(1)(u)(i).

<sup>31</sup> Income Tax Act, art. 12(1)(u)(ii); E&Y p. 632.

<sup>32</sup> IBFD Malta Country Analysis A.2.12.

## B. International Aspects of Taxation in Malta

### Individuals

Individuals who are both ordinarily resident and domiciled in Malta are subject to income tax in Malta on their worldwide income and certain capital gains.<sup>33</sup> Individuals are resident in Malta if they permanently reside in Malta, allowing for temporary absences deemed reasonable by the Maltese tax commissioner and which are not inconsistent with the individuals' claim of Maltese residence.<sup>34</sup> Individuals who are not of Maltese origin and who do not intend to permanently establish themselves in Malta are not considered to be domiciled in Malta for tax purposes.<sup>35</sup>

Individuals who are either not ordinarily resident in Malta or are not domiciled in Malta are generally subject to Maltese income tax on their income and capital gains arising in Malta and on their foreign income (but not foreign capital gains) that is received in Malta.<sup>36</sup> Non-residents are exempt from tax on any capital gains derived from the disposal of shares in a Maltese resident company the assets of which do not consist wholly or principally of immovable property situated in Malta.<sup>37</sup> Non-resident individuals are subject to different tax rates than those generally applicable to resident individuals. Non-resident rates extend from zero percent for taxable income up to €700 (\$983) to 35 percent for taxable income exceeding €7,800 (\$10,954).<sup>38</sup> As Malta generally provides a full imputation credit for residents and non-residents alike, no withholding tax is imposed on dividends received from companies that are tax resident in Malta. Furthermore, distributions from "untaxed income" to non-resident shareholders are also not taxable.<sup>39</sup> No withholding taxes apply to interest and royalty payments unless the interest or royalties are effectively connected with a permanent establishment situated in Malta. In such cases, the withholding tax would be 25 percent if paid to an individual. Such withholding taxes are not final in that any withholding taxes paid are credit against the nonresident's tax liability in respect of the income, and any excess withholding tax paid is refunded.<sup>40</sup>

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<sup>33</sup> Income Tax Act, art. 4.

<sup>34</sup> Income Tax Act, art. 2.

<sup>35</sup> IBFD Malta Country Analysis B.1.2.1.; IBFD Malta Country Analysis B.1.1.4.

<sup>36</sup> Income Tax Act, art. 4(1)(g); IBFD Malta Country Analysis B.1.2.1.

<sup>37</sup> Income Tax Act, art. 12(a)(c).

<sup>38</sup> Income Tax Act, art. 56; *see also* Inland Revenue Malta, Non-Resident Tax Rates, 2009, [http://www.ird.gov.mt/services/taxrates\\_nr.aspx](http://www.ird.gov.mt/services/taxrates_nr.aspx).

<sup>39</sup> Income Tax Act, art. 66; IBFD Malta Country Analysis B.7.3.1.

<sup>40</sup> IBFD Malta Country Analysis B.7.3.2.

## **Corporations**

Companies that are both ordinarily resident and domiciled in Malta are liable to tax in Malta on a worldwide basis.<sup>41</sup> A company is a resident of Malta if either (1) it is incorporated in Malta, or (2) the management and control of the business of the corporation is exercised in Malta. A corporation is domiciled in Malta if it is incorporated in Malta.<sup>42</sup>

Nonresident companies are taxed in Malta on income arising in Malta or derived from Malta at the normal flat rate of 35 percent.<sup>43</sup> As a general rule, capital gains arising in Malta to a person not resident in Malta are taxed in Malta.<sup>44</sup> The gain is determined in accordance with the general rules, and is taxed in the same manner as income and at the rate applicable to resident companies. However, any gains or profits derived by a non-resident company are exempt from tax in Malta if they are realized on a disposition of the following: (1) units in a collective investment scheme; (2) units and like instruments relating to the “linked long-term business of insurance” (that is, life insurance contracts under which benefits are wholly or partially determined by reference to the value of, or income from property); and (3) shares or securities in a company which is not a company the assets of which consist wholly or principally of immovable property situated in Malta.<sup>45</sup> The exemption does not apply where the recipient company is owned and controlled by, directly or indirectly, or acts on behalf of, a person who is ordinarily resident and domiciled in Malta.<sup>46</sup>

If a non-resident person is engaged in a trade or business in Malta through a permanent establishment situated in Malta, interest and royalties paid to the non-resident are taxed as business income in the normal manner, provided that the claim or right in respect of which the payment is made is effectively connected with the permanent establishment.<sup>47</sup> Dividends, interest, and royalty payments to foreign companies are not subject to withholding tax under Maltese domestic law.<sup>48</sup>

## **Relief from double taxation**

In the absence of a treaty, relief from double taxation of foreign-source income may be provided in the form of a tax credit with per-country and income-based limitations.<sup>49</sup> The

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<sup>41</sup> IBFD Malta Country Analysis B.8.2.1.1.

<sup>42</sup> IBFD Malta Country Analysis A.8.2.

<sup>43</sup> Income Tax Act, art. 56(6); IBFD Malta Country Analysis A.8.4.2.

<sup>44</sup> Income Tax Act, art. 5.

<sup>45</sup> Income Tax Act, art. 12(1)(c)(ii).

<sup>46</sup> Income Tax Act, art. 12(1); IBFD Malta Country Analysis A.8.4.2.3.

<sup>47</sup> Income Tax Act, arts. 4(1)(e), 12(1)(c); IBFD Malta Country Analysis A.8.4.2.4.

<sup>48</sup> IBFD Malta Country Analysis A.8.5.2.

<sup>49</sup> Income Tax Act, Part X, arts. 79-88.

taxpayer is required to determine the maximum tax credit available to him with regard to a given item of income. The underlying principle is that the credit is the lesser of two amounts: (1) the Maltese tax effectively chargeable on the given income and (2) the foreign tax imposed on the item of foreign income.<sup>50</sup> To the extent that the foreign tax exceeds the Maltese tax chargeable on the foreign income, the excess cannot be claimed as a credit and cannot be deducted as an expense.<sup>51</sup>

Relief is also extended to dividends received by a shareholder resident in Malta for the foreign tax imposed on the profits out of which the dividend was distributed,<sup>52</sup> generally referred to as underlying relief. Multi-tier underlying relief applies to any qualifying tax which has been imposed at any level in the chain, provided that the Maltese company holds, directly or indirectly, not less than 10 percent of the voting power in the entity at the level of which the tax has been imposed.<sup>53</sup> The underlying relief is subject to the per-country and income based limitations on an aggregated basis.<sup>54</sup>

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<sup>50</sup> Income Tax Act, art. 81.

<sup>51</sup> Income Tax Act, art. 83.

<sup>52</sup> Income Tax Act, art. 82.

<sup>53</sup> Income Tax Act, art. 82.

<sup>54</sup> IBFD Malta Country Analysis A.8.3.3.

## C. Other Taxes

### **Inheritance, gift and wealth taxes**

Malta imposes no inheritance, gift, or wealth taxes.<sup>55</sup>

### **Social security**

Social security contributions are levied at the rate of 10 percent of the weekly basic wages up to a maximum contribution of €32.33 (\$45) per week.<sup>56</sup> For self-employed individuals, the contribution rate is 15 percent of the net income received from a trade, business, or profession during the previous year. The weekly contributions range from a minimum of €1.29 (\$30) to a maximum of €48.50 (\$68).<sup>57</sup> Social security contributions are not deductible for income tax purposes.<sup>58</sup>

### **Other indirect taxes**

Malta imposes a value added tax (“VAT”) on the consumption of goods and services.<sup>59</sup> Although the VAT is levied at each stage of the economic chain, it is ultimately borne by the final customer. The VAT due on any sale is a percentage of the sale price less all the tax paid at the preceding stages. The standard VAT rate is 18 percent.<sup>60</sup> The rate is reduced for certain products and services and in some cases is zero.<sup>61</sup>

An initial registration fee applies upon the incorporation of a company. The registration fee is calculated on the basis of the amount of the authorized share capital of the company.

Stamp duty is levied on the purchase of shares, business assets, and immovable property.<sup>62</sup> The stamp duty is imposed at the rate of five percent or two percent on the amount of consideration received from a transfer of, respectively, immovable property or marketable

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<sup>55</sup> IBFD Malta Country Analysis B.6.; IBFD Malta Country Analysis B.5.1.

<sup>56</sup> Social Security Act, c. 318, sch. 10, Part I, available at [http://docs.justice.gov.mt/lom/legislation/english/leg/vol\\_7/chapt318.pdf](http://docs.justice.gov.mt/lom/legislation/english/leg/vol_7/chapt318.pdf) [hereinafter Social Security Act].

<sup>57</sup> Social Security Act, sch. 10, Part II.

<sup>58</sup> IBFD Malta Country Analysis B.3.

<sup>59</sup> Value Added Tax Act, art. 4, c. 406, available at [http://docs.justice.gov.mt/lom/legislation/english/leg/vol\\_12/chapt406.pdf](http://docs.justice.gov.mt/lom/legislation/english/leg/vol_12/chapt406.pdf) [hereinafter Value Added Tax Act].

<sup>60</sup> Value Added Tax Act, art. 19(1).

<sup>61</sup> IBFD Malta Country Analysis A.11.6.

<sup>62</sup> Duty on Documents and Transfers Act, c. 364, art. 3, available at [http://docs.justice.gov.mt/lom/legislation/english/leg/vol\\_10/chapt364.pdf](http://docs.justice.gov.mt/lom/legislation/english/leg/vol_10/chapt364.pdf) [hereinafter Duty on Documents and Transfers Act].

securities (or, if greater, on the value of the property transferred).<sup>63</sup> The five-percent rate also applies to a transfer of marketable securities in a company if 75 percent or more of the value that company's assets (excluding all current assets other than immovable property) is comprised of immovable property.<sup>64</sup>

An environmental tax is imposed at fixed rates on products, such as plastic, metal and glass containers, batteries, and household appliances that result in waste. The tax is payable by traders importing or manufacturing taxable goods.<sup>65</sup>

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<sup>63</sup> Duty on Documents and Transfers Act, art. 32.

<sup>64</sup> Duty on Documents and Transfers Act, art. 42(2); IBFD Malta Country Analysis A.12.1; IBFD Malta Country Analysis A.12.3.

<sup>65</sup> IBFD Malta Country Analysis A.12.6.

## **IV. THE UNITED STATES AND MALTA: CROSS-BORDER INVESTMENT AND TRADE**

### **A. Introduction**

A principal rationale for negotiating tax treaties is to improve the business climate for businesses in one country that aspire to sell goods and services to customers in the other country and to improve the investment climate for investors in one country who aspire to own assets in the other country. Clarifying the application of the two nations' income tax laws makes more certain the tax burden that arises from different transactions, but may also increase or decrease that burden. If there is, or where there is the potential to be, substantial cross-border trade or investment, changes in the tax structure applicable to the income from trade and investment have the potential to alter future flows of trade and investment. Therefore, in reviewing the proposed treaty, it may be beneficial to examine the cross-border trade and investment between the United States and Malta. Whether measured by trade in goods or services, or by direct and non-direct cross-border investment, the United States and Malta engage in modest cross-border activity at present. The income from cross-border trade and investment generally is subject to income tax in either the United States or Malta, and in many cases the income is subject both to gross basis withholding taxes in the source country and net basis income tax in the residence country (before possible elimination of one country's tax under the proposed treaty).

## **B. Overview of International Transactions Between the United States and Malta**

### **Cross-border trade**

The current account consists of three primary components: trade in goods; trade in services; and payment of income on assets invested abroad. While detail regarding the balance of payments between the United States and Malta is not publicly available, one can document the value of trade between the United States and Malta. In 2008, the United States exported \$253 million of merchandise to Malta and imported \$279 million in merchandise from Malta. This made Malta the United States' 119th largest merchandise export destination and the 104th largest source of imported merchandise.<sup>66</sup>

### **Cross-border investment**

Income from foreign assets is categorized as income from “direct investments” and income from “non-direct investments.” Direct investment constitutes assets over which the owner has direct control. The Department of Commerce defines an investment as direct when a single person owns or controls, directly or indirectly, at least 10 percent of the voting securities of a corporate enterprise or the equivalent interest in an unincorporated business. Often the income that crosses borders from direct investments is in the form of dividends from a subsidiary to a parent corporation, although interest on loans between such related corporations is another source of income from a direct investment. In non-direct investments the investor generally does not have control over the assets that underlie the financial claims. Non-direct investments consist mostly of holdings of corporate equities and corporate and government bonds, generally referred to as “portfolio investments,” and bank deposits and loans. Hence, the income from non-direct investments generally is interest or dividends.

Maltese efforts to attract foreign direct investment have focused on the value-added manufacturing and information services sectors, with Malta advertising itself on the basis of an advanced infrastructure and a trained population (like the rest of the EU), and strong linkages to both the EU and North Africa. In particular, Malta's chief exports are semiconductors, and, according the European Council of American Chambers of Commerce, “the predominant sectors on which Malta's current industrial strategy is based are the healthcare and pharmaceutical sectors, high-precision engineering, ICT [information and communication technologies], including electronics, knowledge-based services, and logistics-based services.”<sup>67</sup> In addition, the tourism industry plays a significant role in the Maltese economy, and foreign hotel chains make up a key component of that sector.

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<sup>66</sup> Bureau of Economic Analysis, U.S. Department of Commerce, “U.S. International Trade in Goods and Services, Annual Revision for 2008,” June 10, 2009.

<sup>67</sup> European Council of American Chambers of Commerce, [http://www.european-american-business.com/2009/3\\_30.php](http://www.european-american-business.com/2009/3_30.php), November 2009.

According to the State Department, “The United States has been supportive of Malta’s campaign to attract private investment, and several U.S. firms are operating in Malta. These include major hotels, manufacturing and repair facilities, and some offices servicing local and regional operations.”<sup>68</sup> The American Chamber of Commerce in Malta reports at least 10 US firms have operations in Malta, employing over 2,100 Maltese persons in total.<sup>69</sup>

Commensurate with the size of the Maltese economy<sup>70</sup> in comparison to other European countries, the value of cross-border investment between the United States and Malta is smaller than that of cross-border investment between the United States and other European countries. In 2008, U.S. persons held direct investments in Malta valued at \$417 million on a historic cost basis, and Maltese persons held direct investments in the United States valued at \$2 million.<sup>71</sup> The value of U.S. direct investment in Malta has grown steadily since 2001. Before that year, the value of U.S. direct investment in Malta never surpassed \$30 million. Before 2008, the value of Maltese direct investment in the U.S. was generally negligible. U.S. direct investments in Malta produced approximately \$40 million in income to U.S. persons in 2008. Maltese direct investments in the United States produced less than \$500,000 of income to Maltese persons in 2008.

The data presented above do not report the amount of U.S. or Maltese portfolio investments or holdings of stocks and bonds (including holdings of U.S. government securities). The Bureau of Economic Analysis generally reports portfolio holdings by country only for the several largest portfolio investment countries.

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<sup>68</sup> U.S. Department of State, <http://www.state.gov/r/pa/ei/bgn/5382.htm>, October 2009.

<sup>69</sup> American Chamber of Commerce in Malta, <http://www.amcham-malta.org/us%20companies%20in%20malta.htm>, November 2009.

<sup>70</sup> The Maltese GDP was \$8.3 billion (U.S. dollars) in 2008. CIA World Factbook, <https://www.cia.gov/library/publications/the-world-factbook/geos/mt.html>, October 2009.

<sup>71</sup> Bureau of Economic Analysis, U.S. Department of Commerce, “International Economic Accounts,” [www.bea.gov/international](http://www.bea.gov/international), October 2009.

The Bureau of Economic Analysis prepares detailed estimates of direct investment by country and industry on an historical cost basis only. Thus, the estimates reported reflect price levels of earlier periods. For estimates of aggregate direct investment the Bureau of Economic Analysis also produces current-cost and market value estimates.

### **C. Analyzing the Economic Effects of Income Tax Treaties**

Tax treaties often change both the amount and timing of income taxes and the country (source or residence) that has priority to impose such taxes. If the tax treaty changes increase the after-tax return to cross-border trade and investment, or to particular forms of trade or investment, in the long run there could be significant economic effects. Generally, to the extent a treaty reduces barriers to capital and labor mobility, more efficient use of resources results and economic growth in both countries is enhanced, although there may be negative transitional effects occurring in specific industries or geographic regions. On the other hand, tax treaties may also lead to tax base erosion if they create new opportunities for tax arbitrage. Tax treaties also often increase and improve information sharing between tax authorities. Improvements in information sharing and the limitation of benefits provision should reduce the potential for outright evasion of U.S. and Maltese income tax liabilities.

Generally, a treaty-based reduction in withholding rates directly reduces U.S. tax collections in the near term on payments from the United States to Malta, but increases U.S. tax collections on payments from foreign persons to the United States because of the reduction in foreign taxes that are potentially creditable against the U.S. income tax. To the extent that the withholding rate reduction encourages more income flows between the treaty parties, this initial dampening of collections on payments to foreign persons and related decrease in foreign tax credits begins to reverse. The proposed treaty's reductions in dividend withholding rates will reduce U.S. withholding tax collections on dividend payments from the United States to Malta. Over the longer term, the withholding tax rate changes coupled with other changes in the proposed treaty are likely to cause small revenue increases in later years as capital flows increase and from improved allocation of capital.

However, this simple analysis is incomplete. A complete analysis of a withholding change, or any other provision of a treaty, would account for both tax and nontax related factors, such as portfolio capital needs in the affected countries, and the corresponding relation between current and financial accounts. The potential for future growth in each country is also an important determinant of cross-border investment decisions. In sum, even in the short run, the larger macroeconomic outlook, compared to treaty modifications, is likely to be a more important determinant of future cross-border income and investment flows and the related tax collections.

## V. EXPLANATION OF PROPOSED TREATY

### Article 1. General Scope

#### In general

The general scope article describes the persons who may claim the benefits of the proposed treaty. It also includes a “saving clause” provision similar to provisions found in most U.S. income tax treaties, and a special rule for fiscally transparent entities similar to that found in the U.S. Model treaty.

#### Who may claim treaty benefits

Paragraph 1 provides that the proposed treaty generally applies only to residents of the United States and to residents of Malta. The determination of whether a person is a resident of the United States or Malta is made under Article 4 (Resident) of the treaty. Certain provisions are applicable to persons who may not be residents of either treaty country. For example, paragraph 1 of Article 24 (Non-Discrimination) applies to nationals of the treaty countries. Under Article 26 (Exchange of Information and Administrative Assistance), information may be exchanged with respect to residents of third states.

#### Relationship to U.S. law and other agreements

Paragraph 2 states the generally accepted relationship both between the treaty and domestic law and between the treaty and other agreements to which the United States and Malta are parties. It provides that the treaty generally does not restrict any benefit accorded by internal law or by any other agreement between the United States and Malta. This means that the proposed treaty does not apply to increase the tax burden of a resident of either the United States or Malta beyond that determined under internal law.

Under the principles of paragraph 2, a taxpayer’s U.S. tax liability need not be determined under the proposed treaty if the Code would produce a more favorable result. The Technical Explanation<sup>72</sup> states, however, that a taxpayer may not choose among the provisions of the Code and the proposed treaty in an inconsistent manner in order to minimize U.S. tax. The Technical Explanation includes an example illustrating this rule. In the example, a resident of Malta has three separate businesses in the United States. One is a profitable permanent establishment and the other two are trades or businesses that would earn taxable income (or loss) under the Code but that do not meet the permanent establishment threshold tests of the proposed treaty. One is profitable and the other incurs a loss. Under the proposed treaty, the income of the permanent establishment is taxable in the United States, and both the income and loss of the other two businesses are ignored. Under the Code, all three would be subject to tax, but the loss would offset the income of the two profitable ventures. The Technical Explanation states that

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<sup>72</sup> Department of the Treasury Technical Explanation of the Convention Between the Government of the United States of America and the Government of Malta for the Avoidance of Double Taxation and the Prevention of Fiscal Evasion with Respect to Taxes on Income (hereinafter referred to as the “Technical Explanation”).

the taxpayer may not invoke the proposed treaty to exclude the income of the profitable trade or business and invoke the Code to claim the loss of the loss trade or business against the income of the permanent establishment. However, if the taxpayer invokes the Code for the taxation of all three ventures, he would not be precluded from invoking the proposed treaty with respect, for example, to any dividend income he may receive from the United States that is not effectively connected with any of his business activities in the United States.

Paragraph 3 of the proposed treaty specifically relates to non-discrimination obligations of the treaty countries under the General Agreement on Trade in Services (the “GATS”). The provisions of paragraph 3 are an exception to the rule provided in paragraph 2 under which the proposed treaty may not restrict any benefit accorded by any other agreement between the United States and Malta.

Paragraph 3 provides that, unless the competent authorities determine that a taxation measure is not within the scope of Article 24 (Non-Discrimination) of the proposed treaty, the national treatment obligations of the GATS do not apply with respect to that measure. Further, for purposes of paragraph 3 of Article 22 (Consultation) of the GATS, any question arising as to the interpretation or application of the proposed treaty, including whether a taxation measure is within the scope of the proposed treaty, is determined exclusively in accordance with the provisions of Article 25 (Mutual Agreement Procedure) of the proposed treaty. According to the Technical Explanation, the result under paragraph 3 of the proposed treaty is that paragraph 3 of Article 22 (Consultation) of the GATS may not be used to bring a dispute before the World Trade Organization unless the competent authorities of both treaty countries have determined that the relevant taxation measure is not within the scope of Article 24 (Non-Discrimination) of the proposed treaty.

Paragraph 3 provides that the term “measure” means a law, regulation, rule, procedure, decision, administrative action, or any similar provision or action.

#### Saving clause

Like all U.S. income tax treaties and the U.S. Model treaty, the proposed treaty includes a “saving clause” in paragraph 4. Under this clause, with specific exceptions described below, the proposed treaty does not affect the taxation by either treaty country of its residents or its citizens. By reason of this saving clause, subject to the exceptions described below, either treaty country may continue to tax its residents and its citizens who are residents of the other treaty country as if the treaty were not in force.

Paragraph 4 generally also allows the United States to tax, in accordance with the laws of either treaty country, a former citizen or former long-term resident for a period of ten years following the loss of citizenship or long-term resident status.

The United States defines “long-term resident” as an individual (other than a U.S. citizen) who was a lawful permanent resident of the United States in at least eight of the 15 taxable years ending with the taxable year in which the individual ceased to be a long-term resident. An individual is not treated as a lawful permanent resident for any taxable year in which the individual is treated as a resident of Malta under the proposed treaty, or as a resident of any

country other than the United States under the provisions of any other tax treaty of the United States, and, in either case, the individual does not waive the benefits of the relevant treaty.

Section 877 of the Code provides special rules for the imposition of tax on certain individuals who expatriate (that is, U.S. citizens and long-term residents who relinquish their citizenship or cease to be long-term residents) before June 17, 2008. Under section 877, those taxpayers are subject to U.S. tax for a period of ten years on both their U.S.-source income (including deemed U.S.-source income), and their foreign-source income that is effectively connected with the conduct of a trade or business within the United States.

For any individual who expatriates on or after June 17, 2008, the Heroes Earnings Assistance and Relief Tax Act of 2008,<sup>73</sup> replaces section 877 with the mark-to-market regime provided in section 877A. In general, taxpayers who expatriate are treated as having sold all of their property on the day before the expatriation date for its fair market value.<sup>74</sup> However, at a taxpayer's election, the time for payment of additional tax attributable to any gain so recognized (but not realized) may be deferred until the taxpayer actually disposes of property deemed sold.<sup>75</sup> This election may be made only if the taxpayer irrevocably waives any right under any U.S. treaty that would preclude assessment or collection of the tax deferred by reason of the election.<sup>76</sup>

The proposed treaty's ten-year grant of taxing jurisdiction to the treaty country from which an individual has expatriated corresponds with the ten-year rule in section 877. However, for any individual who expatriates on or after June 17, 2008, section 877A requires the payment of tax after the ten-year period if that individual elects to defer payment of the section 877A tax and sells property after the ten-year period. In this circumstance, the individual will have been required, as a condition of making the election under section 877A, to waive the benefits of the proposed treaty's ten-year rule.

Paragraph 5 contains exceptions to the saving clause. The referenced provisions are intended to provide benefits to citizens and residents even if such benefits do not exist under internal law. Paragraph 5 thus preserves these benefits for citizens and residents of the treaty countries. Exceptions to the saving clause are provided for the following benefits conferred by the proposed treaty: the allowance of correlative adjustments when the profits of an associated enterprise are adjusted by the other country (Article 9, paragraph 2); exemption from source or resident state taxation for certain pension distributions, social security payments and child support (Article 17, paragraphs 1 b), 2 and 5); exemption for certain investment income of pension funds located in the other state (Article 18); relief from double taxation through the provision of a foreign tax credit or an exemption for income earned in the other state (Article

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<sup>73</sup> Pub. L. No. 110-245, sec. 301 (June 17, 2008).

<sup>74</sup> Sec. 877A(a)(1).

<sup>75</sup> Sec. 877A(b)(1).

<sup>76</sup> Sec. 877A(b)(5).

23); protection of residents and nationals of one state from discriminatory tax treatment in the other country (Article 24); and benefits under the mutual agreement procedures of the treaty (Article 25).

In addition, the saving clause does not apply to certain benefits conferred by the United States or Malta upon individuals who are neither citizens of, nor have been admitted for permanent residence in, the United States or Malta, respectively. Under this set of exceptions to the saving clause, the specified treaty benefits are available to, for example, a citizen of Malta who spends enough time in the United States to be taxed as a U.S. resident but who has not acquired U.S. permanent residence status (that is, does not hold a “green card”). The benefits that are covered under this set of exceptions are exemptions from host country taxation for certain income for government service (Article 19), certain income received by visiting students and trainees (Article 20), and certain income received by members of diplomatic missions and consular posts (Article 27).

#### Fiscally transparent entities

Paragraph 6 sets forth a special rule for fiscally transparent entities (such as, partnerships). Under this rule, income derived through an entity that is fiscally transparent under the laws of either treaty country is considered to be the income of a resident of one of the treaty countries only to the extent that the income is treated, for purposes of that country’s tax laws, as the income of a resident. As an example, the Technical Explanation states that if a corporation resident in Malta pays interest to an entity that is treated as fiscally transparent for U.S. tax purposes, the interest is considered derived by a resident of the United States only to the extent that U.S. tax laws treat one or more U.S. residents (whose status as U.S. residents is determined under U.S. tax laws) as deriving the interest for U.S. tax purposes.

The Technical Explanation states that the result in the above example would be the same if the entity were viewed differently under the laws of Malta (that is, as not fiscally transparent). The Technical Explanation also states that this result follows regardless of whether the entity is organized in the United States, Malta, or a third country. Finally, the Technical Explanation states that these results follow regardless of whether the entity is disregarded as a separate entity under the laws of one jurisdiction but not the other, such as a single owner entity that is viewed as a branch for U.S. tax purposes and as a corporation for tax purposes in Malta.

As an example, the Technical Explanation states that income from U.S. sources received by an entity organized under the laws of the United States, which is treated for Maltese tax purposes as a corporation and is owned by a shareholder who is a resident of Malta for its tax purposes, is not considered derived by the shareholder of that corporation even if, under the tax laws of the United States, the entity is treated as fiscally transparent. Rather, for purposes of the proposed treaty, the income is treated as derived by a U.S. entity.

Paragraph 6 is not an exception to the saving clause in paragraph 4. Accordingly, paragraph 6 does not prevent a treaty country from taxing an entity that is treated as a resident of that treaty country under its tax laws. For example, if a U.S. corporation has Maltese shareholders, the United States will tax the corporation on its worldwide income on a net basis, without regard to whether Malta views the corporation as fiscally transparent. Similarly, if an

entity organized in Malta and owned by U.S. residents is treated as a corporation under the tax laws of Malta, Malta may tax the entity on its worldwide income on a net basis, even if the United States views the entity as fiscally transparent.

## **Article 2. Taxes Covered**

The proposed treaty applies to all taxes on income, including gains, irrespective of the manner in which they are levied. Except with respect to the benefits provided by Article 24 (Non-Discrimination), state and local taxes are not covered by the proposed treaty. The proposed treaty covers taxes on total income or any part of income and includes tax on gains derived from the alienation of property. According to the Technical Explanation, the proposed treaty does not apply to social security charges or any other charges where there is a direct connection between the levy and individual benefits. Nor does it apply to property taxes, except with respect to Article 24 (Non-Discrimination).

In the case of Malta, the proposed treaty applies to income tax. In the case of the United States, the proposed treaty applies to the Federal income taxes imposed by the Code, together with excise taxes imposed with respect to private foundations. Social security and unemployment taxes are specifically excluded from coverage.

The proposed treaty also applies to any taxes that are identical or substantially similar to the taxes described in the preceding paragraph and that are imposed after the signing of the proposed treaty in addition to or in place of existing taxes. This provision generally is found in U.S. income tax treaties. The proposed treaty obligates the competent authority of each country to notify the competent authority of the other country of any changes in its internal taxation or other laws that significantly affect a country's obligation under the proposed treaty.

## **Article 3. General Definitions**

This article provides definitions of a number of terms for purposes of the proposed treaty. Certain of the standard definitions found in most U.S. income tax treaties are included in the article.

The term "person" includes an individual, an estate, a trust, a partnership, a company, and any other body of persons.

The term "company" means a body corporate or an entity treated as a body corporate for tax purposes in the country where it is organized.

The terms "enterprise of a Contracting State" and "enterprise of the other Contracting State" mean, respectively, an enterprise carried on by a resident of a treaty country and an enterprise carried on by a resident of the other treaty country. The Technical Explanation clarifies that an enterprise of a treaty country need not be carried on in that country. These terms also encompass an enterprise conducted through an entity (such as a partnership) that is treated as fiscally transparent in the Contracting State where the entity's owner is resident

The term "enterprise" applies to the carrying on of any business. The term "business" is not defined, but the proposed treaty provides that the term includes the performance of

professional services and other activities of an independent character. According to the Technical Explanation, these definitions are intended to clarify that income from the performance of professional services or other activities of an independent character is covered by Article 7 (Business Profits) and not Article 21 (Other Income).

The term “international traffic” means any transport by a ship or aircraft, except when such transport is solely between places within a treaty country. This definition is applicable principally in the context of Article 8 (Shipping and Air Transport).

The article designates the “competent authorities” for Malta and the United States. The U.S. competent authority is the Secretary of the Treasury or his delegate. According to the Technical Explanation, the Secretary of the Treasury has delegated the competent authority function to the Commissioner of Internal Revenue, who in turn has delegated the authority to the Deputy Commissioner (International) LMSB. In the case of Malta, the competent authority is the Minister responsible for finance or an authorized representative.

The article sets forth the geographical scope of the proposed treaty with respect to United States and Malta. The term “United States”, it encompasses the United States of America, including the States and the District of Columbia, and the territorial sea thereof. It also includes the sea bed and subsoil of the submarine areas adjacent to the territorial sea over which the United States exercises sovereign rights in accordance with international law. The term does not include Puerto Rico, the Virgin Islands, Guam, or any other U.S. possession or territory. “Malta” includes the island of Malta, the Island of Gozo and the other islands of the Maltese archipelago including the territorial sea thereof as well as any area of the sea-bed, it’s sub-soil and the superjacent water column adjacent to the territorial waters, where the Republic of Malta exercises sovereign rights, jurisdiction or control in accordance with international law and its national law, including its legislation relating to the exploration of the Continental Shelf and exploitation of its natural resources.

The term “national,” as it relates to the United States and to Malta, means (1) an individual who is a citizen or national of that country, and (2) any legal person, partnership, or association deriving its status, as such, from the laws of that country. This term is relevant for purposes of Articles 19 (Government Service) and 24 (Non-Discrimination).

The term “pension fund” means any person established in a treaty country that, in the case of the United States, is generally exempt from income taxation, and in the case of Malta, is a licensed fund or scheme subject to tax only on income derived from immovable property situated in Malta, and that is operated principally to provide pension or retirement benefits or to earn income for the benefit of one or more such arrangements. The Technical Explanation provides that, in the case of the United States, the term “pension fund” includes the following: a trust providing pension or retirement benefits under a section 401(a) qualified pension plan, profit sharing or stock bonus plan; a qualified annuity plan under section 403(a); a trust providing pension or retirement benefits under a section 403(b) plan; a trust that is an individual retirement account under section 408, a Roth individual retirement account under section 408A, or a simple retirement account under section 408(p); a trust providing pension or retirement benefits under a simplified employee pension plan under section 408(k); a trust described in

section 457(g) providing pension or retirement benefits under a section 457(b) plan; and the Thrift Savings Fund (section 7701(j)).

Terms that are not defined in the proposed treaty are addressed under paragraph 2 of Article 3. Paragraph 2 provides that in the application of the proposed treaty, any term not defined in the proposed treaty will have the meaning that it has under the law of the country whose tax is being applied, unless the context requires otherwise or the competent authorities have agreed on a different meaning pursuant to Article 25 (Mutual Agreement Procedure). If the term is defined under both the tax and non-tax laws of a treaty country, the definition in the tax law prevails.

#### **Article 4. Resident**

The assignment of a country of residence is important because the benefits of the proposed treaty generally are available only to a resident of one of the treaty countries as that term is defined in the proposed treaty. Issues arising because of dual residency, including situations of double taxation, may be avoided by the assignment of one treaty country as the country of residence when under the internal laws of the treaty countries a person is a resident of both countries.

##### Internal taxation rules

##### United States

Under U.S. law, the residence of an individual is important because a resident alien, like a U.S. citizen, is taxed on his or her worldwide income, while a nonresident alien is taxed only on certain U.S.-source income and on income that is effectively connected with a U.S. trade or business. An individual who spends sufficient time in the United States in any year or over a three-year period generally is treated as a U.S. resident. A permanent resident for immigration purposes (that is, a “green card” holder) also is treated as a U.S. resident.

Under U.S. law, a company is taxed on its worldwide income if it is a “domestic corporation.” A domestic corporation is one that is created or organized in the United States or under the laws of the United States, a State, or the District of Columbia.

##### Malta

Individuals are resident in Malta if they permanently reside in Malta, allowing for temporary absences deemed reasonable by the Maltese tax commissioner and which are not inconsistent with the individuals’ claim of Maltese residence. Individuals who are not of Maltese origin and who do not intend to permanently establish themselves in Malta are not considered to be domiciled in Malta for tax purposes. A company is considered to be resident in Malta if either (1) it is incorporated in Malta, or (2) the management and control of the business of the corporation is exercised in Malta. A corporation is domiciled in Malta if it is incorporated in Malta.

### Proposed treaty rules

Article 4 provides rules to determine whether a person is a resident of the United States or Malta under the proposed treaty. The rules are consistent with the rules of the U.S. Model treaty.

The proposed treaty generally defines “resident of a Contracting State” to mean any person who, under the laws of that State, is liable to tax in that State by reason of the person’s domicile, residence, citizenship, place of management, place of incorporation, or any other criterion of a similar nature. The Technical Explanation notes that this definition generally incorporates the definitions of residence in the tax laws of the United States and Malta. Residents of the United States under this definition include aliens who are considered U.S. residents under the substantial presence and green card tests of the Code.

According to the Technical Explanation, certain entities such as U.S. regulated investment companies (“RICs”) and real estate investment trusts (“REITs”) are residents of the United States for purposes of the proposed treaty even though those entities are rarely required to pay tax. The Technical Explanation notes that these entities are taxable to the extent they do not satisfy certain requirements for distributing their profits currently and, consequently, that they may be considered “liable to tax” in the United States.

The term “resident of a Contracting State” does not include any person who is liable to tax in that State only in respect of income from sources in that State or of profits attributable to a permanent establishment in that State. Consequently, according to the Technical Explanation, a consular official of Malta posted in the United States is not a resident of the United States because under the Code the official may be taxed by the United States on his U.S.-source investment income but not on his non-U.S. source income. Similarly, an enterprise of Malta with a permanent establishment in the United States does not become a resident of the United States as a result of its U.S. permanent establishment: The enterprise generally is liable to tax by the United States only on income attributable to its U.S. permanent establishment, not on its worldwide income, as it would be if it were a resident.

The proposed treaty includes in the definition of “resident of a Contracting State” the government of that State and any political subdivision or local authority of that State.

The proposed treaty also treats as a resident of a treaty country a pension fund established in that country and an organization that is established and maintained in that country exclusively for religious, charitable, scientific, artistic, cultural, or educational purposes even though all or part of the income or gains of the pension fund or the latter organization may be exempt from tax under the internal law of that country. The diplomatic notes provide that this rule encompasses organizations exempt from tax under Maltese law as philanthropic institutions, philharmonic societies, or sports clubs.

The proposed treaty provides a series of tie-breaker rules to determine the residence of an individual who, under the basic residence definition, would be considered to be a resident of both countries. These tie-breaker rules are to be applied in the order in which they are set forth in the proposed treaty and described below. An individual is deemed to be a resident of the country in

which he or she has a permanent home available. If the individual has a permanent home in both treaty countries, the individual's residence is deemed to be the country with which his or her personal and economic relations are closer (that is, the individual's "center of vital interests"). If it cannot be determined in which country the individual has his or her center of vital interests, or if the individual does not have a permanent home available in either treaty country, the individual is deemed to be a resident of the country in which he or she has a habitual abode. If the individual has a habitual abode in both countries or in neither country, the individual is deemed to be a resident of the country of which he or she is a national. If the individual is a national of both countries or of neither country, the competent authorities of the countries will settle the question of residence by mutual agreement.

The proposed treaty also provides a tie-breaker rule for dual-resident companies. If, under the general residence rules described above, a company is a resident of both the United States and Malta – because, for example, the company is incorporated in the United States and is managed and controlled in Malta – the company is treated as a resident of the country under the laws of which it is incorporated (in this example, the United States). If the incorporation test does not answer the question of a company's residence – because, for example, the company was incorporated in one treaty country and was migrated to the other treaty country but is still treated as a resident by the first country – the competent authorities of the treaty countries must attempt to agree on the company's residence. If the competent authorities are unable to agree that a company is a resident of one country or the other, the company will not be treated as a resident of either country for purposes of its claiming any benefits provided by the proposed treaty.

According to the Technical Explanation, a dual resident company the residence of which is not agreed upon by the competent authorities may claim treaty benefits that are not limited to residents, such as those provided by the nondiscrimination rules of Article 24. The dual resident company also may be treated as a resident of a treaty country for purposes other than obtaining benefits under the proposed treaty. For example, according to the Technical Explanation, if a dual resident company pays a U.S.-source dividend to a resident of Malta, the tax on the dividend is limited to the treaty rate because the treaty reduction is a benefit of the resident of Malta, not a benefit of the dual resident company. Moreover, information related to the dual resident company may be exchanged because Article 26 (Exchange of Information and Administrative Assistance) is not limited to residents of the treaty countries.

If, under the general residence rules described previously, a person other than an individual or company is a resident of both countries, the proposed treaty requires the competent authorities to endeavor to settle the issue of residence by mutual agreement and to determine the mode of application of the proposed treaty to that person.

#### **Article 5. Permanent Establishment**

The proposed treaty contains a definition of the term "permanent establishment" that generally follows the language of other recent U.S. income tax treaties, the U.S. Model treaty, and the OECD Model treaty.

The permanent establishment concept is one of the basic devices used in income tax treaties to limit the taxing jurisdiction of the host country and thus to mitigate double taxation.

Generally, an enterprise that is a resident of one country is not taxable by the other country on its business profits unless those profits are attributable to a permanent establishment of the resident in the other country. In addition, the permanent establishment concept is used to determine whether the reduced rates of, or exemptions from, tax provided for dividends, interest, and royalties apply, or whether those items of income will be taxed as business profits.

In general, under the proposed treaty, a permanent establishment is a fixed place of business in which the business of an enterprise is wholly or partly carried on. A permanent establishment includes a place of management, a branch, an office, a factory, a workshop, a mine, an oil or gas well, a quarry, or other place of extraction of natural resources. It also includes a building site or a construction or assembly project if the site or project lasts for more than 12 months, and includes an installation used for the exploration of natural resources if the activity continues in the treaty country for more than 12 months. The Technical Explanation states that the 12-month test applies separately to each individual site or project, with a series of contracts or projects that are interdependent both commercially and geographically treated as a single project. The Technical Explanation further states that if the 12-month threshold is exceeded, the site or project constitutes a permanent establishment as of the first day that work in the country began.

The proposed treaty provides that the following activities of a preparatory or auxiliary character are deemed not to constitute a permanent establishment: (1) the use of facilities solely for storing, displaying, or delivering goods or merchandise belonging to the enterprise; (2) the maintenance of a stock of goods or merchandise belonging to the enterprise solely for storage, display, or delivery or solely for processing by another enterprise; and (3) the maintenance of a fixed place of business solely for the purchase of goods or merchandise or for the collection of information for the enterprise. The proposed treaty also provides that the maintenance of a fixed place of business solely for the purpose of carrying on, for the enterprise, any other activity of a preparatory or auxiliary character does not constitute a permanent establishment. The proposed treaty further provides that a combination of these activities will not give rise to a permanent establishment if the combination results in an overall activity that is of a preparatory or auxiliary character. These rules are consistent with the OECD and U.S. Model treaties.

Under the proposed treaty, if a person, other than an independent agent, is acting in a treaty country on behalf of an enterprise of the other country and has, and habitually exercises in such first country, the authority to conclude contracts that are binding on such enterprise, the enterprise is deemed to have a permanent establishment in the first country in respect of any activities undertaken for that enterprise. This rule does not apply in cases in which the activities are limited to the activities described in the preceding paragraph that would not give rise to a permanent establishment if carried on by the enterprise through a fixed place of business. The Technical Explanation states that the language “binding on the enterprise,” which also appears in the U.S. Model treaty, is intended to have the same meaning as the language “in the name of the enterprise” found in the OECD Model treaty. Both phrases are intended to encompass persons who have sufficient authority to bind the enterprise’s participation in the business activity in the treaty country.

No permanent establishment is deemed to arise under the proposed treaty if the agent is a broker, general commission agent, or any other agent of independent status, provided that the

agent is acting in the ordinary course of its business. The Technical Explanation states that whether an enterprise and an agent are independent is a factual determination, and that the relevant factors in making this determination include: (1) the extent to which the agent operates on the basis of instructions from the principal; (2) the extent to which the agent bears business risk; and (3) whether the agent has an exclusive or nearly exclusive relationship with the principal.

The proposed treaty provides that the fact that a company that is a resident of one country controls or is controlled by a company that is a resident of the other country or that carries on business in the other country does not cause either company to be a permanent establishment of the other. The Technical Explanation clarifies that, consistent with the U.S. Model treaty, such control is not taken into account in determining whether either company has a permanent establishment in the other treaty country.

### **Article 6. Income from Real (Immovable) Property**

Article 6 covers income from real (immovable) property. The rules governing gains from the sale of real (immovable) property are included in Article 13 (Gains). Under paragraph 1 of Article 6 of the proposed treaty, income derived by a resident of one treaty country from real (immovable) property, including income from agriculture or farming, situated in the other treaty country may be taxed in that other treaty country. This rule and, in general, the other rules of this article are consistent with the rules in the U.S. and OECD Model treaties.

Paragraph 2 of Article 6 provides that the term “real (immovable) property” generally has the meaning that it has under the law of the country in which the property in question is situated. According to the Technical Explanation, in the case of the United States, this term has the meaning given to it by Treas. Reg. section 1.897-1(b). The proposed treaty provides, however, that regardless of internal law definitions, real (immovable) property also includes property accessory to real (immovable) property, including livestock and equipment used in agriculture and forestry; rights to which the provisions of general law respecting landed property apply; usufruct of real (immovable) property; and rights to variable or fixed payments as consideration for the working of, or the right to work, mineral deposits, sources, and other natural resources. Ships, boats, and aircraft are not regarded as real (immovable) property. The definition of real (immovable) property in paragraph 2 of Article 6 is narrower than it is under paragraph 1 of Article 13 (Gains). The Article 13 (Gains) definition also includes certain other interests in real (immovable) property.

Paragraph 3 of Article 6 of the proposed treaty specifies that the country in which the property is situated also may tax income derived from the direct use, letting, or use in any other form of real (immovable) property. The Technical Explanation discusses the manner in which a net lease of real (immovable) property is treated if a net election is not made under paragraph 5 of Article 6. In such circumstances, the gross rental payment (before deductible expenses incurred by the lessee) is treated as income from the property.

Paragraph 4 of Article 6 provides that the rules permitting source-country taxation of income from real (immovable) property also apply to the income from real (immovable) property of an enterprise. However, the rules do not apply if the beneficial owner of the income, resident

in one treaty country, has a permanent establishment in the other treaty country through which the beneficial owner carries on a business and the income from the real (immovable) property is effectively connected with that permanent establishment. In such case, the provisions of Article 7 (Business Profits) apply.

The Technical Explanation, through examples, clarifies that specific types of other income that may be closely associated with real (immovable) property are addressed by other Articles of the proposed treaty. The Technical Explanation points out that: (1) income from the disposition of an interest in real (immovable) property is addressed under Article 13 (Gains); (2) interest paid on a mortgage on real (immovable) property is covered under Article 13 (Interest); (3) distributions by a U.S. REIT or certain RICs are covered under Article 13 if related to U.S. real property gain or by Article 10 (Dividends) if related to distributions treated as dividends; and (4) distributions from a U.S. real property holding corporation are addressed under Article 10 (Dividends) or Article 13 (Gains).

The proposed treaty does not grant an exclusive taxing right to the country where the property is located; that country is merely given the primary right to tax. The proposed treaty also does not impose any limitation on the rate or form of tax that the source country may impose. Furthermore, paragraph 5 of Article 6 of the proposed treaty provides that a taxpayer may elect to be taxed on a net basis in the country in which the real property is situated. By making this election, a taxpayer generally is able to obtain the same treatment in the country where the real (immovable) property is situated regardless of whether the income is treated as business profits attributable to a permanent establishment or income from real (immovable) property. For real (immovable) property situated in the United States, this election is binding for the taxable year of the election and for any subsequent taxable years unless the competent authority of the United States agrees to terminate the election.

## **Article 7. Business Profits**

### Internal taxation rules

#### United States

U.S. law distinguishes between the U.S. business income and the other U.S. income of a nonresident alien or foreign corporation. A nonresident alien or foreign corporation is subject to a flat 30-percent rate (or lower treaty rate) of tax on certain U.S. source income if that income is not effectively connected with the conduct of a trade or business within the United States. The regular individual or corporate rates apply to income (from any source) that is effectively connected with the conduct of a trade or business within the United States. The performance of personal services within the United States may constitute a trade or business within the United States.

The treatment of income as effectively connected with a U.S. trade or business depends upon whether the source of the income is U.S. or foreign. In general, U.S. source periodic income (such as interest, dividends, rents, and wages) and U.S. source capital gains are effectively connected with the conduct of a trade or business within the United States if the asset generating the income is used in (or held for use in) the conduct of the trade or business or if the

activities of the trade or business are a material factor in the realization of the income. All other U.S. source income of a person engaged in a trade or business in the United States is treated as effectively connected with the conduct of a trade or business in the United States (under what is referred to as a “force of attraction” rule).

The income of a nonresident alien individual from the performance of personal services within the United States is excluded from U.S.-source income, and therefore is not taxed by the United States in the absence of a U.S. trade or business, if the following criteria are met: (1) the individual is not in the United States for over 90 days during the taxable year; (2) the compensation does not exceed \$3,000; and (3) the services are performed as an employee of, or under a contract with, a foreign person not engaged in a trade or business in the United States, or are performed for a foreign office or place of business of a U.S. person.

Foreign source income generally is effectively connected income only if the foreign person has an office or other fixed place of business in the United States and the income is attributable to that place of business. In those circumstances, only three types of foreign source income are considered to be effectively connected income: rents and royalties for the use of certain intangible property derived from the active conduct of a U.S. business; certain dividends and interest either derived in the active conduct of a banking, financing or similar business in the United States or received by a corporation the principal business of which is trading in stocks or securities for its own account; and certain sales income attributable to a U.S. sales office. Special rules apply for purposes of determining the foreign source income that is effectively connected with a U.S. business of an insurance company.

Any income or gain of a foreign person for any taxable year that is attributable to a transaction in another year is treated as effectively connected with the conduct of a U.S. trade or business if it would have been so treated had it been taken into account in that other year (section 864(c)(6)). In addition, if any property ceases to be used or held for use in connection with the conduct of a trade or business within the United States, the determination of whether any income or gain attributable to a sale or exchange of that property occurring within ten years after the cessation of business is effectively connected with the conduct of a trade or business within the United States is made as if the sale or exchange occurred immediately before the cessation of business (section 864(c)(7)).

### Malta

Individuals who are both ordinarily resident and domiciled in Malta are subject to tax on their worldwide income. An individual’s taxable income is the sum of all gain and profits from the following sources: trade or business; profession or vocation; employment or office; dividends, interests or discounts; pensions, annuities or annual payments; rents, royalties, premiums and any other profits arising from property; certain capital gains; and other gains or profits. Corporations that are both ordinarily resident and domiciled in Malta are subject to tax in Malta on a worldwide basis. The Maltese income tax system provides for a participation exemption, exempting from tax income and capital gains derived by a company registered in Malta from a participating holding or from the disposition of such a holding.

### Proposed treaty limitations on internal law

Under the proposed treaty, business profits of an enterprise of a treaty country are taxable in the other treaty country only to the extent that they are attributable to a permanent establishment in the other country through which the enterprise carries on business. This rule is one of the basic treaty limitations on a country's right to tax income of a resident of the other country. The rule is similar to the rules found in the U.S. and OECD Model treaties.

Although the proposed treaty does not provide a definition of the term "business profits," the Technical Explanation states that the term is intended to cover income derived from any trade or business. The term "business profits" includes income attributable to notional principal contracts and other financial instruments to the extent that the income is attributable to a trade or business of dealing in such instruments or is otherwise related to a trade or business (as in the case of a notional principal contract entered into for the purpose of hedging currency risk arising from an active trade or business). Any other income derived from financial instruments is, according to the Technical Explanation, addressed in Article 21 (Other Income), unless specifically governed by another article.

The term "business profits" also includes income from the rental of tangible personal property, unless the property consists of aircraft, ships or containers, income from which is governed by Article 8 (Shipping and Air Transport). Thus, income of a resident of a treaty country can be taxed (on a net basis) by the other treaty country only if the income is attributable to a permanent establishment maintained by the resident in the other treaty country. The Technical Explanation provides that income from rental of tangible personal property not derived in connection with a trade or business is governed by Article 21 (Other Income).

As a result of the definitions of "enterprise" and "business" in Article 3, the definition of business profits includes income from independent personal services, which, like the U.S. and OECD Model treaties, is not addressed in a separate article. The inclusion in business profits of income of an enterprise from personal services is consistent with the long-standing U.S. position that an enterprise's personal services income is business profits. Accordingly, a consulting firm resident in one treaty country whose employees or partners perform services in the other treaty country through a permanent establishment may be taxed in that other country under Article 7, and not under Article 14 (Income from Employment) because that article applies only to income of employees.

The proposed treaty provides rules for the attribution of business profits to a permanent establishment. Under these rules, the treaty countries attribute to a permanent establishment the business profits that the permanent establishment might be expected to make if it were a distinct and separate enterprise engaged in the same or similar activities under the same or similar conditions, and dealing wholly independently with the enterprise of which it is a permanent establishment. For this purpose, the business profits to be attributed to the permanent establishment include only the profits derived from the assets used, risks assumed, and activities performed by the permanent establishment. The Technical Explanation points out that the concept of "attributable to" is analogous but not entirely equivalent to the concept of effectively connected income in Code section 864(c), and notes that profits attributable to a permanent establishment may be from sources within or outside of a treaty country.

The proposed treaty provides that in computing taxable business profits of a permanent establishment, deductions are allowed for expenses, wherever incurred, that are for the purposes of the permanent establishment. These deductions include executive and general administrative expenses so incurred. The Technical Explanation states that deductions are allowed regardless of which accounting unit of the enterprise books the expenses, so long as the expenses are incurred for the purposes of the permanent establishment (including for the purposes of the enterprise as a whole or that part of the enterprise that includes the permanent establishment). This rule permits a treaty country to apply the type of expense allocation rules provided by U.S. law (such as in Treas. Reg. sections 1-861-8 and 1.882-5). However, the proposed treaty does not permit a deduction for expenses charged to a permanent establishment by another unit of the enterprise.

Like the U.S. and OECD Model treaties, the proposed treaty provides that business profits are not attributed to a permanent establishment merely by reason of the purchase of goods or merchandise by the permanent establishment for the enterprise of which it is a part. According to the Technical Explanation, this rule applies only to an office that performs functions in addition to purchasing because purchasing does not by itself give rise to a permanent establishment under Article 5 (Permanent Establishment) to which income can be attributed. When it applies, the rule provides that business profits may be attributable to a permanent establishment for its non-purchasing activities (sales activities, for example), but not for its purchasing activities.

The proposed treaty requires that the determination of the business profits of a permanent establishment be made using the same method year by year unless there is a good and sufficient reason to the contrary. The Technical Explanation states that this rule limits the ability of both the treaty country and the enterprise to change accounting methods to be applied to the permanent establishment.

Where business profits include items of income that are dealt with separately in other articles of the proposed treaty, those other articles, and not the business profits article, generally govern the treatment of those items of income. Thus, for example, the taxation of dividends is determined under the rules of Article 10 (Dividends), and not by the rules of Article 7, except as specifically provided in Article 10 (that is, when dividends are attributable to a permanent establishment).

The proposed treaty provides that, for purposes of the taxation of business profits, income may be attributable to a permanent establishment (and therefore may be taxable in the source country) even if the payment of the income is deferred until after the permanent establishment has ceased to exist. This rule incorporates into the proposed treaty the rule of section 864(c)(6) described above. This rule applies for purposes of the rules for business profits under this article, dividends (Article 10, paragraph 6), interest (Article 11, paragraph 5), royalties (Article 12, paragraph 4), gains (Article 13, paragraph 3) and other income (Article 21, paragraph 2).

The Technical Explanation notes that Article 7 is subject to the saving clause of paragraph 4 of Article 1 (General Scope). Thus, in the case of the saving clause, if a U.S. citizen who is a resident of Malta derives business profits from the United States that are not attributable to a permanent establishment in the United States, the United States may, subject to the special

foreign tax credit rules of paragraph 4 of Article 23 (Relief from Double Taxation), tax those profits, notwithstanding that paragraph 1 of this article would exempt the income from U.S. tax.

The Technical Explanation further notes that Article 7 is subject to Article 22 (Limitation on Benefits). Consequently, a Maltese enterprise with income that is effectively connected to a U.S. trade or business is not entitled to the benefits of Article 7 unless the resident carrying on the enterprise qualifies for those benefits under Article 22.

### **Article 8. Shipping and Air Transport**

Article 8 of the proposed treaty covers income from the operation of ships and aircraft in international traffic. The rules governing income from the disposition of ships, aircraft, and containers are in paragraphs 4 and 5 of Article 13 (Gains). The Exchange of Notes accompanying the proposed treaty provides that neither the provisions of Article 8 nor any other provision of the proposed treaty affect the continued validity and application of the provisions of the Agreement between the United States and Malta regarding the Taxation of Shipping and Aircraft effectuated by exchange of notes dated at Washington December 26, 1996, and March 11, 1997.

The United States generally taxes the U.S.-source income of a foreign person from the operation of ships or aircraft to or from the United States. An exemption from U.S. tax is provided if the income is earned by a corporation or nonresident alien individual organized or resident in a foreign country that grants an equivalent exemption to U.S. corporations and residents. As a result of a diplomatic note exchanged with the United States, Malta is considered to grant an equivalent exemption.<sup>77</sup>

The proposed treaty provides that profits of an enterprise of one treaty country from the operation of ships or aircraft in international traffic are taxable only in that country. Paragraph 6 of Article 7 (Business Profits) provides that if profits include items of income that are described in both Article 7 and other articles of the proposed treaty, including Article 8, the provisions of those other articles are not affected by the provisions of Article 7. The rules of Article 8, therefore, are not affected by the general rule of Article 7 that profits attributable to a permanent establishment that an enterprise of a treaty country has in the other treaty country may be taxed in the other treaty country. Consequently, the profits of an enterprise of a treaty country from the operation of ships or aircraft in international traffic may not be taxed in the other treaty country even if the enterprise has a permanent establishment in that other treaty country.

“International traffic” is defined in Article 3(1)(f) (General Definitions) as any transport by a ship or aircraft, except when the transport is solely between places in a treaty country.

The proposed treaty includes a nonexclusive list of items that constitute profits from the operation of ships or aircraft in international traffic. That list includes profits derived from the

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<sup>77</sup> See Rev. Rul. 2008-17, 2008-12 I.R.B. 626 (Mar. 24, 2008) (identifying countries that give U.S. entities equivalent exemptions from tax for income from international operations of ships and planes); 1997-1 C.B. 314 (exchange of notes between Malta and the United States providing the equivalent exemption).

rental of ships or aircraft on a full basis (i.e., rental with crew, whether on a time or voyage basis). The list also includes profits from the rental of ships or aircraft on a bareboat basis (that is, without crew), whether the ships or aircraft are operated in international traffic by the lessee or the rental income is incidental to the lessor's other profits from the operation of ships or aircraft in international traffic.

The proposed treaty provides that profits of an enterprise from the inland transport of property or passengers within either treaty country are treated as profits from the operation of ships or aircraft in international traffic (and, therefore are governed by Article 8) if the transport is undertaken as part of international traffic. Thus, according to the Technical Explanation, if a U.S. enterprise contracts to carry property from Malta to a U.S. city and as part of that contract transports the property by truck from its point of origin to an airport in Malta (or contracts with a trucking company to carry the property to the airport), the income earned by the U.S. enterprise from the overland leg of the transport is taxable only in the United States. Similarly, the Technical Explanation states that Article 8 also applies to all income derived from a contract for the international transport of goods even if the goods are transported to the port by a lighter (a barge used in loading and unloading ships), and not by the vessel that carries the goods in international waters.

The proposed treaty provides that profits of an enterprise of a treaty country from the use, maintenance, or rental of containers (including trailers, barges, and related equipment for the transport of containers) used in international traffic are taxable only in that treaty country. According to the Technical Explanation, this exclusive residence country taxation applies even if the enterprise is not engaged in the operation of ships or aircraft in international traffic and even if the enterprise has a permanent establishment in the other treaty country.

As under the U.S. Model treaty, the shipping and air transport provisions of the proposed treaty apply to profits from participation in a pool, a joint business, or an international operating agency. These arrangements are common methods of cooperation among international shipping and air transport companies.

The Technical Explanation notes that Article 8 is subject to the saving clause of paragraph 4 of Article 1 (General Scope). Consequently, if a U.S. citizen who is a resident of Malta derives profits from the operation of ships or aircraft in international traffic, the United States may tax those profits as part of the citizen's worldwide income (subject to the proposed treaty's foreign tax credit rules). The benefit of exclusive residence country taxation is available to an enterprise of a treaty country only if that enterprise satisfies the limitation on benefits requirements of Article 22.

### **Article 9. Associated Enterprises**

The proposed treaty, like most other U.S. tax treaties, contains an arm's-length pricing provision. The proposed treaty recognizes the right of each country to make an allocation of profits to an enterprise of that country in the case of transactions between related enterprises if conditions are made or imposed between the two enterprises in their commercial or financial relations that differ from those that would be made between independent enterprises. In such a

case, a country may allocate to such an enterprise the profits that it would have accrued but for the conditions so imposed. This treatment is consistent with the U.S. and OECD Model treaties.

For purposes of the proposed treaty, an enterprise of one country is related to an enterprise of the other country if one of the enterprises participates directly or indirectly in the management, control, or capital of the other enterprise. Enterprises are also related if the same persons participate directly or indirectly in the enterprises' management, control, or capital.

Under the proposed treaty, when a redetermination of tax liability has been made by one country under the provisions of this article, and the other country agrees with that redetermination, then that other country will make an appropriate adjustment to the amount of tax paid in that country on the redetermined income. In making such a correlative, or corresponding, adjustment, the other provisions of the proposed treaty must be taken into account. For example, if the correlative adjustment is treated as a distribution of profits from a U.S. company for U.S. tax purposes, then the five-percent U.S. withholding tax, as provided by Article 10 (Dividends) of the proposed treaty, would apply to the correlative adjustment.

Based on a specific exception provided in paragraph 5(a) of Article 1 (General Scope), the proposed treaty's saving clause, which generally permits the country of residence or citizenship full taxing rights over its residents or citizens, does not apply in the case of correlative adjustments. Accordingly, the statute of limitations of a treaty country does not prevent the allowance of any appropriate correlative adjustments that may be necessary following an adjustment described in Article 9. For example, if a correlative adjustment would result in a refund, but the applicable statute of limitations for the refund claim has expired, the refund can still be made. However, the Technical Explanation states that statutory or procedural limitations cannot be overridden to impose additional tax, because paragraph 2 of Article 1 (General Scope) provides that the proposed treaty cannot restrict any statutory benefit.

## **Article 10. Dividends**

### Overview

Article 10 (Dividends) of the proposed treaty is generally consistent with the U.S. Model treaty. It allows full residence-country taxation and limited source-country taxation of dividends. With respect to dividends paid by a company resident in the United States, the proposed treaty generally permits a maximum 15-percent withholding rate and allows reduced five-percent maximum rate for dividends received by a company owning at least 10 percent of the dividend-paying company. With respect to dividends paid by a company resident in Malta, the tax that may be charged by Malta is limited to the Maltese tax chargeable on the profits out of which the dividends are paid. This rule takes account of Malta's imputation credit for Maltese corporate tax imposed on the earnings from which dividends are paid.<sup>78</sup> A zero rate of withholding tax generally applies to dividends received by pension funds. Special rules apply to dividends received from RICs and REITs. The provisions in Article 10 of the proposed treaty are generally consistent with the U.S. Model treaty, although the proposed treaty does not provide the

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<sup>78</sup> The imputation system is described above in Part III.

complete exemption from withholding tax for certain direct dividends that is found in a number of recent U.S. tax treaties and protocols.

### Internal taxation rules

#### United States

The United States generally imposes a 30-percent tax on the gross amount of U.S.-source dividends paid to nonresident alien individuals and foreign corporations. The 30-percent tax does not apply if the foreign recipient is engaged in a trade or business in the United States and the dividends are effectively connected with that trade or business. In such a case, the foreign recipient is subject to U.S. tax on such dividends on a net basis at graduated rates in the same manner that a U.S. person would be taxed.

Under U.S. law, the term “dividend” generally means any distribution of property made by a corporation to its shareholders from current or accumulated earnings and profits.

In general, corporations are not entitled under U.S. law to a deduction for dividends paid. Thus, the withholding tax on dividends theoretically represents imposition of a second level of tax on corporate taxable income. Treaty reductions of this tax reflect the view that where the United States already imposes corporate-level tax on the earnings of a U.S. corporation, a 30-percent withholding rate may represent an excessive level of source-country taxation. Moreover, the reduced rate of tax often applied by treaty to dividends paid to direct investors reflects the view that the source-country tax on payments of profits to a substantial foreign corporate shareholder may properly be reduced further to avoid double corporate-level taxation and to facilitate foreign direct investment.

A REIT is a corporation, trust, or association that is subject to the corporate income tax, but that receives a deduction for dividends paid to its shareholders if certain conditions are met. In order to qualify for the deduction for dividends paid, a REIT must distribute most of its income. Thus, a REIT is treated, in essence, as a conduit for federal income tax purposes. Because a REIT is taxable as a U.S. corporation, a distribution of its earnings is generally treated as a dividend rather than income of the same type as the underlying earnings. Such distributions are subject to the U.S. 30-percent withholding tax when paid to foreign owners. However, a distribution from a REIT is generally treated as gain from the disposition of a U.S. real property interest that must be recognized by a nonresident alien individual or a foreign corporation to the extent that the distribution is attributable to gain from the sale or exchange of a U.S. real property interest by the REIT.<sup>79</sup>

A REIT is generally organized to allow persons to diversify ownership in primarily passive real estate investments. As such, the principal income of a REIT often is rentals from real estate holdings. Like dividends, U.S.-source rental income of foreign persons generally is

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<sup>79</sup> There is an exception for distributions to a shareholder that owns five percent or less of the REIT, if the REIT stock is regularly traded on an established securities market located in the United States. Code sec. 897(h)(1). Such distributions are treated as dividends under U.S. internal law.

subject to the 30-percent withholding tax (unless the recipient makes an election to have such rental income taxed in the United States on a net basis at the regular graduated rates). Unlike the withholding tax on dividends, however, the withholding tax on rental income generally is not reduced in U.S. income tax treaties. When rental income (or interest income) of a REIT is distributed to a foreign shareholder as a REIT dividend, it is treated as a dividend under U.S. internal law.

U.S. internal law also generally treats a RIC as both a corporation and a conduit for income tax purposes. The purpose of a RIC is to allow investors to hold a diversified portfolio of securities. Dividends paid by a RIC are generally treated as dividends received by the payee, and if the RIC distributed substantially all of its income, it generally pays no tax because it is permitted to deduct dividends paid to its shareholders in computing its taxable income. However, a RIC generally may pass through to its shareholders the character of its net long-term and, before January 1, 2010, net short-term, capital gains by designating a dividend it pays as a long-term or short-term capital gain dividend, to the extent that the RIC has such net capital gains.<sup>80</sup> Nonresident aliens and foreign corporations are generally not subject to tax on capital gains. However, a distribution by a RIC to a nonresident alien or a foreign corporation before January 1, 2010 is treated as gain recognized by such person from the sale or exchange of a U.S. real property interest to the extent such gain is attributable to gain from sales or exchanges of U.S. real property interests.<sup>81</sup>

Similarly, a RIC that earns interest income that would not be subject to U.S. tax if earned by a foreign person directly (“qualified interest income”)<sup>82</sup> may generally designate a dividend it pays prior to January 1, 2010 as derived from such interest income, to the extent of such income.<sup>83</sup> Nonresident aliens and foreign corporations are not subject to tax on such interest-related dividends. The aggregate amount that may be designated by a RIC as interest-related dividends generally is limited to the sum of qualified interest income less the amount of expenses of the RIC properly allocable to such interest income.

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<sup>80</sup> Code sec. 871(k)(2)(C).

<sup>81</sup> Code sec. 897(h)(1), (4)(A)(i)(II), (4)(A)(ii).

<sup>82</sup> Qualified interest income of the RIC is equal to the sum of its U.S.-source income with respect to: (1) bank deposit interest; (2) short term original issue discount that is currently exempt from the gross-basis tax under Code section 871; (3) any interest (including amounts recognized as ordinary income in respect of original issue discount, market discount, or acquisition discount under the provisions of Code sections 1271-1288, and such other amounts as regulations may provide) on an obligation which is in registered form, unless it is earned on an obligation issued by a corporation or partnership in which the RIC is a 10-percent shareholder or is contingent interest not treated as portfolio interest under Code section 871(h)(4); and (4) any interest-related dividend from another RIC.

<sup>83</sup> Code sec. 871(k)(1)(C).

## Malta

Malta's corporate tax includes rules imputing the corporate tax on earnings out of which dividends are paid to the shareholders receiving those dividends.. This imputation system is described in more detail in Part III above. Malta does not impose a withholding tax on dividends paid to nonresident individuals and companies.

### Proposed treaty limitations on internal law

#### In general

Under the proposed treaty, dividends paid by a company that is a resident of a treaty country to a resident of the other country may be taxed in that other country. The dividends also may be taxed by the country in which the payor company is resident (the source country), but the rate of tax is limited. When the United States is the source country, dividends paid by a company that is resident in the United States to a beneficial owner that is resident in Malta are generally limited to 15 percent of the gross amount of the dividends paid. A lower rate of five percent applies if the beneficial owner of the dividends is a company that owns directly at least 10 percent of the voting stock of the dividend-paying company. When Malta is the source country, the proposed treaty limits the tax that may be imposed by Malta to the Maltese tax on the profits out of which the dividends are paid. This provision is drafted to permit flexibility in the application of Malta's imputation system, such that Malta could switch from its single-level corporate tax system to a two-level system in which a portion of the tax is collected at the shareholder level, without violating the provisions of the treaty. As a result, the withholding tax rule for Maltese-source dividends differs not only from the provision applicable to U.S. source dividends paid to Maltese residents, but also from the rules of other U.S. treaties and protocols.

The term "beneficial owner" is not defined in the proposed treaty and therefore is defined under the internal law of the source country. The Technical Explanation states that the beneficial owner of a dividend for purposes of this article is the person to which the dividend income is attributable for tax purposes under the laws of the source country.

Special rules apply to companies holding shares through fiscally transparent entities. As explained in the Technical Explanation, the rules of paragraph 6 of Article 1 (General Scope) of the proposed treaty apply to determine whether the dividends should be treated as derived by a resident of a treaty country. The laws of the residence country determine who derives the dividend, and the laws of the source country determine whether the person who derives the dividends is the beneficial owner of the dividends. The principles of paragraph 6 of Article 1 (General Scope) of the treaty also apply to determine whether other requirements have been satisfied, such as the 10-percent ownership threshold that must be met to qualify for the five-percent rate under this article.

Consistent with the U.S. Model treaty, the proposed treaty provides a zero rate of withholding tax for dividends received by a pension fund that is resident in the other treaty country, provided that the dividends are not derived from the carrying on of a business, directly or indirectly, by the pension fund. The proposed treaty defines a pension fund as any person established in one of the treaty countries that, (1)(a) in the case of the United States, is generally

exempt from income taxation, and (b) in the case of Malta, is a licensed fund or scheme subject to tax only on income derived from immovable property situated in Malta, and (2) that is operated principally to provide pension or retirement benefits or to earn income for the benefit of one or more such arrangements.

#### Dividends paid by U.S. RICs and REITs

The special rules for RICs and REITs are consistent with the U.S. Model treaty. First, the proposed treaty generally denies the five-percent rate of withholding tax to dividends paid by U.S. RICs and REITs.

A 15-percent withholding tax rate generally is allowed for dividends paid by a RIC. The 15-percent withholding rate is allowed for dividends paid by a REIT, provided one of three additional conditions is met: (1) the beneficial owner of the dividend is an individual or pension fund holding an interest of not more than 10 percent in the REIT; (2) the dividend is paid with respect to a class of stock that is publicly traded, and the beneficial owner of the dividend is a person holding an interest of not more than five percent of any class of the REIT's stock; or (3) the beneficial owner of the dividend holds an interest in the REIT of not more than 10 percent, and the REIT is diversified. A REIT is diversified if the value of no single interest in real property held by the REIT exceeds 10 percent of the total interests of the REIT in real property. For purposes of determining if a REIT is diversified, (1) foreclosure property is not considered an interest in real property and (2) a REIT holding a partnership interest is treated as owning its proportionate share of any interest in real property held by the partnership.

The Technical Explanation indicates that the restrictions on availability of the lower rate are intended to prevent the use of RICs and REITs to gain inappropriate U.S. tax benefits. For example, a company resident in Malta could directly own a diversified portfolio of U.S. corporate shares and bear a U.S. withholding tax of 15 percent on dividends paid with respect to those shares. Absent the additional RIC restrictions, such a company instead might purchase 10 percent or more of the interests in a RIC and thereby obtain a lower withholding tax rate by holding the portfolio through the RIC (transforming portfolio dividends generally taxable at 15 percent into direct investment dividends taxable under the proposed treaty at five percent).

Similarly, the Technical Explanation provides an example of a resident of Malta that directly holds real property and is required to pay U.S. tax either at a 30-percent rate on gross income or at graduated rates on the net income from the property. By placing the property in a REIT, the investor could transform real estate income into dividend income, taxable at the lower rates provided in the proposed treaty. The limitations on REIT dividend benefits are intended to protect against this result.

#### Definitions, special rules and limitations

Consistent with the U.S. Model treaty, the proposed treaty generally defines dividends as income from shares or other participation rights that are not treated as debt, as well as other amounts that are subject to the same tax treatment by the source country as income from shares (for example, constructive dividends).

Consistent with the U.S. and OECD Model treaties, the proposed treaty's reduced rates of tax on dividends do not apply if the dividend recipient carries on business through a permanent establishment in the source country and the dividend is paid with respect to holdings that are effectively connected with that permanent establishment. In this case, the dividend is taxed under Article 7 (Business Profits).

Consistent with the U.S. and OECD Model treaties, the proposed treaty prevents each treaty country from imposing a tax on dividends paid by a resident of the other treaty country unless the dividends are (1) paid to a resident of the first country or (2) attributable to a permanent establishment in that country. For example, the United States may not impose a secondary withholding tax on dividends paid from a Maltese company unless such dividends (1) are paid to a U.S. resident or (2) are attributable to profits the Maltese company derives from a U.S. permanent establishment.

Consistent with the U.S. Model treaty, the proposed treaty allows each country to impose a branch profits tax on a company resident in the other country if the company (1) has income attributable to a permanent establishment in that country, (2) derives income from real property in that country that is taxed on a net basis under Article 6 (Income from Real (Immovable) Property) of the proposed treaty, or (3) realizes gains taxable in that country under Article 13 (Gains) of the proposed treaty. In the case of the United States, the base of the tax is limited to the "dividend equivalent amount," consistent with the branch profits tax under U.S. internal law (Code section 884). In the case of Malta, the base of the tax (if any is imposed) is limited to an amount that is analogous to the dividend equivalent amount. The branch profits tax rate is limited to five percent.

#### Relation to other articles

The Technical Explanation notes that the saving clause of paragraph 4 of Article 1 (General Scope) of the proposed treaty permits the United States to tax dividends received by its residents and citizens, subject to the special foreign tax credit rules of paragraph 4 of Article 23 (Relief from Double Taxation), as if the proposed treaty had not come into effect.

The benefits of the dividends article are also subject to the provisions of Article 22 (Limitation on Benefits) of the proposed treaty.

### **Article 11. Interest**

#### Internal taxation rules

##### United States

Subject to several exceptions (such as those for portfolio interest, bank deposit interest, and short-term original issue discount), the United States imposes a 30-percent withholding tax on U.S.-source interest paid to foreign persons under the same rules that apply to dividends. U.S.-source interest, for purposes of the 30-percent tax, generally is interest on the debt obligations of a U.S. person, other than a U.S. person that satisfies specified foreign business requirements. Also subject to the 30-percent tax is interest paid by the U.S. trade or business of a foreign corporation. A foreign corporation is subject to a branch-level tax on certain "excess

interest” of a U.S. trade or business of that corporation. Under this rule, an amount equal to the excess of the interest deduction allowed to the U.S. business over the interest paid by the business is treated as if paid by a U.S. corporation to a foreign parent and, therefore, is subject to the 30-percent withholding tax.

Portfolio interest generally is defined as any U.S.-source interest that is not effectively connected with the conduct of a trade or business if the interest (1) is paid on an obligation that satisfies certain registration requirements or specified exceptions and (2) is not received by a 10-percent owner of the issuer of the obligation, taking into account shares owned by attribution. The portfolio interest exemption does not apply to certain contingent interest income.

If an investor holds an interest in a fixed pool of real estate mortgages that is a real estate mortgage interest conduit (“REMIC”), the REMIC generally is treated for U.S. tax purposes as a pass-through entity, and the investor is subject to U.S. tax on a portion of the REMIC’s income (generally, interest income). If the investor holds a so-called “residual interest” in the REMIC, the Code provides that a portion of the net income of the REMIC that is taxed in the hands of the investor – referred to as the investor’s “excess inclusion” – may not be offset by any net operating losses of the investor, must be treated as unrelated business income if the investor is an organization subject to the unrelated business income tax, and is not eligible for any reduction in the 30-percent rate of withholding tax (by treaty or otherwise) that would apply if the investor otherwise were eligible for such a rate reduction.

### Malta

Maltese-source interest payments made to nonresident individuals and foreign corporations are not subject to tax in Malta, unless the interest is effectively connected with a permanent establishment in Malta.

### Proposed treaty limitations on internal law

The proposed treaty provides that interest arising in one treaty country (the source country) and beneficially owned by a resident of the other treaty country generally may be taxed by both countries. However, the proposed treaty generally limits the rate of source-country tax that may be imposed so that it may not exceed 10 percent of the gross amount of the interest. These provisions differ from the U.S. Model treaty, which provides an exemption from source-country tax for interest earned by a resident of the other country.

The proposed treaty provides two anti-abuse exceptions to the general interest provisions. The first exception relates to contingent interest payments arising in the United States. If the contingent interest is of a type that does not qualify as portfolio interest under U.S. law, it may be taxed by the United States. If the beneficial owner is a resident of Malta, however, the interest may not be taxed at a rate exceeding 15 percent. According to the Technical Explanation, the reference to the U.S. definition of contingent interest (found in section 871(h)(4)) is intended to ensure that the exceptions of section 871(h)(4)(C) apply.

The second anti-abuse exception provides that the general interest provisions do not apply to interest that is an excess inclusion with respect to a residual interest in a REMIC. That interest may be taxed by each treaty country in accordance with its domestic law. The Technical

Explanation states that this exception is consistent with the policy of sections 860E(e) and 860G(b) that excess inclusions with respect to a REMIC should bear full U.S. tax in all cases.

The proposed treaty defines interest as income from debt-claims of every kind, whether or not secured by mortgage and whether or not carrying a right to participate in the debtor's profits. In particular, interest includes income from government securities and from bonds or debentures, including premiums and prizes attaching to those securities, bonds, or debentures. Interest also includes all other income that is subjected to the same tax treatment as income from money lent under the tax law of the treaty country in which the income arises. Interest does not include income covered in Article 10 (Dividends). Penalty charges for late payment also are not treated as interest.

The term "beneficial owner" is not defined in the proposed treaty and therefore is defined under the internal law of the country imposing tax (that is, the source country). The Technical Explanation states that the beneficial owner of the interest for purposes of this article is the person to which the interest income is attributable for tax purposes under the laws of the source country.

The limitations in Article 11 (Interest) on a source-country's taxation of interest income do not apply if the beneficial owner of the interest carries on business through a permanent establishment in the source country and the debt-claim in respect of which the interest is paid is effectively connected with that permanent establishment. (The Technical Explanation describes interest as being "attributable to" the permanent establishment, a common usage in U.S. income tax treaties, rather than adopting the U.S. Model treaty's phrase that a debt-claim is "effectively connected with" a permanent establishment.) In that circumstance, the interest is taxed as business profits (Article 7). According to the Technical Explanation, interest attributable to a permanent establishment but received after the permanent establishment is no longer in existence is taxable in the country in which the permanent establishment existed.

The proposed treaty includes a rule for determining the source of interest. Interest generally is deemed to arise in the payer's country of residence. If, however, the person paying the interest has a permanent establishment in a treaty country, the indebtedness on which the interest is paid was incurred in connection with that permanent establishment, and the interest is borne (that is, is deductible) by that permanent establishment, the interest is deemed to arise in the treaty country in which the permanent establishment is situated. This source rule is not in the U.S. Model treaty, but is equivalent to the rule in the OECD Model treaty.

The proposed treaty addresses non-arm's-length interest charges between a payer and a beneficial owner that have a special relationship. In such cases, the provisions of this article apply only to the amount of interest that would have been agreed in the absence of a special relationship. Any excess amount is taxable according to the laws of each treaty country, with due regard being given to other provisions of the proposed treaty. According to the Technical Explanation, for example, excess interest paid to a parent corporation may be treated as a dividend under a country's internal laws and, accordingly, is entitled to the benefits of Article 10 (Dividends). The Technical Explanation notes that the term "special relationship" is not defined in the proposed treaty and states that the United States considers the term to include the relationships described in Article 9 (Associated Enterprises). Those relationships, according to

the Technical Explanation, involve control as defined under the transfer pricing rules of section 482.

The proposed treaty includes a rule that permits the United States to impose its branch-level interest tax on excess interest payments deemed to be received by a corporation resident in Malta. Under this rule, the United States may tax an amount that is deemed to be interest equal to the excess of (1) the amount of interest allocable to the profits of a company resident in Malta that are either attributable to a permanent establishment in the United States or subject to tax in the United States under Article 6 (Income from Real (Immovable) Property) or Article 13 (Gains) over (2) the interest actually paid by the permanent establishment or trade or business in the United States. The United States may tax that excess amount as if the deemed interest arose in the United States and were beneficially owned by a resident of Malta. The deemed interest thus may be taxed at a rate not exceeding the 10-percent rate generally permitted to a source country.

The Technical Explanation notes that the benefits of this article, like benefits provided by other articles, are subject to the saving clause of paragraph 4 of Article 1 (General Scope) and are available only if a resident satisfies the limitation-on-benefits requirements of Article 22.

## **Article 12. Royalties**

### Internal taxation rules

#### United States

Under the same system that applies to dividends and interest, the United States imposes a 30-percent withholding tax on U.S.-source royalties paid to foreign persons. U.S.-source royalties include royalties for the use of or right to use intangible property in the United States.

#### Malta

Royalty payments made to nonresident companies are not subject to tax, provided that the recipient (1) is not owned and controlled by, and does not act on behalf of, persons ordinarily resident and domiciled in Malta and (2) does not carry on a business in Malta through a permanent establishment in Malta with which the royalty income is effectively connected.

### Proposed treaty limitations on internal law

Article 12 (Royalties) of the proposed treaty provides that royalties arising in a treaty country (the source country) and beneficially owned by a resident of the other treaty country may be subject to a source country tax of up to 10 percent of the gross amount of the royalties. Such source-country taxation is not consistent with the exclusive residence country taxation provisions for royalties in both the U.S. and OECD Model treaties.

The term “royalties” as used in this article means payments of any kind received as consideration for the use of, or the right to use, any copyright of literary, artistic, or scientific work (including cinematographic films), any patent, trade mark, design or model, plan, secret

formula or process, or for information concerning industrial, commercial, or scientific experience.

The term “royalties” does not expressly include consideration for the use of computer software. The Technical Explanation states that consideration received for the use, or the right to use, computer software is treated either as royalties or as business profits, depending on the facts and circumstances of the transaction giving rise to the payment. The primary factor in determining whether consideration is treated as royalties or as business profits is the nature of the rights transferred.

Consistent with the U.S. Model treaty, the term “royalties” includes contingent gain from the alienation of any property that would give rise to royalties. “Contingent gain” is gain contingent on the productivity, use, or disposition of the right or property. To the extent that any gain from the alienation of such property is not contingent gain, the Technical Explanation states that the gain is addressed in Article 13 (Gains).

If (1) the beneficial owner of the royalties carries on a business through a permanent establishment in the source country, and (2) the right or property with respect of which the royalties are paid is effectively connected with that permanent establishment, the royalties are taxed as business profits (Article 7). The Technical Explanation states that royalties attributable to a permanent establishment but received after the permanent establishment is no longer in existence remain taxable under the provisions of Article 7 (Business Profits), and not under this article. In determining the source of royalties paid, royalties are deemed to arise in a treaty country if they are for the use of, or the right to use, property, information or experience in that country. Because both the U.S. and OECD Model treaties contemplate a zero rate on royalties, neither contains provisions that define the source of a royalty payment.

The proposed treaty addresses the issue of non-arm’s-length royalties between related parties (or parties otherwise having a special relationship) by providing that this article applies only to the amount of arm’s-length royalties. Any excess amount of royalties paid is taxable according to other provisions of the proposed treaty. For example, the Technical Explanation states that if excess royalties paid by a subsidiary corporation to its parent corporation are treated as a profit distribution under the domestic laws of the source country, the excess amount is taxed as a dividend and not as a royalty. However, the tax imposed on the dividend payment is subject to the rate limitations of Article 10 (Dividends).

## **Article 13. Gains**

### Internal taxation rules

#### United States

Generally, gain realized from the sale of a capital asset by a nonresident alien individual or a foreign corporation is not subject to U.S. tax unless the gain is effectively connected with the conduct of a U.S. trade or business or, in the case of a sale by a nonresident alien individual, that individual is physically present in the United States for at least 183 days in the taxable year. A nonresident alien individual or foreign corporation generally is subject to U.S. tax on gain from the sale of a U.S. real property interest as if the gain were effectively connected with a trade

or business conducted in the United States. “U.S. real property interests” include interests in certain corporations if U.S. real property comprises at least 50 percent of the assets of the corporation.

### Malta

Maltese source capital gains derived by a nonresident alien individual or foreign corporation are generally subject to Maltese income tax. Nonresident alien individuals and foreign corporations are exempt from tax on any capital gains derived from the disposal of shares in a Maltese resident company the assets of which do not consist wholly or principally of immovable property situated in Malta. Additional exemptions apply to foreign corporations to the extent of any gain attributable to units in a collective investment scheme or to units and like instruments relating to the linked long-term business of insurance (that is, life insurance contracts under which benefits are wholly or partially determined by reference to the value of, or income from property).

### Proposed treaty limitations on internal law

The proposed treaty provides rules governing when a treaty country may tax gains from the alienation of property by a resident of the other treaty country. The rules generally are consistent with those included in the U.S. Model treaty.

Under the proposed treaty, gains derived by a resident of one treaty country that are attributable to the alienation of real (immovable) property situated in the other treaty country may be taxed in that other treaty country. For the purposes of this article, real (immovable) property situated in the other treaty country includes: (1) real (immovable) property referred to in Article 6 (Income from Real (Immovable) Property) that is, an interest in the real (immovable) property itself; (2) in the case of the United States, a U.S. real property interest; and (3) in the case of Malta, (a) shares, including rights to acquire shares, in a company resident in Malta whose assets consist wholly or principally of real (immovable) property situated in Malta, and (b) an interest in a partnership or trust to the extent that the assets of that partnership or trust consist of real (immovable) property situated in Malta or shares described in (3)(a), above. Under U.S. internal law, a U.S. real property interest includes, among other property, shares in a U.S. corporation that owns sufficient U.S. real property interests to satisfy an asset-based test.

The Technical Explanation notes the significance of paragraph 1, Article 13’s reference to gains “attributable to the alienation of real (immovable) property” as opposed to “gains from the alienation” found in the OECD Model treaty. This difference is intended to clarify that the United States looks through distributions made by a REIT and certain RICs. As a result, distributions from a REIT or RIC are taxable under Article 13 (Gains) as opposed to Article 10 (Dividends) when attributable to gains derived from the alienation of real property.

The proposed treaty includes a standard provision that permits a treaty country to tax gains from the alienation of movable property (that is, property other than real (immovable) property) that forms a part of the business property of a permanent establishment that an enterprise of the other treaty country has in the first treaty country. This rule permits source-country (i.e., the country in which the property is located) taxation of gains from the alienation of

the permanent establishment (alone or with the enterprise as a whole). According to the Technical Explanation, this taxation is permitted whether or not the permanent establishment exists at the time of alienation. Consequently, income that is attributable to a permanent establishment, but that is deferred and is received after the permanent establishment no longer exists, may nevertheless be taxed in the treaty country in which the permanent establishment was located. This rule is similar to a rule of section 864(c)(6) of the Code.

In addressing what constitutes gain attributable to a permanent establishment, the Technical Explanation discusses the taxation of a resident of Malta that is a partner in a partnership that has activities in the United States that rise to the level of a U.S. permanent establishment. It clarifies that, as a result of its partnership interest, the partner generally has a U.S. permanent establishment. The U.S. may, therefore, tax the partner on the partner's distributive share of income realized by a partnership on the disposition of movable property forming part of the business property of the partnership in the United States.

The proposed treaty provides that gains derived by an enterprise of one treaty country from the alienation of ships or aircraft operated or used in international traffic, or of personal property related to the operation of the ships or aircraft are taxable only in that country. This rule applies even if the gains are attributable to a permanent establishment maintained by the enterprise in the other treaty country. As noted in the Technical Explanation, this rule is consistent with the manner in which taxing rights are allocated under Article 8 (Shipping and Air Transport).

The proposed treaty provides a similar rule for gains derived by an enterprise of one treaty country from the alienation of containers (including trailers, barges, and related equipment for the transport of containers) in the other treaty country. Those gains may be taxed only in the first treaty country, unless the containers are used for transport solely between destinations within the other treaty country.

Gain from the alienation of any property other than the property described above or property described in paragraph 3(b) of Article 12 (Royalties) (that is, gain that is contingent on the productivity, use or disposition of such property) is taxable under the proposed treaty only in the country in which the person alienating the property is a resident. Examples of gains from property subject to exclusive residence country taxation include the following: (1) gains from shares other than those described above attributable to real (immovable) property; (2) gain attributable to debt instruments and various financial instruments to the extent the income is not otherwise covered under another article such as Article 10 (Dividends) or Article 11 (Interest); and, (3) gains attributable to tangible personal property. The Technical Explanation also notes that gain derived by a resident of a treaty country from real (immovable) property located in a third country is not taxable in the other treaty country if the gain is attributable to a permanent establishment located in the other treaty country.

The Technical Explanation states that the saving clause of paragraph 4 of Article 1 (General Scope) permits the United States to tax its citizens and residents as if the proposed treaty has not come into effect. In addition, the benefits of this Article 13 are available only to a treaty country resident that satisfies one of the conditions in Article 22 (Limitation on Benefits).

## **Article 14. Income from Employment**

The proposed treaty provides that salaries, wages, and other similar remuneration derived by a resident of one treaty country from employment generally may be taxed by the country of residence. In addition, if the employment is exercised in the other treaty country (the source country), then that country may also tax the remuneration derived from the employment. However, the source country may not tax the remuneration if three conditions are met: (1) the individual is present in the source country for not more than 183 days in any 12-month period commencing or ending in the taxable year concerned; (2) the individual is paid by, or on behalf of, an employer who is not a resident of the source country; and (3) the remuneration is not borne by a permanent establishment of the employer in the source country (whether or not such expenses are actually deductible when determining the taxable income of the permanent establishment).

According to the Technical Explanation, this article applies to any form of compensation for employment, including payments in kind. Further, it applies without regard to the timing of the payment. Thus, a bonus paid to a resident of a treaty country with respect to services provided in the other treaty country would be subject to the terms of this article even if the bonus is paid in a subsequent year.

This article is subject to the provisions of the separate articles covering directors' fees (Article 15), pensions, social security, and annuities (Article 17) and government service (Article 19). Thus, even though a treaty country may have the right to tax income from employment under this article, the right may be preempted if the income is also described, for example, in Article 19 (Government Service).

The proposed treaty contains a special rule that permits remuneration derived by a resident of one treaty country for employment as a member of the regular complement (including the crew) of a ship or aircraft operated in international traffic by an enterprise of the other treaty country to be taxed only in the first treaty country. U.S. internal law does not impose tax on such income of a person who is neither a citizen nor a resident of the United States, even if the person is employed by a U.S. entity.

The Technical Explanation notes that Article 14 is subject to the saving clause of paragraph 4 of Article 1 (General Scope). Consequently, if a U.S. citizen who is a resident of Malta performs services as an employee in the United States and meets the requirements for source country exemption, the United States may nevertheless tax the remuneration earned from that employment (subject to the proposed treaty's foreign tax credit rules).

## **Article 15. Directors' Fees**

Under the proposed treaty, directors' fees and other similar payments derived by a resident of one treaty country for services rendered in the other treaty country in his or her capacity as a member of the board of directors of a company that is a resident of that other treaty country may be taxed in that other country. The Technical Explanation states that this rule is an exception to the more general rules of Articles 7 (Business Profits) and 14 (Income from Employment) and provides, as an example, that in determining whether a director's fee paid to a

non-employee director is subject to tax in the country of residence of the corporation, it is not relevant to establish whether the fee is attributable to a permanent establishment in that State.

This article is subject to the saving clause of paragraph 4 of Article 1 (General Scope). Thus, if a U.S. citizen who is a resident of Malta is a director of a U.S. corporation, the United States may tax his full remuneration regardless of where he performs his services.

### **Article 16. Entertainers and Sportsmen**

Article 16 of the proposed treaty addresses the taxation in a treaty country of entertainers and sportsmen resident in the other treaty country from the performance of services as entertainers and sportsmen. The Technical Explanation states that Article 16 applies to the income both of an entertainer or sportsman who performs services on his own behalf and of an entertainer or sportsman who performs services on behalf of another person, either as an employee of that person, or pursuant to any other arrangement. The rules of this article take precedence, in some circumstances, over those of Articles 7 (Business Profits) and 14 (Income from Employment).

#### **In general**

Paragraph 1 describes the circumstances in which a treaty country may tax the performance income of an entertainer or sportsman who is a resident of the other treaty country. Under the paragraph, income derived by an individual resident of a treaty country from activities as an entertainer or sportsman exercised in the other treaty country may be taxed in that other country if the amount of the gross receipts derived by the performer exceeds \$20,000 (or its equivalent in Euros) for the taxable year. The Technical Explanation states that the determination as to whether the \$20,000 threshold has been exceeded is made separately with respect to each year of payment.

According to the Technical Explanation, the monetary threshold is intended to reach entertainers and athletes who are paid relatively large sums of money for short periods of service, and who would, therefore, normally be exempt from host-country tax under the standard personal services income rules.

Tax may be imposed under paragraph 1 even if the performer would have been exempt from tax under Article 7 or 14. On the other hand, if the performer would be exempt from host-country tax under Article 16, but would be taxable under either Article 7 or 14, tax may be imposed under either of those articles. For example, a performer who receives less than the \$20,000 threshold amount and therefore is not taxable under Article 16 nevertheless may be subject to tax in the host country under Article 7 or 14 if the tests for host-country taxability under the relevant article are met.

The Technical Explanation states that nothing in Article 16 precludes a treaty country from withholding tax from payments during the year and refunding the tax after the close of the year if the monetary threshold has not been met.

The Technical Explanation states that Article 16 applies to all income connected with a performance by the entertainer, such as appearance fees, award or prize money, and a share of

the gate receipts. Income derived from a treaty country by a performer who is a resident of the other treaty country from other than actual performance, such as royalties from record sales and payments for product endorsements, is covered not by Article 16 but by other articles of the treaty, such as Article 12 (Royalties) or Article 7. The Technical Explanation states that in determining whether income falls under Article 16 or another article, the controlling factor is whether the income in question is predominantly attributable to the performance itself or to other activities or property rights.

According to the Technical Explanation, where an individual fulfills a dual role as performer and non-performer (such as a player-coach or an actor-director), but his role in one of the two capacities is negligible, the predominant character of the individual's activities should control the characterization of those activities. In other cases, there should be an apportionment between the performance-related compensation and other compensation.

#### Income accrues to another person

The Technical Explanation states that paragraph 2 of Article 16 is intended to address the potential for circumvention of the rule in paragraph 1 when a performer's income does not accrue directly to the performer himself, but to another person.

For example, the "employer" may be a company established and owned by the performer, which is merely acting as the nominal income recipient in respect of the remuneration for the performance (a "star company"). The performer may act as an "employee," receive a modest salary, and arrange to receive the remainder of the income from his performance from the company in another form or at a later time. In that case, absent the provisions of paragraph 2, the income arguably could escape host-country tax because the company earns business profits but has no permanent establishment in that country. The performer may largely or entirely escape host-country tax by receiving only a small salary, perhaps small enough to place him below the monetary threshold in paragraph 1.

Paragraph 2 seeks to prevent this result. Under paragraph 2, when the income accrues to a person other than the performer, the income may be taxed in the treaty country where the performer's services are exercised, without regard to the provisions of the proposed treaty concerning business profits (Article 7) or income from employment (Article 14), unless the contract pursuant to which the personal activities are performed allows the person other than the performer to designate the individual who is to perform the personal activities.

According to the Technical Explanation, the premise of this rule is that, in a case in which a performer is using another person in an attempt to circumvent the provisions of paragraph 1, the recipient of the services of the performer would contract with a person other than that performer (i.e., a company employing the performer) only if the recipient of the services were certain that the performer himself would perform the services (that is, the contract mentioned the performer by name or description or else allowed the recipient of the services to designate who is to perform the services). If instead the person to whom the income accrues is allowed to designate the individual who is to perform the services, then it is likely that the person is a service company not formed to circumvent the provisions of paragraph 1.

Taxation under paragraph 2 is on the person providing the services of the performer. Paragraph 2 does not affect the rules of paragraph 1, which apply to the performer himself. According to the Technical Explanation, the income taxable by virtue of paragraph 2 is reduced to the extent of salary payments to the performer, which fall under paragraph 1.

#### Relationship to other articles

Article 16 is subject to the provisions of the saving clause of paragraph 4 of Article 1 (General Scope). Thus, if an entertainer or a sportsman who is resident in Malta is a citizen of the United States, the United States may tax all of his income from performances in the United States without regard to the provisions of Article 16, subject to the foreign tax credit provisions of Article 23 (Relief from Double Taxation). In addition, the benefits of this article are subject to the provisions of Article 22 (Limitation on Benefits).

### **Article 17. Pensions, Social Security, Annuities, Alimony, and Child Support**

Article 17 addresses the taxation of private pensions and annuities, social security benefits, alimony, and child support payments. The article does not cover payments of government pensions covered under Article 19 (Government Service). Article 17 is generally consistent with the corresponding article in the U.S. Model treaty.

#### Pension distributions

The proposed treaty includes the provision of the U.S. Model treaty under which pensions and other similar remuneration beneficially owned by a resident of a treaty country in consideration of past employment are taxable only in that country.

According to the Technical Explanation, the term “pensions and other similar remuneration” includes both periodic and lump sum payments and is intended to encompass payments made by qualified private retirement plans. In the United States, the plans encompassed by the phrase “pensions and other similar remuneration” include qualified plans under section 401(a), individual retirement plans (including individual retirement plans that are part of a simplified employee pension plan that satisfies section 408(k), individual retirement accounts and section 408(p) accounts), section 403(a) qualified annuity plans, and section 403(b) plans. Distributions from section 457 plans may also be covered by the phrase if they are not paid in respect of government services covered by Article 19 (Government Service).

Pensions in respect of government services covered by Article 19 are not covered by the term “pensions and other similar remuneration.” If those pensions are in the form of social security benefits, they are covered by paragraph 2 of this article. Otherwise, they are subject to paragraph 2 of Article 19.

Under an exception to the rule permitting the residence country to tax cross-border pensions and similar remuneration, the residence country may not tax any amount of such a pension or similar remuneration that would be exempt from taxation in the other country if the beneficial owner of the pension or similar remuneration were a resident of that other country. Thus, for example, according to the Technical Explanation, a distribution from a U.S. Roth IRA to a resident of Malta is exempt from tax by Malta to the same extent the distribution would be

exempt from tax by the United States if the beneficial owner of the distribution were a U.S. resident. This rule is included in the U.S. Model treaty.

#### Social security benefits

Like the U.S. Model treaty, the proposed treaty provides exclusive source-country taxation of payments made under provisions of the social security or similar legislation of a treaty country to a resident of the other treaty country or to a citizen of the United States. This provision is an exception to the saving clause of paragraph 4 of Article 1 (General Scope) by virtue of subparagraph 5(a) of Article 1. Thus, only Malta and not the United States may tax social security benefits paid by Malta to a U.S. citizen who is not a resident of the United States.

The exclusive source-country tax rule for payments under the social security or similar legislation applies to both private sector and government employees. The term “similar legislation” is intended to refer to United States tier 1 Railroad Retirement benefits.

#### Annuities

The proposed treaty also provides that annuities derived and beneficially owned by an individual resident of either treaty country are taxable only in the recipient’s country of residence. This rule is the same as the provision in the U.S. Model treaty. The term “annuities” means a stated sum paid periodically at stated times during a specified number of years, or for life, under an obligation to make the payments in return for adequate and full consideration (other than services rendered). The Technical Explanation states that an annuity received in consideration for services rendered would be treated either as deferred compensation taxable in accordance with Article 14 (Income from Employment) or as a pension subject to the pension rules of this article.

#### Alimony and child support

Like the U.S. Model treaty, the proposed treaty provides that alimony paid by a resident of a treaty country to a resident of the other treaty country may be taxed only in the recipient’s country of residence. By contrast, and also in accord with the U.S. Model treaty, cross-border child support payments are exempt from tax in both the United States and Malta.

Both alimony and child support are defined as periodic payments made under a written separation agreement or a decree of divorce, separate maintenance, or compulsory support. Alimony includes only amounts that are taxable to the recipient under the laws of the treaty country of which that individual is a resident. Child support includes only amounts that are for the support of a child.

#### Saving clause

The rules allowing exclusive residence country taxation of pensions and similar remuneration, annuities, and alimony are subject to the saving clause of paragraph 4 of Article 1 (General Scope). Thus, according to the Technical Explanation, a U.S. citizen who is a resident of Malta and receives a pension, annuity, or alimony payment from the United States may be subject to U.S. tax on the payment, notwithstanding the general allocation of taxing rights to the

residence country. The rules (1) exempting from residence country tax pension and similar remuneration that would be exempt from tax in the source country if the recipient were resident in the source country, (2) providing exclusive source-country taxation of social security payments, and (3) exempting child support payments from tax in either treaty country are excepted from the saving clause by virtue of subparagraph 5(a) of Article 1. Thus, according to the Technical Explanation, the United States will not tax U.S. citizens and residents on the income described in those rules even if the amounts otherwise would be subject to tax under U.S. law.

### **Article 18. Pension Funds**

The proposed treaty provides that if an individual resident of one of the treaty countries is a beneficiary of or a participant in a pension fund that is a resident of the other treaty country, income earned by the pension fund may not be taxed as income of the individual until the income is paid to or for the benefit of that individual from the pension fund. When such a distribution is made, the country of residence of the individual may tax the income, subject to the rules of paragraph 1 of Article 17 (Pensions, Social Security, Annuities, Alimony, and Child Support). Thus, according to the Technical Explanation, if a U.S. citizen contributes to a U.S. pension plan while working in the United States and then establishes residence in Malta, Malta may not tax on a current basis the plan's earnings in respect of that U.S. citizen's contributions. When the individual receives a distribution from the fund, Malta may (subject to Article 17, paragraph 1) tax the distribution.

The rule described above is the same as the rule included in the U.S. Model treaty. The U.S. Model treaty's article on pension funds also has rules for coordinating the deductibility of pension fund contributions by or on behalf of an individual in circumstances in which the fund is a resident of one treaty country and the individual is employed or self-employed in the other treaty country. The proposed treaty lacks similar rules.

### **Article 19. Government Service**

The provisions of Article 19 (Government Service) are consistent with both the U.S. OECD Model treaties. Under this article, salaries, wages and other remuneration (other than a pension) paid to an individual for services rendered to a treaty country (or political subdivision or local authority) are exempt from tax by the other treaty country. However, the remuneration is exclusively taxable by the other treaty country (that is, the host country) if: (1) the services are rendered in the host country; and (2) the individual providing the services is a resident of the host country who (a) is a national of the host country or (b) did not become a resident of the host country solely for the purpose of rendering the services. The Technical Explanation states that this provision applies to anyone performing services for a government, whether as an employee, an independent contractor, or an employee of an independent contractor.

Any pension paid by, or out of funds created by, a country that (1) is not in the form of social security benefits and (2) is in respect of government service rendered to a treaty country (or subdivision or local authority) by an individual is taxable only in that treaty country. However, such a pension is taxable only in the other country if the individual is both a resident and a national of the other country. The Technical Explanation states that pensions paid to

retired civilian and military employees of the government of either treaty country are intended to be covered by this provision.

When benefits paid by a treaty country in respect of services rendered to that country (or political subdivision or local authority) are in the form of social security benefits, those payments are covered by paragraph 2 of Article 17 (Pensions, Social Security, Annuities, Alimony and Child Support). As a general matter, the result is the same whether Article 17 or 19 applies, since both social security benefits and government pensions are taxable exclusively by the source country (i.e., the paying country). The Technical Explanation explains that the result differs only when the payment is made to a person who is both a citizen and a resident of the other country (i.e., the host country) who is not also a citizen of the source country. In this situation, social security benefits continue to be taxable at source while government pensions are taxable only in the residence country.

Where remuneration, or a pension, is paid for services performed in connection with a business carried on by a treaty country (or political subdivision or local authority), the treatment of such payments are subject to the provisions of Articles 14 (Income from Employment), 15 (Directors' Fees), 16 (Entertainers and Sportsmen), and 17 (Pensions, Social Security, Annuities, Alimony and Child Support).

Under subparagraph 5(b) of Article 1 (General Scope), the saving clause (paragraph 4 of Article 1) does not apply to the benefits conferred by one of the treaty countries under Article 19 if the recipient of the benefits is neither a citizen of that country nor a person who has been admitted for permanent residence (in the United States, a "green card" holder). As an example, the Technical Explanation states that a resident of the United States who, in the course of performing functions of a governmental nature for the United States, becomes a resident (but not a permanent resident) of Malta is entitled to the benefits of Article 19. The Technical Explanation states that, similarly, an individual who receives a pension paid by the Government of Malta in respect of services rendered to the Government of Malta may be taxed on this pension only by Malta unless the individual is a U.S. citizen or acquires a U.S. green card.

## **Article 20. Students and Trainees**

The treatment provided to students and business trainees under the proposed treaty generally corresponds to the provision in the U.S. Model treaty, with certain modifications, and is similar to the provision of the OECD Model treaty.

Under the proposed treaty, a student or business trainee who visits a treaty country ("host country") and who is, or was immediately prior to visiting the host country, a resident of the other treaty country is exempt from income tax in the host country on certain payments received if the purpose of the visit is to engage in full-time training or full-time education at a college, university, or other recognized educational institution. The exempt payments are limited to those payments the individual may receive for his or her maintenance, education, or training as long as such payments are from sources outside the host country. In the case of business trainees, the exemption from income tax in the host country applies only for a period of one year from the time the visitor first arrives in the host country for training.

The proposed treaty also provides students and business trainees with an exemption for income from personal services performed in the host country up to a total of 9,000 U.S. dollars or its equivalent in euros annually. The competent authorities are required to adjust this amount every five years to take into account changes in the U.S. personal exemption and standard deduction and in the Maltese personal tax rates.

As similarly defined in the U.S. Model treaty, a business trainee is an individual who is in the host country temporarily either (1) for the purpose of securing training required to qualify the individual to practice a profession or professional specialty or (2) as an employee of, or under contract with, a resident of the other treaty country for the primary purpose of acquiring technical, professional, or business experience from a person other than that resident.

The Technical Explanation notes that that the saving clause of paragraph 4 of Article 1 of the proposed treaty does not apply under this Article in the case of an individual who is neither a citizen of the host country nor admitted to permanent residence in the host country (that is, in the United States, the individual does not acquire a green card). Such an individual is entitled to the exemptions under this Article. The saving clause does, however, apply to citizens and permanent residents of the host country. As an example, the Technical Explanation refers to a person who is not a U.S. citizen, and who visits the United States as a student and remains long enough to become a resident under U.S. law, but does not become a permanent resident. This individual is eligible for the exemption under this article from U.S. tax on remittances from abroad that otherwise constitute U.S. taxable income.

## **Article 21. Other Income**

Article 21 assigns taxing jurisdiction over items of income beneficially owned by a resident of one of the treaty countries and not dealt with in the other articles of the proposed treaty. The general rule is that such items are taxable only in the country of residence of the person receiving the income. This right of taxation applies whether or not the residence country exercises its right to tax the income covered by the article. This rule is similar to the rules in the U.S. and OECD Model treaties.

An item of income is dealt with in another article if it is the type of income described in the article and, in most cases, if it has its source in one of the treaty countries. For example, royalty income that is beneficially owned by a resident of a treaty country is dealt with in Article 12 (Royalties) if the royalty income arises in the other treaty country, but not if the royalty income arises in a third country. However, profits derived in the conduct of a business are dealt with in Article 7 (Business Profits) whether or not they have their source in one of the treaty countries.

According to the Technical Explanation, examples of types of items of income covered by Article 21 include income from gambling, punitive (but not compensatory) damages, and covenants not to compete. Article 21 also applies to income from a variety of financial transactions, where such income does not arise in the course of the conduct of a trade or business. For example, income from notional principal contracts and other derivatives would be covered if derived by persons not engaged in the business of dealing in such instruments, unless such instruments were used to hedge risks arising in a trade or business. It would also apply to

securities lending fees derived by an institutional investor. In most cases guarantee fees paid within an intercompany group would be covered by Article 21, unless the guarantor is engaged in the business of providing such guarantees to unrelated parties.

Article 21 also applies to items of income that are not dealt with in the other articles because of their source, character, or some other attribute. For example, Article 11 (Interest) addresses only the taxation of interest arising in one of the treaty countries. Therefore, interest arising in a third country that is not attributable to a permanent establishment is subject to Article 21.

Distributions from partnerships are not generally dealt with under Article 21 because partnership distributions generally do not constitute income. Under the Code, partners include in income annually their distributive share of partnership income, and partnership distributions themselves generally do not give rise to income. This is also the case under U.S. law with respect to distributions from trusts. Trust income and distributions that, under the Code, have the character of the associated distributable net income (for example, interest or royalties) generally are covered by another article of the proposed treaty.

The general rule of residence taxation does not apply to income (other than income from immovable property (real property) as defined in paragraph 2 of Article 6) if the beneficial owner of the income is a resident of one country and carries on business in the other country through a permanent establishment situated therein, and the income is attributable to such permanent establishment. In such a case, the provisions of Article 7 (Business Profits) apply. Therefore, income arising outside the United States that is attributable to a permanent establishment maintained in the United States by a resident of Malta generally would be taxable by the United States under the provisions of Article 7. This would be true even if the income is sourced in a third state.

Unlike the Model treaty, Article 21 provides for limited source-country taxation of income not dealt with in another article. Income not dealt with in other articles may be taxed in the source country, but the rate may not exceed 10 percent of the amount of the income.

Article 21 is subject to the saving clause in paragraph 4 of Article 1 (General Scope). Accordingly, U.S. citizens who are residents of Malta continue to be taxable by the United States on income to which Article 21 applies, including relevant third-country income. This article is also subject to the provisions of Article 22 (Limitation on Benefits). Thus, if a resident of Malta earns income that falls within the scope of paragraph 1 of Article 21, but that is taxable by the United States under U.S. law, the income would be subject to the reduced rate of U.S. tax under the provisions of Article 21 only if the resident satisfies one of the tests of Article 22 for entitlement to benefits.

## **Article 22. Limitation on Benefits**

### **In general**

Article 22 of the proposed treaty includes rules that are similar to the limitation-on-benefits provisions included in other recent U.S. income tax treaties and protocols. These rules

are intended to prevent the indirect use of the treaty by persons who are not entitled to its benefits by reason of residence in the United States or Malta.

The proposed treaty is intended to limit double taxation caused by the interaction of the tax systems of the United States and Malta as they apply to residents of the two countries. At times, however, residents of third countries attempt to benefit from a treaty by engaging in treaty shopping. Treaty shopping by a third-country resident may involve organizing, in a treaty country, a corporation that is entitled to the benefits of the treaty. Alternatively, a third-country resident eligible for favorable treatment under the tax rules of its country of residency may attempt to reduce the income base of a treaty country resident by having that treaty country resident pay to it, directly or indirectly, interest, royalties, or other amounts that are deductible in the treaty country from which the payments are made. Limitation-on-benefits provisions are intended to deny treaty benefits in certain cases of treaty shopping or income stripping engaged in by third-country residents.

Generally, a resident of either treaty country is entitled to all the benefits accorded by the proposed treaty if the resident has any one of six listed attributes. The six attributes are that the resident is: (1) an individual; (2) one of the two treaty countries or a political subdivision or local authority of one of the two countries; (3) a company that satisfies a public company test, or that is a subsidiary of a public company, and satisfies a base erosion test; (4) an organization that is established and maintained in its country of residence exclusively for religious, charitable, scientific, artistic, cultural, or educational purposes, even if all or part of its income or gains are exempt from tax under the residence country's domestic law; (5) a pension fund that satisfies a beneficiaries test; or (6) an entity that satisfies an ownership test and a base erosion test. A resident that has none of these six attributes may be entitled to treaty benefits with respect to certain items of income under the derivative benefits test or the active business test.

Notwithstanding the general rule that looks to the presence of one of these six attributes, the Exchange of Notes accompanying the proposed treaty provides that a company resident in Malta that is an "international trading company," as defined in article 2 of the Income Tax Act of Malta, is not entitled to any of the benefits of the proposed treaty provided in Articles 10 (Dividends), 11 (Interest), 12 (Royalties), and 21 (Other Income).

Special anti-abuse rules govern items of income derived from one of the treaty countries by an enterprise resident in the other treaty country in so-called "triangular cases."

A person that does not satisfy any of the requirements described above may be entitled to the benefits of the treaty if the source country's competent authority so determines.

#### Six attributes for qualification for all treaty benefits

##### Individuals

Under the proposed treaty, an individual resident of the United States or Malta is entitled to all treaty benefits. If, however, such an individual receives income as a nominee on behalf of a third-country resident, and thus is not the beneficial owner of the income, benefits may be denied.

## Governments

The proposed treaty provides that the United States and Malta, and any political subdivision or local authority of either of the two countries, are entitled to all treaty benefits.

## Publicly traded companies and subsidiaries

A company that is a resident of the United States or Malta is entitled to all treaty benefits if (1) its principal class of shares (and any disproportionate class of shares) is listed on a recognized stock exchange located in its country of residence, (2) its principal class of shares (and any disproportionate class of shares) is regularly traded on one or more recognized stock exchanges located in its country of residence, (3) its principal class of shares is primarily traded on one or more recognized stock exchanges located in its country of residence, and (4) it satisfies a base erosion test (taken together, these requirements are the “primarily and regularly traded test”). Certain key elements of this test are described below.

The term “principal class of shares” means the ordinary or common shares of a company representing the majority of the aggregate voting power and value of that company. If the company does not have a single class of ordinary or common shares representing the majority of the aggregate voting power and value, then the “principal class of shares” means that class or those classes of shares that in the aggregate represent a majority of the aggregate voting power and value of the company.

A company that is resident in one treaty country has a “disproportionate class of shares” if any outstanding class of shares is subject to terms or other arrangements that entitle a shareholder to a larger portion of the company’s income, profit, or gain in the other treaty country than that to which the shareholder would be entitled in the absence of those terms or arrangements. For example, the Technical Explanation states that a company resident in Malta meets this test if it has outstanding a class of tracking stock that pays dividends based upon a formula that approximates the company’s return on its assets employed in the United States.

The term “recognized stock exchange” means the NASDAQ System owned by the National Association of Securities Dealers, Inc., any stock exchange registered with the U.S. Securities and Exchange Commission as a national securities exchange under the U.S. Securities Exchange Act of 1934, the Malta Stock Exchange, and any other stock exchange agreed upon by the competent authorities of the treaty countries.

The term “regularly traded” is not defined in the proposed treaty and therefore has the meaning it has under the laws of the relevant treaty country, usually the source country. In the United States, the term has the same meaning as it does under Treas. Reg. section 1.884-5(d)(4)(i)(B). Based on that provision, the Technical Explanation states that a class of shares is regularly traded if (1) trades in the class of shares are made in more than de minimis quantities on at least 60 days during the taxable year, and (2) the aggregate number of shares in the class traded during the year is at least 10 percent of the average number of shares outstanding during the year. The Technical Explanation notes that trading on one or more recognized stock exchanges may be aggregated for purposes of meeting the “regularly traded” requirement.

The term “primarily traded” is not defined in the proposed treaty and therefore has the meaning it has under the laws of the relevant treaty country, usually the source country. In the United States, the term has the same meaning as it does under Treas. Reg. section 1.884-5(d)(3). Based on that provision, the Technical Explanation states that stock of a corporation is primarily traded in the company’s country of residence if the number of shares in the company’s principal class of shares that are traded during the taxable year on all recognized stock exchanges in the treaty country of which the company is a resident exceeds the number of shares in the company’s principal class of shares that are traded during that year on established securities markets in any other single foreign country.

The base erosion test is satisfied only if less than 25 percent of the person’s gross income for the taxable year, as determined in that person’s country of residence, is paid or accrued, directly or indirectly, to persons who are not residents of either treaty country entitled to treaty benefits under this article as individuals, governments, parent companies that meet the public company test, tax-exempt organizations, or pension funds. Arm’s-length payments made in the ordinary course of business for services or tangible property do not count against the entity in determining whether the 25-percent threshold is reached.

This base erosion test is not a requirement of the primarily and regularly traded test in the U.S. Model treaty; it is a requirement under a separate test described below for qualification for treaty benefits. Moreover, in cases in which the base erosion test applies in the U.S. Model treaty, the test uses a 50-percent threshold (instead of 25 percent) and encompasses only deductible payments, not all payments, as is the case with this test. These differences from the U.S. Model treaty make the test in the proposed treaty more difficult to satisfy than the U.S. Model treaty’s requirements.

The proposed treaty also differs from the U.S. Model treaty in that it does not include a management and control test. The U.S. Model treaty includes a management and control test as an alternative means for a company whose principal class of shares is regularly traded, but not primarily traded, on a recognized stock exchange located in the company’s country of residence to satisfy the public company test. Under the U.S. Model treaty, a company satisfies the management and control test if its primary place of management and control is in the treaty country of which it is a resident.

A company that does not satisfy the primarily and regularly traded test (because, for example, its shares are not publicly traded) may be entitled to treaty benefits if shares representing at least 75 percent of each class of its shares are owned, directly or indirectly, by companies that satisfy the primarily and regularly traded test, provided that, in the case of indirect ownership, each intermediate owner is a resident of the same treaty country as the company qualifying for treaty benefits under this test. In addition, the company must satisfy the same base erosion test that is described above as part of the primarily and regularly traded test. This alternative test allows certain subsidiaries of publicly traded companies to be eligible for all benefits under the treaty.

Similar to the primarily and regularly traded test, however, this test is harder to satisfy than the one provided in the U.S. Model treaty. The U.S. Model treaty requires that shares representing only 50 percent of the aggregate vote and value of the company’s shares (and 50

percent of any disproportionate class of shares) be owned (instead of 75 percent of each class of shares), and there is no requirement to satisfy a base erosion test. In addition, in the case of indirect ownership, the proposed treaty requires that each intermediate owner be a resident of the same country as the company claiming benefits under the treaty. The U.S. Model treaty, in contrast, requires only that the intermediate owners be residents of one of the two treaty countries.

#### Tax-exempt organizations

An organization established in its country of residence exclusively for religious, charitable, scientific, artistic, cultural, or educational purposes is entitled to treaty benefits notwithstanding that all or part of its income or gains may be exempt from tax under the domestic law of that country.

#### Pension funds

A pension fund is entitled to all the benefits of the proposed treaty if more than 75 percent of the fund's beneficiaries, members, or participants are individuals resident in either the United States or Malta. According to the Technical Explanation, for purposes of this provision, the term "beneficiaries" should be understood to refer to the persons receiving benefits from the fund.

This test is more stringent than the U.S. Model treaty, which has a more than 50 percent residence requirement for the fund's beneficiaries.

#### Ownership and base erosion tests

An entity that is a resident of one of the treaty countries is entitled to treaty benefits if it satisfies both an ownership test and a base erosion test.

An entity that is a resident of a treaty country satisfies the ownership test if on at least half the days of the taxable year at least 75 percent of each class of the entity's shares or other beneficial interests are owned, directly or indirectly, by residents of that treaty country who are entitled to treaty benefits under the limitation-on-benefits article as individuals, governments, parent companies that meet the public company test, tax-exempt organizations, or pension funds. In the case of indirect ownership, each intermediate owner must be a resident of the same treaty country as the entity seeking to satisfy the ownership test. This ownership test is more stringent than the U.S. Model treaty, which requires that shares representing only 50 percent of the aggregate vote and value of the company's shares (and 50 percent of any disproportionate class of shares) be owned (instead of 75 percent of each class of shares).

The base erosion test is the same as the one described above as part of the primarily and regularly traded test.

The Technical Explanation states that trusts may be entitled to the benefits of this provision if they are treated as residents under Article 4 (Resident) and they otherwise satisfy the ownership and base erosion tests.

### Derivative benefits rule

The proposed treaty includes derivative benefits rules that are generally intended to allow a treaty-country company treaty benefits for an item of income if the company's owners would have been entitled to the same benefits for the income had those owners derived the income directly. Under these derivative benefits rules, a treaty-country company is eligible for treaty benefits for an item of income only if the company satisfies both an ownership requirement and a base erosion requirement. These rules are not in the U.S. Model treaty, but similar rules are found in many recent U.S. income tax treaties and protocols.

A company satisfies the ownership requirement if shares representing at least 95 percent of each class of shares of the company are owned directly or indirectly by seven or fewer persons who are equivalent beneficiaries.

A company satisfies the base erosion requirement for an item of income only if, in the taxable year in which the income item arises, directly or indirectly, to persons who are not equivalent beneficiaries is less than 25 percent of the company's gross income for the year, as determined in the company's country of residence. Arm's-length payments made in the ordinary course of business for services or tangible property do not count against the entity in determining whether the 25-percent threshold is reached. The Technical Explanation notes that the base erosion requirement under the derivative benefits rule is qualitatively the same as the base erosion test described previously.

An equivalent beneficiary must be a resident of a European Union member state, a European Economic Area state, Australia, or a North American Free Trade Agreement party (together, "qualifying countries") and satisfy either of two criteria described below.

The first criterion includes two requirements. First, the person must be entitled to all treaty benefits under a comprehensive income tax treaty between a qualifying country and the country from which the benefits of the proposed treaty are being claimed (an "applicable treaty"), and this entitlement to treaty benefits must result from satisfaction of limitation-on-benefits provisions analogous to the proposed treaty's rules, described above, for individuals, governments, parent companies that meet the public company test, tax-exempt organizations, and pension funds. If the applicable treaty does not include a comprehensive limitation-on-benefits article, this first requirement is satisfied only if the person would meet the proposed treaty's requirements for entitlement to treaty benefits as an individual, a government, a parent company that meets the public company test, a tax-exempt organization, or a pension fund if such person were a resident of the United States or Malta under Article 4 (Resident) of the proposed treaty. Second, for income from dividends, interest, or royalties, the person must be entitled under an applicable treaty to a rate of tax on that income that is at least as low as the rate applicable under the proposed treaty (the "tax rate test").

The Technical Explanation gives the following example to illustrate the operation of the tax rate test. A U.S. company is wholly owned by a Maltese company that in turn is wholly owned by an Italian company. Assume the Maltese company otherwise satisfies the requirements of the five-percent rate dividend provision, and assume that if the Italian company received a dividend directly from the U.S. company, the applicable dividend withholding tax rate

under the U.S.-Italy treaty would be five percent. Under these facts, the Italian company would be a resident of a qualifying country under the rules described above because it would be entitled to a withholding tax rate at least as low as the applicable rate (five percent) under the proposed treaty.

For dividend, interest, or royalty payments arising in Malta and beneficially owned by a resident of the United States, the proposed treaty includes a special rule for determining whether a company that is a resident of an EU member state satisfies the tax rate test for purposes of determining whether the U.S. resident is entitled to treaty benefits for the payments. The special rule provides that the EU member state resident satisfies the tax rate test if a dividend, interest, or royalty payment arising in Malta and paid directly to that EU member state resident would be exempt from withholding tax under an EU directive even though the income tax treaty between Malta and that EU member state would permit imposition of a higher withholding tax rate on that payment than is permitted by the proposed U.S.-Malta tax treaty. The Technical Explanation states that this special rule takes account of the fact that withholding taxes on many inter-company dividend, interest, and royalty payments are exempt within the EU under various EU directives. The special rule is necessary, according to the Technical Explanation, because many EU member countries have not renegotiated their tax treaties to reflect the EU directives' elimination of withholding tax.

Under the second criterion for determining whether a resident of a qualifying country is an equivalent beneficiary, the resident must be a U.S. or Maltese resident that is entitled to treaty benefits under one of the rules described previously for individuals, governments, parent companies that meet the public company test, tax-exempt organizations, and pension funds. Under this rule, according to the Technical Explanation, a Maltese individual is an equivalent beneficiary for an item of income received by another treaty country resident regardless of whether the individual would have been entitled to receive the same benefits if it had received the income directly. The Technical Explanation states that this criterion was included to clarify that ownership by certain residents of a treaty country does not disqualify a U.S. or Maltese company from treaty benefits under the derivative benefits rules. If, for example, 90 percent of a Maltese company is owned by five companies that are residents of EU member states and that satisfy the first criterion described previously (the applicable treaty rules and the tax rate test), and 10 percent of the Maltese company is owned by a U.S. or a Maltese individual, the Maltese company still can satisfy the requirements of the ownership test of the derivative benefits rules.

#### Active business test

Under the proposed treaty, a resident of one treaty country is entitled to treaty benefits with respect to an item of income derived from the other country if (1) the resident is engaged in the active conduct of a trade or business in its residence country, (2) the income from the other country is derived in connection with or is incidental to that trade or business, and (3) the resident satisfies a base erosion test. The proposed treaty provides that the business of making or managing investments for the resident's own account does not constitute an active trade or business unless the business is banking, insurance, or securities activities carried on by a bank, an insurance company, or a registered securities dealer.

The term “trade or business” is not defined in the proposed treaty. According to the Technical Explanation, under paragraph 2 of Article 3 (General Definitions) of the proposed treaty, when determining whether a resident of Malta is entitled to the benefits of the proposed treaty under the active business test with respect to an item of income derived from sources within the United States, the United States ascribes to this term the meaning that it has under the laws of the United States. Accordingly, the Technical Explanation states, the U.S. competent authority is to refer to the regulations issued under section 367(a) for the definition of the term “trade or business.” In general, a trade or business is considered to be a specific unified group of activities that constitute or could constitute an independent economic enterprise carried on for profit. Furthermore, a corporation generally is considered to carry on a trade or business only if the officers and employees of the corporation conduct substantial managerial and operational activities.

The Technical Explanation elaborates on the requirement that an item of income from the source country be derived “in connection with” or be “incidental to” the resident’s trade or business in its residence country. The Technical Explanation provides that an item of income is derived in connection with a trade or business if the income-producing activity in the source country is a line of business that “forms a part of” or is “complementary to” the trade or business conducted in the residence country by the income recipient.

According to the Technical Explanation, a business activity generally is considered to form part of a business activity conducted in the country of source if the two activities involve the design, manufacture, or sale of the same products or type of products, or the provision of similar services. The line of business in the country of residence may be upstream, downstream, or parallel to the activity conducted in the country of source. Thus, the line of business may provide inputs for a manufacturing process that occurs in the source country, may sell the output of that manufacturing process, or simply may sell the same sorts of products that are being sold by the trade or business carried on in the country of source.

The Technical Explanation states that for two activities to be considered to be “complementary,” the activities need not relate to the same types of products or services but should be part of the same overall industry and should be related in the sense that the success or failure of one activity tends to result in success or failure for the other. In cases in which more than one trade or business is conducted in the country of source and only one of the trades or businesses forms a part of or is complementary to a trade or business conducted in the country of residence, it is necessary, according to the Technical Explanation, to identify the trade or business to which an item of income is attributable. Royalties generally are considered to be derived in connection with the trade or business to which the underlying intangible property is attributable. Dividends are deemed to be derived first out of earnings and profits of the treaty-benefited trade or business and then out of other earnings and profits. Interest income may be allocated under any reasonable method consistently applied. A method that conforms to U.S. principles for expense allocation is considered a reasonable method.

The Technical Explanation further states that an item of income derived from the country of source is “incidental to” the trade or business carried on in the country of residence if production of the item facilitates the conduct of the trade or business in the country of residence.

An example of incidental income is the temporary investment of working capital of a person in the country of residence in securities issued by persons in the country of source.

The proposed treaty provides that if a resident of a treaty country or any of its associated enterprises carries on a trade or business activity in the other country that gives rise to an item of income, the active business test applies to the item of income only if the trade or business activity in the residence country is substantial in relation to the trade or business activity in the source country. The determination is made separately for each item of income derived from the source country.

The Technical Explanation explains that the substantiality requirement is intended to prevent a narrow case of treaty-shopping abuses in which a company attempts to qualify for benefits by engaging in de minimis connected business activities in the treaty country in which it is resident (that is, activities that have little economic cost or effect with respect to the company business as a whole). A trade or business is deemed substantial if, for each of the three preceding taxable years, the asset value, the gross income, and the payroll expense that are related to the trade or business in the residence country each equals at least 10 percent of the resident's (and any related parties') proportionate share of the asset value, gross income, and payroll expense, respectively, related to the activity that generated the income in the source country, and the average of the three ratios in each such year exceeds 15 percent. This numerical test for substantiality differs from the U.S. Model treaty, which makes the substantiality determination based on all of the facts and circumstances.

The proposed treaty provides that, in determining whether a person is engaged in the active conduct of a trade or business in a treaty country, activities conducted by persons "connected" to that first person are deemed to be conducted by that first person. A person is "connected" to another person if one possesses at least 50 percent of the beneficial interest in the other (or, in the case of a company, at least 50 percent of the aggregate voting power and at least 50 percent of the aggregate value of the shares in the company or of the beneficial equity interest in the company), or another person possesses that requisite interest in each of the two entities. A person is also considered to be connected to another if, based on all the relevant facts and circumstances, one has control of the other or both are under the control of the same person or persons.

#### The triangular case

The proposed treaty provides a special anti-abuse rule that, according to the Technical Explanation, addresses a Maltese resident's use of the following structure to earn interest income from the United States. The Maltese resident (who is otherwise qualified for benefits under this article) organizes a permanent establishment in a third country that imposes a low rate of tax on the income of the permanent establishment. The Maltese resident then lends funds into the United States through the permanent establishment. The permanent establishment is an integral part of the Maltese resident. Consequently, the interest income that the permanent establishment earns on the loan is entitled to exemption from U.S. withholding tax under the treaty. Under the tax treaty between Malta and the third country, Malta does not tax the income earned by the permanent establishment. Alternatively, Malta may choose to exempt the income of the

permanent establishment from Maltese income tax. Consequently, the income is not taxed in Malta or the United States, and is only lightly taxed in the third country.

Under the proposed treaty, the United States may impose withholding tax on the interest payments if the combined tax actually paid on the income in Malta and the third country is less than 60 percent of the tax that would have been payable to Malta if the income were earned in Malta and were not attributable to the permanent establishment in the third country.

Although the example in the Technical Explanation involves interest income, the triangular provision applies to all types of income. Any dividends, interest, or royalties to which the provision applies may be subject to a maximum withholding tax rate of 15 percent. Any other income to which the provision applies is subject to tax under the domestic law of the source state, notwithstanding any other provision of the proposed treaty.

According to the Technical Explanation, the principles of the U.S. subpart F rules are employed to determine whether the profits of the permanent establishment are subject to an effective rate of tax that is above the specified threshold.

The triangular provision applies reciprocally. However, the United States does not exempt the income of a third-country permanent establishment of a U.S. resident from U.S. tax, either by statute or by treaty.

The U.S. Model treaty does not include a triangular provision, but similar provisions are found in many recent U.S. income tax treaties and protocols. The triangular provision in the proposed treaty differs, however, from the one found in those other treaties in that it does not include two typical limitations on its application. First, other U.S. treaties that include a triangular provision generally provide that the triangular provision does not apply to royalties that are received as compensation for the use of, or the right to use, intangible property produced or developed by the permanent establishment itself. In the case of any other income, other U.S. treaties generally provide that the triangular provision does not apply if that income is derived in connection with, or is incidental to, the active conduct of a trade or business carried on by the permanent establishment in the third country (other than the business of making, managing, or holding investments for the person's own account, unless the business is banking or securities activities carried on by a bank or a registered securities dealer).

#### Grant of treaty benefits by the competent authority

Under the proposed treaty, a resident of a treaty country that is not otherwise entitled to treaty benefits under this article may nonetheless be granted treaty benefits if the competent authority of the treaty country in which the income in question arises so determines.

According to the Technical Explanation, the competent authority's discretion under this provision is broad. The competent authority, for example, may grant all treaty benefits, may grant benefits only with respect to a particular item of income, and may set time limits on the duration of any relief granted.

### Special rule for amounts subject to a remittance system of taxation

The proposed treaty provides that in cases in which income or gains arising in one of the treaty countries are wholly or partly relieved from tax in that first country and a person is taxable in the other treaty country only in respect of the amount of such income or gains that is remitted or received in that second country, then the relief otherwise allowed in the first country applies only to the portion of such income and gains that is remitted or received in the second country. The Technical Explanation states that this rule is necessary because of Malta's remittance system of taxation for individuals who are Maltese residents not domiciled in Malta.

## **Article 22. Relief from Double Taxation**

### Internal taxation rules

#### United States

The United States taxes the worldwide income of its citizens and residents. It attempts unilaterally to mitigate double taxation generally by allowing taxpayers to credit the foreign income taxes that they pay against U.S. tax imposed on their foreign-source income. An indirect or "deemed-paid" credit is also provided. Under this rule, a U.S. corporation that owns 10 percent or more of the voting stock of a foreign corporation and that receives a dividend from the foreign corporation (or an inclusion of the foreign corporation's income) is deemed to have paid a portion of the foreign income taxes paid by the foreign corporation on its earnings. The taxes deemed paid by the U.S. corporation are included in its total foreign taxes paid for the year the dividend is received.

A fundamental premise of the foreign tax credit is that it may not offset U.S. tax on U.S.-source income. Therefore, the foreign tax credit provisions limit the foreign taxes that a taxpayer may claim as credits for the year to the amount of the taxpayer's U.S. tax liability attributable to its foreign-source income. The limitation is computed separately for "passive category income" and other income in order to prevent the crediting of foreign taxes on certain high-taxed foreign-source income against the U.S. tax on certain types of traditionally low-taxed foreign-source income. Other limitations may apply in determining the amount of foreign taxes that may be credited against the U.S. tax liability of a U.S. taxpayer.

#### Malta

Individuals and companies resident in Malta generally are taxed on their worldwide income. In the absence of a treaty, relief from double taxation of foreign-source income generally is provided in the form of a tax credit.

### Proposed treaty

#### Overview

One of the principal purposes for entering into an income tax treaty is to limit double taxation of income earned by a resident of one of the countries that may be taxed by the other country. Unilateral efforts to limit double taxation are imperfect. Because of differences in rules

as to when a person may be taxed on business income, a business may be taxed by two countries as if it were engaged in business in both countries. Also, a corporation or individual may be treated as a resident of more than one country and be taxed on a worldwide basis by both.

Part of the double tax problem is addressed in other articles of the proposed treaty that limit the right of a source country to tax income. This article provides further relief where both Malta and the United States still tax the same item of income. This article is not subject to the saving clause; the country of citizenship or residence must waive its taxing jurisdiction to the extent that this article applies.

#### U.S. tax relief for taxes paid to Malta

Paragraph 1 of Article 24 generally provides that the United States allows a U.S. citizen or resident a foreign tax credit for the income taxes paid to Malta, and allows a U.S. corporation a deemed-paid credit when the U.S. corporation receives dividends from a Maltese corporation in which the U.S. corporation owns 10 percent or more of the voting stock. The credit generally is to be computed in accordance with the provisions and subject to the limitations of U.S. law (as such law may be amended from time to time without changing the general principles of the proposed treaty provisions). This provision is similar to those found in the U.S. Model treaty and many U.S. tax treaties, and is consistent with U.S. law.

The proposed treaty provides that the taxes referred to in subparagraph 3(a) (this is a typographical error and should instead refer to subparagraph 3(b)) and paragraph 4 of Article 2 (Taxes Covered) are considered income taxes for purposes of paragraph 1. The Technical Explanation states that this rule is based on the Treasury Department's review of Malta's laws.

Paragraph 3 contains a re-sourcing rule that applies for purposes of paragraph 1. Under paragraph 3, an item of gross income (as determined under U.S. law) that is derived by a U.S. resident and that may be taxed by Malta under the proposed treaty is deemed to be income from sources in Malta for U.S. foreign tax credit purposes. The Technical Explanation states that this re-sourcing rule is intended to ensure that a U.S. resident can obtain an appropriate amount of U.S. foreign tax credit for taxes paid to Malta when the proposed treaty assigns to Malta primary taxing jurisdiction over an item of gross income.

In the case of a U.S.-owned foreign corporation, section 904(g)(10) may apply for purposes of determining the U.S. foreign tax credit with respect to income subject to this re-sourcing rule. Section 904(g)(10) generally applies the foreign tax credit limitation described above separately to re-sourced income. Furthermore, because the re-sourcing rule applies to gross income, not net income, U.S. expense allocation and apportionment rules continue to apply to income resourced under paragraph 3.

#### Maltese tax relief for taxes paid to the United States

Specific rules are provided in paragraph 2 under which Malta, in imposing tax on its residents, provides relief for U.S. taxes paid by those residents through a foreign tax credit. Subparagraph 2(a) provides that when a resident of Malta derives income that, in accordance with the provisions of the proposed treaty, may be taxed in the United States, Malta must allow as a credit against Maltese income taxes an amount equal to those taxes paid to the United States.

In addition, in the case of a dividend paid by a U.S. company to a Malta company which owns 10 percent of the voting stock of the payor company, subparagraph 2(b) of the proposed treaty provides that the credit allowed must take into account (in addition to any U.S. tax allowed directly as described above) the U.S. tax payable by the company in respect of the profits out of which such dividend is paid.

#### U.S. citizens who are resident in Malta

Paragraph 4 provides special rules for the tax treatment of certain types of income derived by U.S. citizens who are residents of Malta. As a result, U.S. citizens, regardless of residence, are subject to United States tax on their worldwide income. The U.S. tax on the U.S. source income of a U.S. citizen who is a resident of Malta may exceed the U.S. tax that may be imposed under the proposed treaty on the income if it were derived by a resident of Malta who is not a U.S. citizen. The Technical Explanation states that the provisions of paragraph 4 ensure that Malta does not bear the cost of U.S. taxation of its citizens who are residents of Malta.

Subparagraph 4(a) provides a special credit rule for Malta that limits the amount of credit Malta must allow a resident of Malta. The rule applies to items of income that would be either exempt from U.S. tax or subject to reduced rates of U.S. tax under the provisions of the proposed treaty if they had been received by a resident of Malta who is not a U.S. citizen. The tax credit allowed by Malta under paragraph 4 with respect to such items need not exceed the U.S. tax that may be imposed under the proposed treaty, other than U.S. tax imposed solely by reason of the U.S. citizenship of the taxpayer under the provisions of the saving clause of paragraph 4 of Article 1 (General Scope).

For example, if a U.S. citizen resident in Malta receives a royalty from sources within the United States, the foreign tax credit granted by Malta would be limited to 10 percent of the royalty – the U.S. tax that may be imposed under paragraph 2 of Article 12 (Royalties) on a U.S. source royalty received by a Malta resident that is not a U.S. citizen – even if the shareholder is subject to U.S. net income tax because of his U.S. citizenship.<sup>84</sup> With respect to gains under paragraph 6 of Article 13 (Gains), Malta would allow no foreign tax credit, because its residents are exempt from U.S. tax on such gains.

Subparagraph 4(b) eliminates the potential for double taxation that can arise because subparagraph 4(a) provides that Malta need not provide full relief for the U.S. tax imposed on its citizens resident in Malta. The subparagraph provides that the United States will credit the income tax paid or accrued to Malta, after the application of subparagraph 4(a). It further provides that in allowing the credit for the taxes paid to Malta, the United States will not reduce its tax below the amount that is creditable against Malta tax under subparagraph 4(a). The Technical Explanation notes that clause (iii) of subparagraph 3(c) of Article 25 (Mutual Agreement Procedure) provides a mechanism by which the competent authorities can resolve any disputes regarding the source of income.

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<sup>84</sup> In general, no tax would actually be withheld on the U.S. source royalty paid to the U.S. citizen that is Malta resident since this individual would already be subject to U.S. tax on a net basis.

Since the income described in subparagraph 4(a) generally is U.S. source income, special rules are required to re-source some of the income to Malta in order for a taxpayer to be able to credit the tax paid to Malta. This re-sourcing is provided for in subparagraph 4(c), which deems the items of income referred to in subparagraph 4(a) to be from foreign sources to the extent necessary to avoid double taxation under subparagraph 4(b).

The Technical Explanation contains two examples illustrating the application of paragraph 4 to a U.S. citizen resident in Malta (“the U.S. citizen”) that receives U.S. source royalty income of \$100. In both examples, the rate of withholding on a U.S. source royalty is 10 percent and the U.S. income tax rate on U.S. citizens is 35 percent (“the U.S. citizenship tax”). In the first example, the Malta tax rate that applies to the U.S. citizen that is resident in Malta is 25 percent. In this example, Malta allows the U.S. citizen to take a credit of \$10 (\$100 multiplied by 10 percent) against the Malta resident tax of \$25 under subparagraph 4(a). As a result, the net tax the U.S. citizen pays to Malta post-credit is \$15. In applying subparagraphs 4(b) and (c), the U.S. citizen first calculates the pre-credit citizenship tax of \$35 (\$100 multiplied by 35 percent). Since the tax the U.S. citizen owes to the U.S. government may not be less than the \$10 of credit that the U.S. citizen takes against the Malta income tax under subparagraph 4(b), the maximum U.S. citizenship tax eligible to be offset by a credit is \$25 (\$35 pre-credit citizenship tax less \$10 of Malta credit attributable to the royalty). As the \$15 of net tax the U.S. citizen pays to Malta is less than the \$25 of U.S. citizenship tax that may be offset by a credit, the U.S. citizen may take a credit of \$15 under subparagraph 4(b). Subparagraph 4(c) then applies to re-source \$42.86 (\$15 divided by 35 percent) of the U.S. source royalty income as foreign source income in the current year so that the U.S. citizen may take the credit under the U.S. foreign tax credit limitation.

In the second example, the Malta tax rate that applies to the U.S. citizen that is resident in Malta is 40 percent. In this example, Malta allows the U.S. citizen to take a credit of \$10 (\$100 multiplied by 10 percent) against the Malta resident tax of \$40 under subparagraph 4(a). As a result, the net tax the U.S. citizen pays to Malta post-credit will be \$30. In applying subparagraphs 4(b) and (c), the U.S. citizen first calculates the pre-credit citizenship tax of \$35 (\$100 multiplied by 35 percent). Since the tax the U.S. citizen owes to the U.S. government may not be less than the \$10 of credit that the U.S. citizen takes against the Malta income tax under subparagraph 4(b), the maximum U.S. citizenship tax eligible to be offset by a credit is \$25 (\$35 pre-credit citizenship tax less \$10 of Malta credit attributable to the royalty). As the \$30 of net tax the U.S. citizen pays to Malta is greater than the \$25 of U.S. citizenship tax that may be offset by a credit, the U.S. citizen may take a credit in the current year of \$25 under subparagraph 4(b) with \$5 of excess foreign tax credit available for carryover. Subparagraph 4(c) then applies to re-source \$71.43 (\$25 divided by 35 percent) of the U.S. source royalty income as foreign source income in the current year so that the U.S. citizen may take the credit under the U.S. foreign tax credit limitation.

#### Relationship to other articles

By virtue of subparagraph 5(a) of Article 1 (General Scope), Article 23 is not subject to the saving clause of paragraph 4 of Article 1. Thus, the United States allows a credit to its citizens and residents in accordance with Article 23, even if such credit were to provide a benefit

not available under the Code (such as the re-sourcing provided by paragraph 3 and subparagraph 4(c)).

#### **Article 24. Non-Discrimination**

The proposed treaty includes a comprehensive nondiscrimination article. The article is similar to the nondiscrimination article in the U.S. Model treaty and to provisions that have been included in other recent U.S. income tax treaties.

In general, under the proposed treaty, neither treaty country is permitted to discriminate against nationals of the other country by imposing on those nationals more burdensome taxation than it would impose on its own comparably situated nationals in the same circumstances.<sup>85</sup> Not all instances of differential treatment are discriminatory. Differential treatment is permissible in some instances under this rule on the basis of tax-relevant differences (for example, the fact that one person is subject to worldwide taxation in a treaty country and another person is not, or the fact that an item of income may be taxed at a later date in one person's hands but not in another person's hands).

The Technical Explanation notes that the OECD Model treaty prohibits one treaty country from imposing taxation on nationals of the other treaty country that is "other than or more burdensome" than the taxation imposed on its own nationals. The proposed treaty omits the reference to taxation that is "other than" that imposed on a country's own nationals because, according to the Technical Explanation, the only relevant question should be whether the taxation at issue is more burdensome.

Under the proposed treaty, neither country may tax a permanent establishment of an enterprise of the other country less favorably than it taxes its own enterprises carrying on the same activities.

As under the U.S. and OECD Model treaties, however, a treaty country is not obligated to grant residents of the other treaty country any personal allowances, reliefs, or reductions for tax purposes on account of civil status or family responsibilities that it grants to its own residents.

Except in circumstances in which the anti-avoidance rules described in paragraph 1 of Article 9 (Associated Enterprises), paragraph 7 of Article 11 (Interest), or paragraph 6 of Article 12 (Royalties) apply, interest, royalties, and other disbursements paid by an enterprise of a treaty country to a resident of the other treaty country must be deductible under the same conditions as if those amounts had been paid to a resident of the first treaty country. The Technical Explanation states that the exception relating to paragraph 7 of Article 11 (Interest) would include the denial or deferral of certain interest deductions under section 163(j) of the Code, thus allowing United States to apply its earnings stripping rules.

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<sup>85</sup> A national of one treaty country may claim protection under this article even if the national is not a resident of either treaty country. For example, a U.S. citizen who is resident in a third country is entitled to the same treatment in Malta as a comparably situated Maltese national.

Any debts of an enterprise of one treaty country to a resident of the other treaty country must, for purposes of determining the taxable capital of the enterprise, be deductible under the same conditions as if they had been owed to a resident of the first treaty country. According to the Technical Explanation, this rule, which applies in computing capital tax, is consistent with the nondiscrimination provisions generally because those provisions, in contrast with the general purpose of the treaty, which is to cover only income taxes, apply to all taxes levied in either treaty country.

The nondiscrimination rules also apply to enterprises of one treaty country that are owned in whole or in part by one or more residents of the other treaty country. An enterprise of one treaty country the capital of which is wholly or partly owned or controlled, directly or indirectly, by one or more residents of the other treaty country may not be subjected in the first country to any taxation (or any connected requirement) that is more burdensome than the taxation (or connected requirements) that the first country imposes or may impose on other similar enterprises. As noted above, some differences in treatment may be justified on the basis of tax-relevant differences in circumstances between two enterprises. In this regard, the Technical Explanation provides examples of Code provisions that are understood by the two countries not to violate the nondiscrimination provision of the proposed treaty, including the rules that tax U.S. corporations making certain distributions to foreign shareholders in what would otherwise be nonrecognition transactions, the rules that impose a withholding tax on non-U.S. partners of a partnership, the rules that prevent foreign persons from owning stock in subchapter S corporations, and the rules that prevent foreign corporations from joining in filing consolidated returns with domestic corporations.

The proposed treaty provides that nothing in the nondiscrimination article may be construed as preventing either of the countries from imposing a branch profits tax as described in paragraph 8 of Article 10 (Dividends).

Notwithstanding the definition of taxes covered in Article 2 (Taxes Covered), Article 23 applies to taxes of every kind and description imposed by either country, or any political subdivision or local authority of that treaty country. The Technical Explanation states that customs duties are not regarded as taxes for this purpose.

The saving clause does not apply to the nondiscrimination article. Thus, a U.S. citizen who is a resident of Malta may claim benefits in the United States under Article 23.

#### **Article 25. Mutual Agreement Procedure**

The mutual agreement provision permits taxpayers to bring to the attention of the competent authorities problems that may arise under the proposed treaty and authorizes the competent authorities of the two countries to cooperate to resolve disputes, clarify issues, and address cases of double taxation not provided for in the proposed treaty. The saving clause of the proposed treaty does not apply to the mutual agreement procedure. Consequently, the United States may apply to a U.S. citizen or resident rules and definitions agreed to by the competent authorities under the mutual agreement procedure even if those rules and definitions differ from comparable provisions of the Code.

Under Article 25, a person who considers that the actions of one or both of the treaty countries cause that person to be subject to tax in a manner not in accordance with the provisions of the proposed treaty may, irrespective of internal law remedies or time limits for refund claims, present a case to the competent authority of either treaty country. Unlike the OECD Model treaty, the proposed treaty provides no time limit for when a case must be brought. This rule is the same as the rule in the U.S. Model treaty but, according to the Technical Explanation, is more generous than the rule in most U.S. tax treaties. Under most treaties, a taxpayer may bring a case only to the competent authority of the taxpayer's country of residence, citizenship, or nationality. The Technical Explanation notes that the more generous rule of the proposed treaty allows a U.S. permanent establishment of a corporation that is a resident of Malta to ask the U.S. competent authority for assistance if it is subject to inconsistent treatment in the United States and Malta.

The Technical Explanation notes that typical cases brought under the mutual agreement procedure involve economic double taxation arising from transfer pricing adjustments but that other types of cases also may be brought. The Technical Explanation gives as an example a taxpayer who has received income that the source country has determined is deferred compensation and therefore is taxable in that country but which the taxpayer believes is a pension taxable only in the taxpayer's country of residence.

The proposed treaty provides that if an objection presented to a competent authority appears to be justified and that competent authority is not itself able to arrive at a satisfactory solution, that competent authority must endeavor to resolve the case by mutual agreement with the competent authority of the other treaty country, with a view to the avoidance of taxation that is not in accordance with the proposed treaty. The proposed treaty provides that any agreement reached is implemented notwithstanding any time limits or other procedural limitations in the domestic law of either treaty country (for example, a country's applicable statute of limitations). Assessment and collection procedures are suspended during the period that any mutual agreement proceeding is pending.

The Technical Explanation notes that if a taxpayer has entered into a closing agreement with the United States before bringing a case to the competent authorities, the U.S. competent authority may do nothing other than endeavor to obtain a correlative adjustment from Malta. Procedural limitations can be overridden, according to the Technical Explanation, only for the purpose of making refunds and not to impose additional tax.

The competent authorities of the treaty countries are to endeavor to resolve by mutual agreement any difficulties or doubts arising as to the interpretation or application of the proposed treaty. In particular, the competent authorities may agree to: (1) the same attribution of income, deductions, credits, or allowances of an enterprise of one treaty country to the enterprise's permanent establishment situated in the other country; (2) the same allocation of income, deductions, credits, or allowances between persons; (3) the same characterization of particular items of income; (4) the same characterization of persons; (5) the same application of source rules with respect to particular items of income; (6) a common meaning of a term; (7) the same timing of particular items of income; (8) advance pricing agreements; and (9) the application of the provisions of each treaty country's domestic law regarding penalties, fines, and interest in a manner consistent with the purposes of the proposed treaty. The Technical Explanation clarifies

that this list is a nonexhaustive list of examples of the kinds of matters about which the competent authorities may reach agreement. The list therefore does not grant any authority that is not otherwise provided by the rule that the competent authorities are to endeavor to resolve by mutual agreement any difficulties or doubts about the interpretation or application of the proposed treaty.

The proposed treaty provides that the competent authorities may consult together for the elimination of double taxation in cases not provided for in the proposed treaty.

The proposed treaty authorizes the competent authorities to agree to increase any specific dollar amounts referred to in the proposed treaty to reflect economic or monetary developments. According to the Technical Explanation, this provision refers only to Article 16 (Entertainers and Sportsmen). Furthermore, this provision may be exercised only to the extent necessary to restore the original objectives intended in setting the threshold, and may be applied only to the benefit of taxpayers (i.e., only to increase thresholds).

The proposed treaty authorizes the competent authorities to communicate with each other directly, including through a joint commission, for purposes of reaching an agreement in the sense of this mutual agreement article. The Technical Explanation states that this provision makes clear that the competent authorities may communicate without going through diplomatic channels.

The Technical Explanation states that even after the proposed treaty has been terminated, a taxpayer may bring to the competent authorities a case involving a year for which the proposed treaty was in force.

The Technical Explanation addresses cases involving the taxing jurisdictions of more than two countries. The example given is a case in which a parent corporation resident in country A engages in transactions with its subsidiaries in countries B and C. The Technical Explanation notes that if there is a complete network of treaties among the three countries, the competent authorities of those countries should be able to agree on a three-sided solution to a problem.

A person may seek relief under the mutual agreement procedure even if the person is not generally entitled to benefits under the limitation on benefits rules of the proposed treaty.

## **Article 26. Exchange of Information and Administrative Assistance**

The proposed Article 26 on exchange of information and administrative assistance is substantially similar to Article 26 (Exchange of Information and Administrative Assistance) of the U.S. Model treaty. The description below explains the scope and operation of the individual paragraphs and identifies instances in which the article varies from the U.S. Model treaty.

The United States and Malta agree to exchange such information as is relevant in carrying out the provisions of the proposed treaty or in carrying out the provisions of the domestic laws of the two treaty countries concerning all taxes of any kind imposed by a treaty country. This exchange of information is not restricted by paragraph 1 of Article 1 (Personal Scope) or Article 2 (Taxes Covered). In addition, the use of the word “relevant” indicates the

breadth of the scope of the exchanges, in establishing the standard for determining whether or not information may be exchanged under the treaty. It conforms to the standard used in Code section 7602, which is the principal source of authority for United States information gathering and examination of records. Under section 7602, the IRS may request to examine any books, records or other material that “may be relevant,” as confirmed by the U.S. Supreme Court in a line of cases beginning with *United States v. Powell*.<sup>86</sup>

In the United States, the administrative authority of the IRS to obtain information by service of an administrative summons extends to the territories and possessions under Code section 7651 in the same manner as if the possession or territory were a state. Thus, even though the proposed treaty in Article 3 (General Definitions) paragraph 1(h), provides a definition of “United States” that limits its meaning to its geographic sense for most purposes under the treaty and specifically carves out its possessions and territories, information in the possessions is subject to exchange of information pursuant to a proper request under the treaty.

The proposed treaty provides that information may be exchanged to enable each treaty country to administer its own domestic law, to the extent that taxation under that law is not contrary to the proposed treaty. According to the Technical Explanation, the competent authority of one treaty country may request information about a transaction from the competent authority of another treaty country even if the transaction to which the information relates is a purely domestic transaction in the requested country and information exchange about the transaction would not be undertaken to carry out the proposed treaty. As an example, the Technical Explanation states (referencing the OECD Model treaty) that if a U.S. company and a Maltese company transact with one another through a company resident in a third country that has no treaty with the United States or Malta, the U.S. and Maltese competent authorities may, to enforce their internal rules, exchange information about prices their resident companies paid in their transactions with the third-country company.

The proposed treaty provides that exchange of information may include information relating to the assessment or collection of, the enforcement or prosecution in respect of, or the determination of appeals in relation to, the taxes covered by the proposed treaty. Consequently, the competent authorities may exchange information about collection cases, cases under civil examination or criminal investigation, and cases being prosecuted.

Accordingly, information about persons who are residents of neither Malta nor the United States may be requested and provided under this article. For example, if a third-country resident has a Maltese bank account and the IRS believes that funds in the account should have been, but have not been, reported, the U.S. competent authority may request information from Malta about the bank account. The competent authorities may exchange information relating to, for example, U.S. estate and gift taxes, excise taxes, and Maltese value added taxes.

The confidentiality provision in the proposed treaty is also consistent with Article 26 of the U.S. Model treaty. Any information exchanged under the proposed treaty is to be treated as secret in the same manner as information obtained under the domestic laws of the treaty country

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<sup>86</sup> 379 U.S. 48 (1964).

receiving the information. The exchanged information may be disclosed only to persons or authorities (including courts, administrative bodies and legislative bodies) involved in the administration, enforcement or oversight of the tax laws. Such functions include assessment, collection, civil and criminal prosecution, and the determination of appeals in relation to the taxes to which the proposed treaty applies. The authority to disclose information to persons involved in oversight of taxes includes authority to disclose to persons or authorities such as the tax-writing committees of Congress and the Government Accountability Office. Such persons or authorities receiving the information may use the information only in the performance of their role in overseeing the administration of U.S. tax laws. Finally, exchanged information may be disclosed in public court proceedings or in judicial decisions.

The proposed treaty is broader than the U.S. Model treaty in one respect, in that it permits a state that receives information pursuant to an exchange of information under this treaty to disclose the information to authorities for use in purposes related to the United States and Malta Mutual Legal Assistance Treaty (“MLAT”). Such disclosures require the consent of the state that provided the information. The U.S.-Malta MLAT has not yet entered into force.<sup>87</sup> Under the terms of the MLAT, information obtained under the treaty may be used to investigate or prosecute criminal offenses in either treaty country.

If information is requested by a treaty country in accordance with this article, the proposed treaty provides that the requested treaty country must obtain the information in the same manner and to the same extent as if the tax of the requesting treaty country were the tax of the requested treaty country and were being imposed by that treaty country, notwithstanding that the requested treaty country may not need the information at that time for purposes of administering its own tax rules. According to the Technical Explanation, this rule clarifies that the limitations on information exchange described below do not prevent a treaty country from requesting information from a bank or a fiduciary that the treaty country does not need for its own tax purposes.

As is true under the U.S. Model treaty and the OECD Model treaty, under the proposed treaty a treaty country is not required to carry out administrative measures at variance with the laws and administrative practice of either treaty country; to supply information that is not obtainable under the laws or in the normal administrative practice of either treaty country; or to supply information that would disclose any trade, business, industrial, commercial, or professional secret or trade process, or information the disclosure of which would be contrary to public policy. The Technical Explanation notes, however, that if a treaty country is asked to provide information, it should provide the information even if its own statute of limitations period has expired for the issue to which the information relates. According to the Technical Explanation, the statute of limitations of the treaty country making the request should govern. The Technical Explanation also states that even if the limitations on information exchange mean that a treaty country is not obligated to supply information in response to a request from the other

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<sup>87</sup> The MLAT is ancillary to the MLAT between the United States and the European Union, both of which were ratified by the Senate on September 28, 2008, but neither of which has entered into force. As explained in Part VI below, the MLATs are expected to enter into force in early January 2010.

treaty country, the requested country may choose to supply the information if doing so does not violate its internal law.

The proposed treaty includes a new paragraph, similar to paragraph 4 of Article 26 of the U.S. Model treaty, which limits the ability of either country to refuse to provide information requested based on the lack of need for such information in a domestic tax investigation, or the expiration of the limitations period in the requested state. If the information is of relevance to the requester, the limitations of paragraph 3 will not support a refusal to exchange the information.

Under the proposed treaty, a new paragraph identical to paragraph 5 of the U.S. Model, limits the ability of either country to posit that domestic secrecy laws preclude response to a request for information. The proposed treaty explicitly limits the scope of paragraph 3, which provides the general principle that the treaty is not intended to require any actions by a state at variance with its domestic law, by providing that a treaty country cannot refuse to respond to a request for information based on the fact that the information is in the possession of financial institutions, nominees, or persons acting in an agency or fiduciary capacity. With regard to persons acting in an agency or fiduciary capacity, the scope of any override of domestic law is not explained in the Technical Explanation. Thus, a competent authority receiving a request for information from a financial institution may not decline the request based on an argument that domestic bank secrecy or similar rules override the treaty obligations and preclude honoring the request.

The proposed treaty also provides that the competent authorities may not refuse to exchange information because it relates to information concerning ownership interests in a “person.” The Technical Explanation states that this requirement will have the effect of requiring disclosure of the beneficial owner of bearer shares. However, because the language in the proposed treaty refers to “interests in a person” but not to interests in “instruments” it may not be sufficiently broad to require such exchanges with respect to bearer bonds.

The proposed treaty makes it possible for a treaty country to request that responsive information be provided in an authenticated form that will facilitate use of that information in the administrative or judicial proceedings in the requesting country. Proposed paragraph 6 provides that, upon specific request by the competent authority of a treaty country, the other competent authority must provide information in the form of depositions of witnesses and authenticated copies of unedited original documents (including books, papers, statements, records, accounts, and writings), to the same extent such depositions and documents can be obtained under the laws and administrative practices of the requested country with respect to its own taxes.

The proposed treaty requires a country to permit entry into the country by representatives of the other country for the purpose of conducting interviews and examining books and records, provided that the persons to be interviewed or whose records are to be examined have agreed. The consent of the person whose tax liability is under examination is not needed, unless that person is the person to be interviewed or the owner of the books and records to be reviewed. This paragraph conforms to paragraph 8 of the U.S. Model treaty.

The proposed treaty permits the competent authorities to develop agreements about the mode of application of this article, including methods for ensuring adequate reciprocity or establishing timetables and minimum thresholds of tax in controversy to warrant use of this procedure, etc. However, the lack of such an agreement does not justify a refusal or failure to comply with the obligations of the exchange of information article. In the diplomatic notes, the governments of Malta and the United States have agreed to meet at regular intervals, beginning no later than three years from the date of the signing of the treaty, to discuss and review the operation and functioning of the proposed treaty in general and of the exchange of information provisions in particular.

Finally, consistent with the U.S. Model treaty, the treaty partners may exchange information with respect to years prior to the entry into force of the proposed treaty. According to the Technical Explanation, the exchange of information program will be administered under the treaty in force at the time of the request, without regard to any restrictions that may have been applicable during the year to which the request relates. The Technical Explanation refers to paragraph 3 of Article 28 (Entry into Force) for confirmation of this interpretation.

#### **Article 28. Entry into Force**

The proposed treaty provides that the treaty is subject to ratification in accordance with the applicable procedures of each treaty country, and instruments of ratification shall be exchanged. The proposed treaty will enter into force on the date of the exchange of instruments of ratification.

With respect to withholding taxes (principally dividends, interest and royalties), the proposed treaty has effect for amounts paid or credited on or after the first day of the second month following the date on which the proposed treaty enters into force. The Technical Explanation provides an example, in which, as a result of the instruments of ratification being exchanged on April 25 of a given year, the treaty rate of withholding under paragraph 2 of Article 10 (Dividends) is applicable to dividends paid after June 1 of that year.

For other taxes, the proposed treaty has effect for taxes with respect to tax periods beginning on or after the first day of January next following the date on which the proposed treaty enters into force.

With respect to the powers given to Competent Authority under Article 26 (Exchange of Information and Administrative Assistance), the proposed treaty has effect from the date on which the proposed treaty enters into force.

## VI. ISSUES

### A. Treaty Shopping

#### **In general**

The proposed treaty, like nearly all U.S. income tax treaties, generally limits treaty benefits for treaty country residents so that only those residents with a sufficient nexus to a treaty country will receive treaty benefits. Although the proposed treaty generally is intended to benefit residents of Malta and the United States only, residents of third countries sometimes attempt to use a treaty to obtain treaty benefits. This practice is known as treaty shopping. Investors from countries that do not have tax treaties with the United States, or from countries that have not agreed in their tax treaties with the United States to limit source-country taxation to the same extent that it is limited in another treaty may, for example, attempt to reduce the tax on interest on a loan to a U.S. person by lending money to the U.S. person indirectly through a country whose treaty with the United States provides a lower rate of withholding tax on interest. The third-country investor may attempt to accomplish this result by establishing in that treaty country a subsidiary, trust, or other entity that then makes the loan to the U.S. person and claims the treaty reduction for the interest it receives – a reduction in withholding tax that would not have been possible had the investor made the loan directly from his or her country of residence.

#### **Termination of prior U.S.-Malta tax treaty**

The United States first signed an income tax treaty with Malta on March 21, 1980.<sup>88</sup> The treaty had no formal limitation-on-benefits provisions, but Article 16 (Investment or Holding Companies) of the treaty was intended to prevent residents of a third country from taking advantage of the reduced rates of withholding on dividends, interest, or royalties provided by the treaty in cases in which one of the treaty countries provided preferential rates of tax for investment or holding companies deriving foreign source income.<sup>89</sup>

Consistent with the provisions of the treaty, on November 16, 1995, the United States delivered a notice of termination to Malta stating that the income tax treaty between the two countries would cease to have effect as of January 1, 1997. The termination of the treaty was due, at least in significant part, to Treasury's concern with recent changes in Maltese law that might have inappropriately facilitated the use of the treaty by persons who were not residents of Malta or the United States.<sup>90</sup>

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<sup>88</sup> Agreement Between the United States of America and the Republic of Malta with Respect to Taxes on Income Signed at Valleta on March 21, 1980. The treaty entered into force on May 18, 1982.

<sup>89</sup> Department of the Treasury, "Technical Explanation of the Agreement Between the United States of America and the Republic of Malta with Respect to Taxes on Income Signed at Valleta on March 21, 1980."

<sup>90</sup> According to Leslie Samuels, the Assistant Secretary (Tax Policy), the termination "provides an example of Treasury's commitment to prevent misuse of income tax treaties by third-country residents, even if it means termination of long-standing relationships." Department of the Treasury News Release, United States

As discussed in greater detail in Part VI.B below, since 1997 Malta has joined the European Union, implemented the various EU directives assuring mutual administrative assistance and compliance with international transparency norms, and revised its domestic laws to allow Maltese tax authorities to access bank information so as to provide assistance to foreign tax authorities. In contrast, certain key features of Malta's domestic tax law, which are discussed immediately below, remain substantially unchanged.<sup>91</sup>

In light of the prior treaty history, the Committee may wish to ask the Treasury Department whether these or other factors led it to conclude that it was now appropriate to enter into a new income tax treaty with Malta. The Committee may also wish to inquire whether the provisions of the proposed treaty, taken together, assuage all of the types of concerns that led the Treasury Department to terminate the prior treaty, and, in particular, whether the provisions of the limitation-on-benefits article are sufficient to prevent the use of the proposed treaty by persons that are not residents of the United States or Malta.

### **Characteristics of Malta's domestic tax law**

The discussion above provides a brief overview of what constitutes treaty shopping. In addition to having a favorable income tax treaty with other countries that are desirable from an external investment perspective, jurisdictions frequently targeted for treaty shopping often have favorable characteristics under domestic tax law. These characteristics may include: (1) little or no taxation on dividends received from nonresident subsidiaries; (2) no withholding tax on dividends paid to nonresident companies; (3) little or no taxation on capital gains on the disposal of shares of nonresident subsidiaries; (4) no withholding tax on interest paid to nonresidents; (5) deductibility of interest expense attributable to the acquisition of foreign subsidiaries; and (6) no, or at least a non-stringent, controlled foreign corporation ("CFC") regime. At present, Malta's domestic tax law provides many of these favorable features.

Specifically, receipt of dividends from a foreign subsidiary is exempt from Maltese corporate taxation if the foreign subsidiary meets the definition of a "participating holding." A foreign subsidiary generally meets this definition if the Maltese corporation holds at least 10 percent of the shares of the foreign subsidiary. Additionally, the foreign subsidiary must be a resident of the EU, derive less than 50 percent of its income from passive interest or royalties, or be subject to tax at a rate of at least 15 percent. If these conditions are not satisfied, the dividends are subject to Maltese corporate tax at a 35-percent rate, but, under Malta's full imputation system described in more detail in Part III above, a foreign parent receives a credit for 100 percent of the Maltese tax paid when the dividends are distributed. Similar rules apply to a disposition of shares in a foreign subsidiary.

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Terminates 1980 Income Tax Treaty with Malta (RR-717, November 20, 1995) [hereinafter Malta termination statement].

<sup>91</sup> While a modification was made to the Maltese imputation system to address EU concerns, this modification was made primarily to extend the benefits previously only available to Maltese foreign investment to Maltese domestic investments. See, e.g., Christian Ellul, "Malta," 44 Tax Notes International 1074, 1075 (2006).

In addition, payments of dividends and interest to foreign persons are not subject to withholding tax. Furthermore, the deductibility of interest is not subject to any thin capitalization rules, and investments in foreign subsidiaries by a Maltese corporation are not subject to any CFC rules.

In the absence of an effective limitation-on-benefits provision, these features of Malta's domestic tax regime would make it an attractive target for treaty shopping.

### **Deviations from the U.S. Model treaty**

The proposed treaty is based on the U.S. Model treaty. Nonetheless, the treaty deviates from the U.S. Model treaty in two critical areas that often have an impact on a treaty country's attractiveness for treaty shopping – the rate of withholding (principally on dividends, interest, and royalties) and limitation-on-benefits rules.

#### Withholding taxes

One significant reason that residents of nontreaty jurisdictions (or jurisdictions with less favorable treaties) engage in treaty shopping is to access tax treaties that provide for little or no withholding on the payment of dividends, interest, royalties, and other income. The withholding tax rates on dividends under the proposed treaty generally are five percent in the case of dividends from an at least 10-percent owned company and 15 percent in all other cases, which are the same rates available under the U.S. Model treaty. The proposed protocol with France and several other recent U.S. tax treaties provide more favorable treatment of dividends in that they include these rates and also provide for the payment of dividends by at least 80-percent owned subsidiaries to be made to their parents free of any withholding tax.

The lowest withholding rate available for interest, royalties, and other income under the proposed treaty is greater than the lowest withholding tax rates available for those same items of income under the U.S. Model treaty. In particular, the proposed treaty provides for a 10-percent rate of withholding on certain payments of interest, royalties, and other income. In contrast, the U.S. Model treaty does not permit any withholding on these types of payments in the same circumstances.

While the withholding rates under the proposed treaty may make it less attractive from a treaty shopping perspective, the Committee may wish to inquire about the circumstances in which the Treasury Department believes it is appropriate to deviate from the withholding tax rates provided in the U.S. Model treaty. In addition, the Committee may wish to inquire as to why the proposed treaty provides less favorable withholding rates than the U.S. Model treaty for interest, royalties, and other income while matching the U.S. Model treaty's favorable rates for dividends.

#### Limitation-on-benefits provisions

Article 22 (Limitation on Benefits) of the proposed treaty provides anti-treaty shopping provisions. As discussed in more detail in Part V above, a resident of either the U.S. or Malta (unless the Malta entity is an international trading company) is generally entitled to all the benefits accorded by the proposed treaty if the resident has any one of six listed attributes. These

six attributes, which are found in both the proposed treaty and the U.S. Model treaty, are that the resident is: (1) an individual; (2) one of the two treaty countries or a political subdivision or local authority of one of the two countries; (3) a company that satisfies a public company test, or that is a subsidiary of a public company, and satisfies a base erosion test; (4) an organization that is established and maintained in its country of residence exclusively for religious, charitable, scientific, artistic, cultural, or educational purposes, even if all or part of its income or gains are exempt from tax under the residence country's domestic law; (5) a pension fund that satisfies a beneficiaries test; or (6) an entity that satisfies an ownership test and a base erosion test.

Although the limitation-on-benefits rules in the proposed treaty are similar to the rules in other recent and proposed U.S. income tax treaties and protocols and in the U.S. Model treaty, they are not identical. Following is a summary of the differences between the limitation-on-benefits provision of the proposed treaty and the limitation-on-benefits provisions in the U.S. Model treaty. In general, these differences make it more difficult for a person to qualify for benefits under the proposed treaty than under the U.S. Model treaty. A discussion of issues that the Committee may want to consider in light of these differences follows the summary.

#### Publicly traded companies and subsidiaries

Under the proposed treaty, a company may satisfy the limitations-on-benefits provision by meeting the primarily and regularly traded test. The primarily and regularly traded test under the proposed treaty differs from the comparable test under the U.S. Model treaty in several significant respects. First, the proposed treaty includes a base erosion test as one aspect of the primarily and regularly traded test. The U.S. Model treaty, in contrast, does not require a company to satisfy a base erosion test to satisfy the primarily and regularly traded test, although a base erosion test is included as part of other tests.

Second, the base erosion test included in the proposed treaty differs from the one found in the U.S. Model treaty. To satisfy the proposed treaty's base erosion test, less than 25 percent of the person's gross income for the taxable year, as determined in that person's country of residence, may be paid or accrued, directly or indirectly, to persons who are not residents of either treaty country entitled to treaty benefits under the limitation-on-benefits article as individuals, governments, parent companies that meet the public company test, tax-exempt organizations, or pension funds. Under the U.S. Model treaty, the base erosion test applies a 50-percent threshold (instead of 25 percent, as under the proposed treaty) and encompasses only deductible payments, not all payments, as is the case with the proposed treaty's test.

Third, the proposed treaty does not include a management and control test, although such a test is found in the U.S. Model treaty. The management and control test is an alternative means for a company whose principal class of shares is regularly traded, but not primarily traded, on a recognized stock exchange located in the company's country of residence to satisfy the public company test. A company satisfies the management and control test if its primary place of management and control is in the country of which it is a resident.

Finally, both the proposed treaty and the U.S. Model treaty provide an alternative means for certain companies (especially subsidiaries of publicly traded companies) that do not satisfy the primarily and regularly traded test to nevertheless qualify for treaty benefits. To qualify for

benefits under this alternative method under the proposed treaty, at least 75 percent of each class of the company's shares must be owned, directly or indirectly, by companies that satisfy the primarily and regularly traded test, provided that, in the case of the indirect ownership, each intermediate owner is a resident of the same treaty country as the company qualifying for treaty benefits under this test. Additionally, the base erosion test must be satisfied.

Under the U.S. Model treaty, in contrast, the share ownership rule requires that shares representing only 50 percent of the aggregate vote and value of the company's shares (and 50 percent of any disproportionate class of shares) be owned by companies that satisfy the primarily and regularly traded test (instead of 75 percent of each class of shares). Furthermore, the U.S. Model treaty permits intermediate owners to be residents of either of the two treaty countries (instead of requiring that the intermediate owners be residents of the same country as the company claiming benefits under the treaty). Finally, there is no requirement to satisfy a base erosion test as part of this alternative test in the U.S. Model treaty.

#### Pension funds

Under the proposed treaty, a pension fund is entitled to all of the benefits of the proposed treaty if more than 75 percent of the fund's beneficiaries, members, or participants are individuals resident in either treaty country. In contrast, the U.S. Model treaty has only a 50 percent requirement (instead of 75 percent).

#### Ownership and base erosion tests

As discussed above, the U.S. Model treaty differs from the proposed treaty in that, unlike the proposed treaty, it does not have a base erosion test as part of the primarily and regularly traded test. However, both the proposed treaty and U.S. Model treaty have separate ownership and base erosion tests as part of their limitation-on-benefits rules. For an entity that is a treaty country resident to satisfy the ownership test, the proposed treaty generally requires that on at least half the days of the taxable year at least 75 percent of each class of the entity's shares or other beneficial interests are owned, directly or indirectly, by residents of that treaty country who are entitled to treaty benefits under the limitation-on-benefits article as individuals, governments, parent companies that meet the public company test, tax-exempt organizations, or pension funds. This test differs from the U.S. Model treaty, which only requires that shares representing 50 percent of the aggregate vote and value of the company's shares (and 50 percent of any disproportionate class of shares) be owned by qualifying residents of that treaty country.

The base erosion test and the associated differences between the proposed treaty and U.S. Model treaty are the same as discussed above under "Publicly traded companies and subsidiaries."

#### Derivative benefits rule

Like the proposed protocols with France and New Zealand, and like other recent treaties, the proposed treaty includes derivative benefits rules that are generally intended to allow a treaty-country company treaty benefits for an item of income if the company's owners would have been entitled to the same benefits for the income had those owners derived the income directly. The derivative benefits rules may grant treaty benefits to a treaty-country resident

company in circumstances in which the company would not qualify for treaty benefits under any of the other limitation-on-benefits provisions. The U.S. Model treaty does not include derivative benefits rules. This is the one circumstance in which the limitation-on-benefits article of the proposed treaty deviates from the U.S. Model treaty in a notable way that might make it easier for a person to qualify for treaty benefits. However, in this case, the potential for treaty shopping may be limited as the derivative benefits rules require that the person seeking treaty benefits be entitled to comparable benefits under another treaty.

#### Triangular arrangements

The proposed treaty includes special anti-abuse rules intended to deny treaty benefits in certain circumstances in which a Malta-resident company earns U.S.-source income attributable to a third-country permanent establishment and is subject to little or no tax in the third jurisdiction and Malta. Similar, but somewhat less restrictive, anti-abuse rules are included in the proposed protocols with France and New Zealand, as well as other recent treaties. The U.S. Model treaty, however, does not include rules addressing triangular arrangements.

#### Considerations with respect to the differences in the limitation-on-benefits provision

The above discussion highlights differences in the limitation-on-benefits article of the proposed treaty as compared to the same article of the U.S. Model treaty. With the exception of the derivative benefits rule, each of the other differences result in the limitation-on-benefits article of the proposed treaty being more stringent than the U.S. Model treaty.

In light of the numerous differences between the proposed treaty and the U.S. Model treaty, the Committee may wish to ask the Treasury Department what circumstances necessitated the extra stringency in the limitation-on-benefits article in the proposed treaty. To the extent the stringent rules were based on a concern about the Maltese imputation system and other attractive features of Maltese tax law described previously, the Committee may wish to consider the extent to which these rules may prevent treaty shopping motivated by these attractive features. The Committee may also wish to consider whether the limitation-on-benefits article in the U.S. Model treaty should be modified to apply these more stringent rules. Moreover, in light of its absence from the U.S. Model treaty, the Committee may wish to inquire whether the Treasury Department will insist on inclusion of an anti-abuse rule applicable to triangular arrangements whenever a treaty partner's internal tax rules provide an exemption for the income of a third-country permanent establishment of a treaty-country resident.

## **B. Exchange of Information and Administrative Assistance**

### **Background**

The United States and Malta have not had a bilateral income tax treaty in force since the United States terminated the previous income tax treaty effective in 1997. At the time of the termination, the Treasury Department issued a statement that attributed the termination to changes in Malta domestic law that facilitated “misuse” of the treaties by persons who were not residents of Malta or the United States.<sup>92</sup> It did not expressly mention deficiencies in the exchange of information program, but informal commentary since then has noted the possibility that such problems contributed to the termination.<sup>93</sup>

In the proposed treaty, Article 26 (Exchange of Information and Administrative Assistance) closely tracks the language of the exchange of information provisions in the U.S. Model treaty in most respects. The proposed treaty facilitates the exchange of information, and tends to limit the circumstances in which the treaty countries can refuse to provide requested information. In particular, the proposed treaty permits the competent authorities to exchange such information as is relevant to the assessment, collection and enforcement of the domestic laws of the two countries, rather than limiting the information to that which is necessary. This conforms to the standard of section 7602 of the Code. The proposed treaty also requires that the other country use its domestic powers to obtain the requested information in the same manner and to the same extent as if the tax of the requesting country were the tax of the other country and were being imposed by that country, whether or not the country receiving the request needs the information currently. Further, the proposed treaty provides that a treaty country may not refuse to provide requested information on the basis of domestic bank secrecy laws.

The proposed treaty permits the competent authorities to develop agreements about the mode of application of this article, including methods for ensuring adequate reciprocity or establishing timetables and minimum thresholds of tax in controversy to warrant use of this procedure. In the diplomatic notes, the governments of Malta and the United States have agreed to meet at regular intervals, beginning no later than three years from the date of the signing of the treaty, to discuss and review the operation and functioning of the proposed treaty in general and of the exchange of information provisions in particular.

### **Changes in Maltese law relevant to exchange of information**

To the extent that there were perceived deficiencies in the former information exchange program that contributed to the decision to terminate the prior treaty, the Committee may wish to seek reassurances that they have been addressed and that a recurrence is unlikely. Since the termination of the prior treaty between the United States and Malta, Malta has acceded to membership in the European Union. As a result, Malta has implemented the various directives

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<sup>92</sup> See Malta termination statement, note 90.

<sup>93</sup> E.g., Lawrence M. Hill, “The Increasingly Vital Role of International Tax Law,” 2008 WL 5689074 (ASPATORE).

assuring mutual administrative assistance and compliance with international transparency norms, such as the Third EU Money Laundering Directive and the EU Savings Directive.<sup>94</sup>

In addition, changes to Malta's domestic laws came into force in January 2008 that now grant tax authorities in Malta access to bank information for the purpose of exchanging such information with other tax authorities pursuant to a reciprocal exchange of information agreement. It has entered into 45 agreements that include exchange of information provisions in compliance with the OECD standards.<sup>95</sup> Malta is now considered to have fully committed to the transparency standards of the OECD.<sup>96</sup>

### **Relationship to Mutual Legal Assistance bilateral agreement**

In its only departure from the U.S. Model treaty's exchange of information provisions, the proposed treaty permits the recipient of information exchanged under the treaty to use that information for purposes sanctioned by the U.S.-Malta Treaty on Certain Aspects of Mutual Legal Assistance in Criminal Matters. The Technical Explanation does not elaborate on the reasons for that provision or its expected effect. The agreement is an MLAT negotiated and executed as part of the development of the EU-U.S. Mutual Legal Assistance Treaty ("EU Framework agreement"). Twenty-five bilateral agreements and the EU Framework agreement were considered by the Committee and ratified by the Senate in September 23, 2008.<sup>97</sup> They are expected to enter into force early next year. The exchange of instruments of ratification for the EU Framework agreement is scheduled for November 2009. Under Article 18 of that Agreement, it enters into force on the first day following the third month after the exchange of instruments. Under paragraph 5 of the bilateral MLAT, it will be effective as of the entry into force of the EU Framework agreement.

The inclusion of a cross-reference to the MLAT in the tax treaty exchange of information article is unique among U.S. treaties, although both the OECD Convention on Mutual Assistance in Tax Matters (in Article 4) and the OECD Model treaty (in Article 26) allow for the use of information obtained under a treaty for nontax matters, such as violations of the U.S. foreign bank account reporting requirements, money laundering, and corruption, if the country supplying the information consents to such use. The U.S. tax information exchange agreement ("TIEA") with Liechtenstein includes a similar provision.<sup>98</sup> Although the practical impact of this variation

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<sup>94</sup> OECD, *Tax Cooperation: Towards a Level Playing Field, 2008 Assessment by the Global Forum on Taxation*, p. 28, Table A-2.

<sup>95</sup> *Ibid.*, pp. 6 and 22, Table A-1.

<sup>96</sup> OECD, *A Progress Report On The Jurisdictions Surveyed By The OECD Global Forum In Implementing The Internationally Agreed Tax Standard*. 2009 TNT 62-65, April 2, 2009.

<sup>97</sup> S. Exec. Rep. 110-13 (September 11, 2008), S. Report 111-012 (March 31, 2009).

<sup>98</sup> Article 8 (Confidentiality) in the TIEA signed on December 8, 2008, 2008 TNT 237-26. The Liechtenstein TIEA was approved by Liechtenstein Parliament on June 25, 2009, at which time Liechtenstein also announced that it is in the process of adopting legislation required to enable it to comply with the terms of the TIEA. Under Article 13 of the TIEA, "Legislation necessary to comply with and give effect to the terms of this Agreement shall be enacted by December 31, 2009, to the extent necessary." 2009 TNT 122-89.

from the U.S. Model treaty is not clear, it likely has the effect of expanding the scope of exchange of information, by agreement of the parties, to permit use of tax information obtained under the treaty in a non-tax matter that could have been the subject of a request for exchange of information under the MLAT. Because the MLAT itself is not restricted to criminal prosecution, but permits exchanges with administrative authorities who have dual civil and criminal investigative purposes, the tax information would be available for administration in non-tax, non-criminal matters.

Unlike the tax treaties, MLATs designate the Department of Justice as the “Central Authority” having the role of administering the treaty on behalf of the United States.<sup>99</sup> If the information available under the tax treaty represents a subset of information otherwise available under the MLAT, it may be appropriate to consider the provision as an attempt to remove requirements for duplicative treaty requests in order to use information available under both treaties. On the other hand, the provision may override restrictions in Code section 6103, which establishes the standards under which information collected in the course of a tax examination may be disclosed to another agency for a non-tax purpose. If it would permit use of information that would not otherwise be obtained under an MLAT, or would not otherwise be available to the Department of Justice under domestic law, the Committee may wish to inquire about the circumstances under which it would be advisable for the United States to grant consent to the disclosure of exchanged tax information on the basis of this authority. By way of comparison to the proposed treaty, the proposed protocol that modernizes and updates the exchange of information provisions with France does not refer to the MLAT between the United States and France, which was approved at the same time that the Malta MLAT was ratified.

The Committee may wish to request clarification about the operation and intended effect of this deviation from the U.S. Model treaty. For example, the Committee may wish to ask to what extent this change should be understood to expand the scope of permissible exchange of information.

### **Effectiveness of the U.S. Model treaty Article 26**

In addition to the above issues, which are specific to the agreement between U.S. and Malta, there are several questions about the effectiveness and scope of provisions that conform to the U.S. Model treaty. Since the proposed treaty was signed, there has been extensive bilateral and multilateral cooperation in addressing issues of cross-border tax compliance and financial regulatory reform. A broad international consensus has coalesced around the issue of bank transparency for tax purposes and strengthened in the past year. Greater attention to all means of restoring integrity and stability to financial institutions has led to greater efforts to reconcile the conflicts between jurisdictions, particularly between jurisdictions with strict bank secrecy and those seeking information to enforce their own tax laws.<sup>100</sup> As a result, the Committee may

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<sup>99</sup> See I.R.M. Pars. 11.3.28.3.2.

<sup>100</sup> See, Joint Committee on Taxation, *Description of Revenue Provisions Contained in the President's Fiscal Year 2010 Budget Proposal; Part Three: Provisions Related to the Taxation of Cross-Border Income and Investment* (JCS-4-09), September 2009. Section VI of that pamphlet provides an overview of the international efforts to address these issues.

wish to inquire as to whether the U.S. Model treaty published in 2006 remains the appropriate standard by which to measure an effective exchange of information program.

The U.S. Model treaty conforms with the norms for transparency and effective exchange of information articulated by the OECD, which are in turn the standards by which the OECD determines whether a country is committed to transparency. Those standards require that the existence of mechanisms for exchange of information upon request; that exchange of information is available for purposes of domestic tax law in both criminal and civil matters; that there are no restrictions of information exchange caused by application of the dual criminality principle<sup>101</sup> or a domestic tax interest requirement; respect for safeguards and limitations; strict confidentiality rules for information exchanged; and availability of reliable information (in particular bank, ownership, identity and accounting information) and powers to obtain and provide such information in response to a specific request.<sup>102</sup>

### Methods of exchange of information

The OECD standards do not require exchange other than upon specific requests for information, although the language would permit the treaty country to agree to provide for other exchange mechanisms. The OECD, in its commentary to the exchange of information provisions in the OECD Model treaty, specifies that the treaty “allows” the competent authorities to exchange information in any of three ways that treaty countries have traditionally operated<sup>103</sup> – routine, spontaneous,<sup>104</sup> or specific exchanges.<sup>105</sup> With regard to the latter type of exchange, the Committee may wish to inquire as to the extent to which a request that a treaty country provide information in response to a John Doe summons<sup>106</sup> is a specific request within the meaning of the

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<sup>101</sup> The principle of dual criminality derives from the law regarding extradition and grounds for refusal to grant a request. Extradition is generally permitted only if the crime for which a person is to be extradited is treated as a similarly serious offense in the state in which the fugitive has sought refuge. *Restatement (Third) of the Foreign Relations Law of the United States*, sec. 476 (1987). The principle is relevant to a request for exchange of tax information only if the treaty in question limits the scope of its permitted exchanges to criminal tax matters.

<sup>102</sup> OECD, *Tax Cooperation: Towards a Level Playing Field, 2008 Assessment by the Global Forum on Taxation*, p. 8.

<sup>103</sup> OECD, *Commentary on the Model Treaty Article 26*, par. 9.

<sup>104</sup> A “spontaneous exchange of information” occurs when one treaty country who is in possession of an item of information that it determines may interest the other treaty country for purposes of its tax administration spontaneously transmits the information to its treaty country through their respective competent authorities.

<sup>105</sup> A “specific exchange” is a formal request by one contracting state for information that is relevant to an ongoing investigation of a particular tax matter. These cases are generally taxpayer specific. Those familiar with the case prepare a request that explains the background of the tax case and the need for the information and submit it to the Competent Authority in their country. If he determines that it is an appropriate use of the treaty authority, he forwards it to his counterpart.

<sup>106</sup> When the existence of a possibly noncompliant taxpayer is known but not his identity, as in the case of holders of offshore bank accounts or investors in particular abusive transactions, the IRS is able to issue a summons to learn the identity of the taxpayer, but must first meet greater statutory requirements, to guard against fishing expeditions. Prior to issuance of the summons intended to learn the identity of unnamed “John Does,” the United States must seek judicial review in an *ex parte* proceeding. In its application and supporting documents,<sup>106</sup> the

article, and whether protracted litigation similar to that which occurred in the UBS litigation<sup>107</sup> can be avoided or shortened.

The Committee may wish to explore issues related to “routine exchange of information.” In this type of exchange, also referred to as “automatic exchange of information,” the treaty countries identify categories of information that are consistently relevant to the tax administration of the receiving jurisdiction and agree to share such information on an ongoing basis, without the need for a specific request. Information that is automatically shared under this authority may include information that is not taxpayer-specific, such as news about changes in domestic tax legislation, or it may comprise voluminous taxpayer filings, such as magnetic disks containing the information from IRS Form 1042-S, relating to U.S.-source fixed or determinable income paid to persons claiming to be residents of the treaty country receiving the forms. The type of information, when it will be provided, and how frequently it will be provided are determined by the respective Competent Authorities after consultation. Once an agreement is reached, the information is automatically provided.

The Committee may wish to inquire about the existence of any practical impediments to effective automatic exchange of information under the proposed treaty and what steps are needed to remove the impediments. In the past, there have been concerns that information received pursuant to automatic exchanges under bilateral and multilateral agreements was not in a usable form. Examples of practical hurdles that reportedly limited the value of information exchanged were the lack of timeliness of its production, lack of conformity in reporting periods, the need to translate the language of the documents and the currencies, and its voluminous nature.<sup>108</sup> To the extent that useful information can be gathered through exchange of information, the United States may be able to reduce its reliance upon self-reporting, that is, information provided by the taxpayer and, therefore, only available with respect to those in compliance with the tax laws.

Practical challenges with automatic exchanges are not exclusive to the United States. The OECD has developed standards for the electronic format of such exchanges, to enhance their utility to tax administration.<sup>109</sup> Despite these efforts to standardize the information exchanged and improve its usefulness, there remain numerous shortcomings, both practical and legal, in the

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United States must establish that the information sought pertains to an ascertainable group of persons, that there is a reasonable basis to believe that taxes have been avoided, and that the information is not otherwise available.

<sup>107</sup> On July 1, 2008, a Federal district court in Florida granted the IRS permission to issue a John Doe summons to UBS seeking the names of as many as 20,000 U.S. citizens who were UBS customers for which reporting or withholding obligations may not have been met, Case No. 08-21864-MC-LENARD/GARBER. The summons was served on July 21, 2008. A petition to enforce that summons was filed on February 21, 2009. See *United States v. UBS AG*, Civil No. 09-20423 (S.D. Fla.). On August 19, 2009, after extensive negotiations between the Swiss and U.S. governments, the United States and UBS announced that UBS had agreed to provide information on over 4,000 U.S. persons with accounts at UBS.

<sup>108</sup> Letter from Commissioner, IRS, to Chairman, Senate Committee on Finance (June 12, 2006), 2006 *Tax Notes Today* 115-17.

<sup>109</sup> See, OECD, Committee on Fiscal Affairs, *Manual on the Implementation of Exchange of Information Provisions for Tax Purposes*, Module 3 (January 23, 2006) (“OECD Exchange Manual”).

routine exchange of information. Chief among them is the lack of taxpayer identification numbers (“TINs”) in the information provided under the exchange, despite the recommendation of the OECD that member states provide such information.<sup>110</sup> Ideally, the information received by the IRS should either include a TIN or be subject to a process referred to as “TIN perfection” to enable the IRS to correlate account data in the information received with a valid TIN in its taxpayer databases, although such an undertaking may be time-consuming and costly.

#### U.S. reciprocity in providing information on beneficial ownership

The United States has come under increasing pressure to eliminate policies that provide foreign persons with the ability to shelter income. The criticism has focused on disparities between the U.S. standards and foreign standards governing “know-your-customer” rules for financial institutions and the maintenance of information on beneficial ownership. With respect to the latter, U.S. norms have been criticized in recent years.<sup>111</sup> The Committee may wish to explore the extent to which either the existing U.S. know-your-customer rules or the corporate formation and ownership standards prevent the United States from providing information about beneficial ownership on a reciprocal basis with its treaty countries. It may also consider whether there are steps to take that would help refute the perception that the United States permits states to operate as tax havens and that would help the United States better respond to information requests from treaty countries who suspect that their own citizens and residents may be engaging in illegal activities through U.S. corporations and limited liability companies.<sup>112</sup>

#### Override of domestic law privileges or confidentiality

The scope and operation of the provision that overrides potential arguments based on bank secrecy law of the requested treaty country presents questions about its possible impact on other privileges. Under the proposed article as well as both the OECD Model and U.S. Model treaties, a treaty country is generally not obligated to take any action at variance with its domestic law, including disclosure of professional or trade secrets. That principle is limited by a special rule, which provides that a treaty country may not decline to provide information on the ground that the information is held by a financial institution, nominee, or person acting in an agency or intermediary capacity. The Technical Explanations to the proposed treaty and to the U.S. Model treaty state that this rule overrides claims of bank secrecy, but do not address its

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<sup>110</sup> OECD Exchange Manual refers to a recommendation dating to 1997, “Recommendation on the use of Tax Identification Numbers in an International Context” C(97)29/FINAL (1997).

<sup>111</sup> Financial Action Task Force, IMF, *Summary of the Third Mutual Evaluation Report on Anti-Money Laundering and Combating the Financing of Terrorism United States of America*, pp. 10-11 (June 23, 2006); Government Accountability Office, *Company Formations: Minimal Ownership Information Is Collected and Available*, a report to the Permanent Subcommittee on Investigations, Committee on Homeland Security and Governmental Affairs, U.S. Senate GAO-06-376 (April 2006); Government Accountability Office, *Suspicious Banking Activities: Possible Money Laundering by US Corporations Formed for Russian Entities*, GAO-01-120 (October 31, 2006).

<sup>112</sup> E.g., the “Incorporation Transparency and Law Enforcement Assistance Act,” 111th Congress, 1st Sess., S. 569 (March 11, 2009), would require States to obtain and periodically update beneficial ownership information from persons who seek to form a corporation or limited liability company.

potential intersection with the law of professional privileges. In contrast, the OECD explains the general principle and provides as an example of information that a requested treaty country could decline to obtain any information that would violate safeguards against self-incrimination.<sup>113</sup> The OECD further explains the abrogation of the general principle and clarifies that the provision may limit the use of certain claims of professional privilege, but only to the extent that the domestic law in question was so broad as to base its protection solely on the status of the person holding the information.<sup>114</sup> Under the OECD approach, a treaty country may refuse to supply information held by a bank, financial institution, agent, fiduciary or nominee as long as the ground for refusal is not the mere fact of the custodian's status as a bank, financial institution, agent, fiduciary or nominee. The OECD provides an example of a legal representative acting for a client in an agency capacity. To the extent that confidential communications between the legal representative and his client are protected under local law, the general rule against requiring a treaty country to violate its own law continues to apply and the treaty country may decline the request to exchange information.

At least one recently concluded treaty, the Income Tax Treaty between the United States and Finland,<sup>115</sup> departs from the U.S. Model treaty and expressly provides that the override of domestic law is not intended to include the ability to obtain information that would reveal confidential communications between a client and an attorney, in cases in which the client seeks legal advice. The Committee may wish to inquire as to the intended scope of the provision of the proposed treaty and of the U.S. Model treaty, and the extent to which the provision may override any privilege or confidentiality law that may be available under a treaty country's domestic law, and the circumstances in which this provision is likely to be involved. The Committee may wish to specifically inquire about its effect on the attorney-client privilege in the United States.

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<sup>113</sup> OECD, "Commentary to the OECD Model Treaty Article 26," par. 15.2.

<sup>114</sup> OECD, "Commentary to the OECD Model Treaty Article 26," pars. 19.12, 19.14.

<sup>115</sup> Senate Treaty Doc. 109-18.